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Income and Happiness: An Imperfect Link

By ROBERT H. FRANK

DOES money buy happiness? This week, Senator Byron Dorgan, Democrat of North Dakota, will join a long line of people who have taken serious stabs at trying to answer that thorny question. He will hold a hearing exploring whether traditional economic measures like per-capita income accurately capture people's sense of well-being.

This has long been a contested issue. Although everyone concedes that income is an imperfect welfare measure, conservative economists have tended to emphasize its virtues while liberals have been more likely to stress its shortcomings.

The debate is not just of philosophical interest; it also has important policy implications. Recent research findings offer support for specific arguments on both sides. Mounting evidence suggests, however, that per-capita income is a less reliable measure of well-being when income inequality has been rising rapidly, as it has in recent decades.

First, a few words about how economists measure income: The most commonly used metric is gross domestic product, the annual market value of all final goods and services produced within a country. Per-capita G.D.P. is simply G.D.P. divided by total population. Measured in 2000 dollars, it was $32,833 in 1998 and $37,832 in 2006. The real value of goods and services bought by Americans in 2006 was thus about 15 percent higher than it was in 1998. In purely economic terms, does that mean we were roughly 15 percent better off in 2006?

Not necessarily. To measure changes in the standard of living over time, it is necessary to adjust for inflation. But as conservatives stress, traditional inflation adjustments may overstate actual inflation because they fail to account adequately for quality improvements.

For example, although the current Honda Civic, a compact car, is about the same size as the company's midsize Accord from 1998, it is in almost every respect far superior and sells for only slightly more than the earlier Accord. Because inflation adjustments for auto prices are based on changes for corresponding models, the result is to overstate increases in ownership costs — thereby causing per-capita G.D.P. to understate the corresponding increases in our standard of living.

Quality changes are not always positive, by the way. If you had a question about your health insurance in 1998, you could talk to a real person; today, you may find yourself in an endless phone loop. On balance, however, most consumers would probably prefer today's overall menu of goods and services in the economy to that of a decade ago.

Inflation adjustments may introduce further bias if people rearrange their spending patterns when prices rise unevenly. When beef prices rise twice as fast as chicken prices, people typically eat less beef and more chicken. Traditional inflation measures fail to take such adjustments fully into account — again, causing per-capita G.D.P. growth to understate increases in the standard of living.

Liberals, for their part, have long objected that many expenditures included in G.D.P. reflect reductions, not increases, in our standard of living. When crime rates increase, people spend more on burglar alarms, purchases that clearly do not signal improved living standards. A similar objection applies when tasks once performed at home are now more often bought in the marketplace — as when time-pressed parents substitute meals at fast-food restaurants for home-cooked meals.

The bias that results from the inclusion of such expenditures in G.D.P. works in the opposite direction from the bias caused by inaccurate inflation adjustment. For all anyone knows, the two distortions may roughly offset each other.

But there is a much bigger problem, one that challenges the very foundation of the presumed link between per-capita G.D.P. and economic welfare. That’s the assumption, traditional in economic models, that absolute income levels are the primary determinant of individual well-being.

This assumption is contradicted by consistent survey findings that when everyone’s income grows at about the same rate, average levels of happiness remain the same. Yet at any given moment, the pattern is that wealthy people are happier, on average, than poor people. Together, these findings suggest that relative income is a much better predictor of well-being than absolute income.

In the three decades after World War II, the relationship between well-being and income distribution was not a big issue, because incomes were growing at about the same rate for all income groups. Since the mid-1970s, however, income growth has been confined almost entirely to top earners. Changes in per-capita G.D.P., which track only changes in average income, are completely silent about the effects of this shift.

When measuring the economic welfare of the typical family, the natural focus is on median, or 50th percentile, family earnings. Per-capita G.D.P. has grown by more than 85 percent since 1973, while median family earnings have grown by less than one-fifth that amount. Changing patterns of income growth have thus caused per-capita G.D.P. growth to vastly overstate the increase in the typical family's standard of living during the past three decades.

Some economists have advanced an even stronger claim — that there is no link, at least in developed countries, between absolute spending and well-being. Recent work suggests that this is especially true for spending categories in which the link between well-being and relative consumption is strongest. For instance, when the rich spend more on larger mansions or more elaborate coming-of-age parties for their children, the apparent effect is merely to redefine what counts as adequate.

Evidence also suggests that higher spending at the top instigates expenditure cascades that pressure middle-income families to spend in mutually offsetting ways. Thus, when all spend more on interview suits, the same jobs go to the same applicants as before.

Yet in many other categories, greater levels of absolute income clearly promote well-being, even in the richest societies. The economist Benjamin Friedman has found that higher rates of G.D.P. growth are associated with increased levels of social tolerance and public support for the economically disadvantaged. Richer countries also typically have cleaner environments and healthier populations than their poorer counterparts.

THAT per-capita G.D.P. is an imperfect index of economic welfare is not news. The lesson of recent work is that its weaknesses are more serious than we previously realized.

And it is an especially uninformative metric when income inequality has been rising sharply, as it has been in recent decades. A society that aspires to improve needs a better measure of what counts as progress.

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