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# **“Happiness Economics: Policy Implications from a New Science”**

by

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As OXONIA’s Distinguished Speaker in Michaelmas 2005, Professor Lord Richard Layard delivered a seminar entitled “Happiness Economics: Policy Conclusions from a New Science.”

Starting point for Layard was his observation that 19th century psychology did have a conception of cardinal utility. This was swept away by the behaviourist revolution including the view that one cannot say what makes people happy. Economists usually seem to follow psychologist with some lag, so this lead to an abstract concept of utility maximisation without further specification of what it is that makes people happy.

Layard argued, however, that recent research in psychology establishes that happiness can be measured as cardinal, making comparisons in terms of happiness across persons and time possible. This enables us to start thinking about whether policy makes us just richer, or really happier.

How can we measure happiness then? Possibilities are self-reporting, or the observation of people, or the matching of both. The real breakthrough, however, has come from neuroscience. Areas in the brain have been identified which are particularly active when people self-report happiness, or receive certain positive stimuli.

Initial observations with regard to the strenuous link between income and happiness are that--for 1st-world countries beyond a certain threshold--increases in real income do not coincide with further increases in happiness. Still, 1st-world countries are happier than 3rd-world countries. Also within 1st-world countries, rich individuals tend to be happier than poor persons. Further, Layard put forward

4 stylised facts about happiness from which he went on to deduce direct policy implications:

- 1) Social Comparisons: Happiness depends on relative income as well as absolute income;
- 2) Adaption: happiness today depends on previous income (negatively) as well as current income (positively);
- 3) Taste changes: Happiness with a given income depends on our wants (negatively);
- 4) There is a declining value of extra income, as income rises.

First, the consequences of social comparisons are that people end up working more than they desire, i.e. that aggregate hours worked are raised to a socially inefficient level. Striving to work harder than others due to social comparison, individuals generate a negative externality on others as these in turn have to work harder in order to pull ahead in social comparisons. Hence, people work harder than makes them happy.

From this Layard draws out policy implications. To reduce work to a level bringing individuals greater overall happiness, the relative price of work needs to be raised to discourage work at the margin. Taxes are the obvious way to achieve this.

The conventional wisdom is that higher taxes are more distortionary and necessary evils as such. Layard emphasises, however, that a key implication of his argument is that thinking in terms of happiness can make higher taxes more efficient as they rectify negative happiness externalities.

Secondly, turning to adaptation, Layard does not believe in complete adaptation, but only partial adaptation. Income can be interpreted as an addictive good. Once we have a certain level of it, we need an increase to trigger happiness. There is extensive empirical evidence that income changes hence are a better predictor than income levels of happiness. Also people routinely overproject the happiness they will derive from greater income. As a result, this is a second mechanism inciting people to work harder than as such would make them happy.

An important corollary of the importance of changes rather than levels is the fact that research not least by Kahneman and others have shown that people are loss averse. Income losses damage happiness disproportionately. This throws new light onto Robert Lucas's Presidential Address assertion that from a welfare point of view only long-run growth is important while short-run stabilisation is too negligible to be pursued. However, considering how much people are made unhappy by losses, instability of relationships and disorder, short-run stabilisation gains support from a new viewpoint, the science of happiness economics. In this vein it seems that politicians often know much better than economists what people value.

Thirdly, happiness depends on tastes at any given level of income. What makes us happy depends on what we think we need. Casual evidence in this

respect suggests that people watching more television for a given level of income are unhappier as facing more advertisements creates more wants. Policy implications are clear, e.g. as in the case of banning advertisement for children aged under 12.

Similar reasoning, however, could change radically how we think about designing institutions. For instance, Layard considers situations where total status within a group cannot be changed, e.g. where people need to be ranked from 1 to 10. Performance pay attaches rewards to higher ranks. This incites people to increase their status, and in turn very much the effort to achieve this. Again this increases effort above levels which are socially efficient in terms of happiness. Layard admits that free-riding by others also makes people unhappy on fairness grounds. However, triggering excessive competition in zero-sum situations is to be strictly avoided.

Such competition is motivated by principal-agent theory which focuses on purely monetary rewards by the principal to incite an agent to perform a certain task without perfect supervision. Layard suggests that this has led to an excessive focus on monetary returns and competition in the workplace at the cost of trust and cooperation as the basis for interaction. He also insists that cooperation is more than a way to overcome the Prisoner's Dilemma. Rather, working in cooperative rather than competitive environments generally makes people happier. This also extends to classrooms where more and more competition among students has been encouraged rather than teaching them to cooperate.

While competition among institutions is a must from the economist's perspective as these are units where efficiency rather than happiness as such are the relevant measures, the direct analogy for the individual which is so often drawn by economists without further ado is a fallacy. Over-encouraging competition among individuals may well lead them to lose happiness.

Fourthly, the diminishing marginal utility of income. As this is well established Layard focused on what is fundamental to happiness, i.e. the cardinality of happiness. In addition to the research cited on measurability at the outset, he referred to psychological research which showed that in happiness terms people judge a deviation from, say, 9.1 to 9.3 similarly to one from 3.1 to 3.3. Hence the happiness scale seems to be uniform, which is exactly what we might want it to be for a cardinal measure of feeling.

Recent research has in fact already ventured into finding functional forms for happiness which is essential for making happiness operational for theoretical and further empirical work. Economists would like a happiness function to be of the familiar "constant-relative-risk-aversion" form, and in fact the best specification so far has proven to be  $\text{happiness} = \alpha \log(\text{income})$ . Hence, marginal happiness with regard to income changes equals  $\alpha/\text{income}$ . Thus, happiness itself runs into large diminishing marginal returns with regard to income. For someone having ten times my income, the gain in happiness from an additional unit of income is just one-tenth. From a happiness perspective then

there is a compelling case for redistribution both within as well as across countries.

Thinking ahead, Layard both recommends as well as expects that in the decades to come cost-benefit analysis will shift from being undertaken in terms of money to in terms of utilities, i.e. happiness units. This will require a shift in thinking on behalf of theorists and policymakers alike. Layard concluded with an appeal especially to young researchers to embark on this route.

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