

The Economics of Happiness

BY ERIC NIELSEN

Most people have probably heard of the term *Homo sapiens*, but fewer are familiar with his more rational relative, *Homo economicus*, who is not emotional or impulsive. He learns quickly, plans ahead, and doesn't make repeated mistakes. He is useful for economists to study because his intelligent, predictable behavior is comparatively easy to model mathematically.

Not surprisingly, there are very few real-life examples of *Homo economicus*. People can be emotional and impulsive. The world is very complex, and our capacities are too limited for us never to be in error.

Behavioral economics is the rapidly growing branch of economics that seeks to incorporate such human imperfections into economic thinking. Instead of assuming perfect rationality, people are modeled as having "bounded" or imperfect rationality; their decisionmaking process can be subject to error or systematic bias. To characterize these less-than-perfect beings, behavioral economists rely on eclectic interdisciplinary tools such as surveys, experiments, and cognitive science. These methods have been applied to a wide range of economic questions, from the pricing of stocks to the hours cab drivers choose to work.

Perhaps the most fundamental behavioral challenge thus far has come from economists studying happiness. These researchers question one of the axioms of mainstream theory: that greater wealth and consumption bring greater happiness and well-being. For example, in a recent article titled "How Not to Buy Happiness," Cornell University economist Robert H. Frank advances the argument that most consumption goods — houses, cars, and clothes — do not permanently increase happiness.

Frank's conclusions come from some surprising survey results. Based on self-reporting surveys in which respondents are asked to rank their happiness, it appears that there is a paradox at the heart of economics. At any one time, rich people will report substantially higher levels of happiness than poor people. However, as all people become richer in tandem, the reported happiness for the two groups does not change. For example, between 1960 and 1980 Japan experienced a tremendous economic boom, yet people reported the same levels of happiness after the boom as before. Could it be that *relative* wealth is important, and not *absolute* wealth as economists assume?

Frank thinks so — at least for some kinds of wealth. Goods that he dubs "conspicuous" do not permanently add to happiness, he argues. A new car might be nice and exciting for a time, but after awhile we start to take it for granted. On the other hand, "inconspicuous goods," such as vacation time, social interaction, and short commutes, might permanently change happiness. For example, people with shorter commutes have lower stress levels, lower blood pressure, and even lower risk of developing lung cancer.

If houses and cars do not really make us happier, then why are most of us willing to spend so much money on them? Frank argues that since happiness is essentially a question of relative consumption, one person's spending imposes negative externalities on others. These externalities will cause everyone to try to consume more than everyone else, instigating a consumption arms-race. If this is correct, the implications for policymakers could be enormous. By overturning one of the cornerstones of economic theory, a wide array of policy actions, such as a progressive consumption tax to discourage spending on consumer goods, may become desirable.

There is a strong case against these conclusions, however. Neoclassical economics uses the concept of *revealed preference* to determine what people want. People reveal their actual preferences by the actions they choose. They vote for their preferences with their consumption dollars.

Revealed preference could be a more reliable indicator of happiness than survey results. When responding to a survey, people might measure their happiness relative to some local norm, which may sound reasonable but would not capture absolute changes in happiness. For example, 150 years ago nobody had electric lighting in their homes. So a person from that era would probably not be unhappy about their lack of electricity. However, given a choice, people overwhelmingly want electricity, and it is difficult to argue electric power has not made us better off in real terms.

So what lies in store for economics as a discipline? Many of the results of behavioral economics are interesting, to be sure. Yet it is unclear how the work being done by Frank and his colleagues can provide a comprehensive, alternative way of looking at the world. This is the challenge now facing behavioral economics.

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"How Not To Buy Happiness"

by Robert H. Frank.

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