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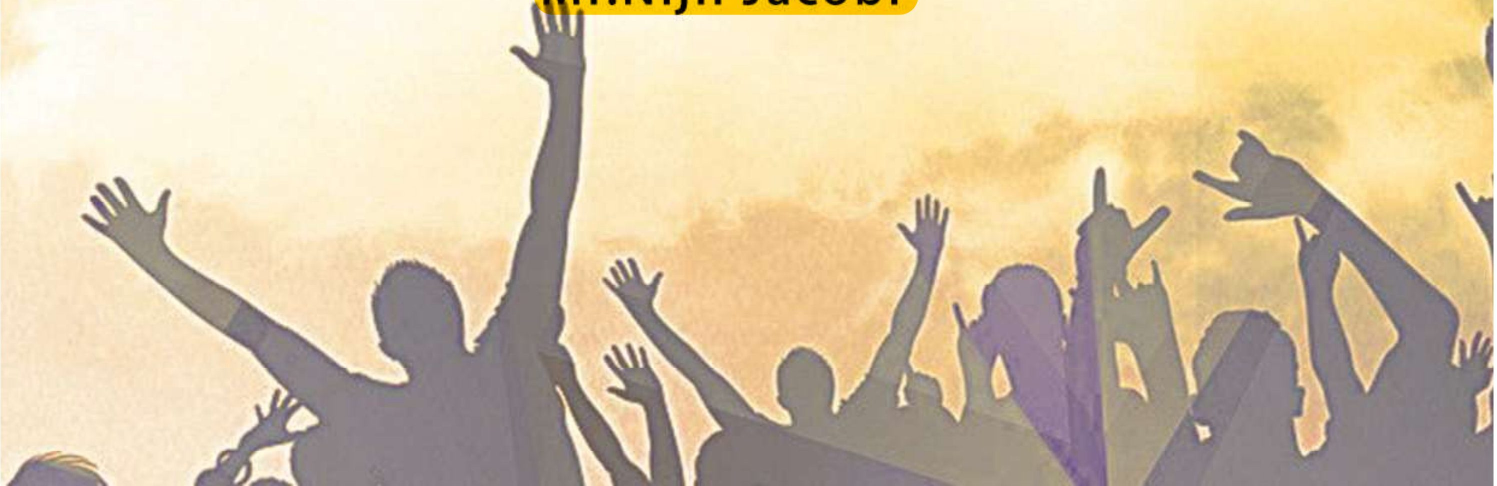
Ms. Daisy P.K

Mr.Nijil Jacobi



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Dr. Chacko Jose P

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Editors

Dr. Chacko Jose P

Associate Professor & Head

Department of Economics

Sacred Heart College, Chalakudy, Kerala

chacko@sacredheartcollege.ac.in

Dr. Shirley Jose K

Associate Professor

Department of Economics

Sacred Heart College, Chalakudy, Kerala

shirley@sacredheartcollege.ac.in

Ms. Daisy P.K

Assistant Professor & Head

Department of Economics

St. Joseph's College (Autonomous), Irinjalakuda, Kerala

daisypk@stjosephs.edu.in

Mr. Nijil Jacobi

Assistant Professor (on contract)

Department of Economics

Sacred Heart College, Chalakudy, Kerala

nijiljacobi@sacredheartcollege.ac.in

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Head of the Department of Economics

St. Joseph's College (Autonomous), Irinjalakuda, Kerala

economics@stjosephs.edu.in

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ECONOMICS OF HAPPINESS – THE LIFE SATISFACTION APPROACH TO INDIVIDUALS' PREFERENCES AND INDIVIDUALS' WELFARE

Mr. Nijil Jacobi
Assistant Professor (on contract)
Department of Economics
Sacred Heart College, Chalakudy, Kerala

Abstract

The economics of happiness is an approach to assessing welfare which combines the techniques typically used by economists with those more commonly used by psychologists. It relies on surveys of the reported wellbeing of hundreds of thousands of individuals across countries and continents. It also relies on more expansive notions of utility than the conventional economics, highlighting the role of non-income factors that affect well-being. It is well suited to informing questions in areas where revealed preferences provide limited information, such as the welfare effects of inequality and of macroeconomic policies such as inflation and unemployment. One such question is the gap between economists' assessments of the aggregate benefits of the globalization process and the more pessimistic assessments that are typical of the general public. Standard analyses based on aggregate, income-based measures provide important benchmarks for assessing the impact of globalization on poverty and inequality. This paper highlights the novel approach — the economics of happiness — using the World Happiness Reports.

Keywords: *Economics, Happiness, Life, Satisfaction, Welfare*

Introduction

What makes people happy in life? This is a crucial question that has the potential to shake up economics. In recent years, the dissatisfaction with the understanding of welfare in economics together with the new opportunities to empirically study people's subjective wellbeing have spurred impressive and stimulating new research in the often called dismal science. The economics of happiness has emerged as one of the most thriving areas in current economic research. Happiness research in economics takes reported subjective well-being as a proxy measure for individual welfare. "Subjective well-being" is used in psychology for an individual's evaluation of the extent to which he or she experiences positive and negative affect, happiness or satisfaction with life. The economic study of individual happiness is based on recognizing that everyone has his or her own ideas about happiness and the good life, and that revealed behavior is an incomplete indicator of individual well-being. Individuals' welfare can nevertheless be captured and analyzed: individuals can be asked how satisfied they are with their lives. They are assumed to be good judges of the overall quality of their lives. Welfare and well-being have traditionally been gauged by using income and employment statistics, life expectancy, and other objective measures. The Economics of Happiness, which is based on people's reports of how their lives are going, provides a complementary yet radically different approach to studying human well-being. Typically, subjective well-being measures include positive and negative feelings (e.g., momentary experiences of happiness or stress), life evaluations (e.g., life satisfaction), and feelings of having a life purpose. Both businesses and policymakers now increasingly make decisions and craft policies based on such measures. This paper provides an overview of the Happiness Economics approach and outlines the promises and pitfalls of subjective well-being measures.

Discussion

Economics of Happiness

The economics of happiness — the approach while psychologists have been using surveys of reported well-being to study happiness for years, economists only recently ventured into this arena. Early economists and philosophers, ranging from Aristotle to Bentham, Mill, and Smith, incorporated the pursuit of happiness in their work. Yet as economics grew more rigorous and quantitative, more parsimonious definitions of welfare took hold. Utility was taken to depend only on income as mediated by individual choices or preferences within a rational individual's monetary budget constraint. Even within a more orthodox framework, focusing purely on income can miss key elements of welfare—as numerous economists have noted over time. People have different preferences for material and non-material goods. They may choose a lower paying but more personally rewarding job, for example. They are nonetheless acting to maximize utility in a classically Walrasian sense. The study of happiness or subjective well-being is part of a more general move in economics that challenges these narrow assumptions. The introduction of bounded rationality and the establishment of behavioral economics, for example, have opened new lines of research.

Happiness economics — which represents one new direction — relies on more expansive notions of utility and welfare, including interdependent utility functions, procedural utility, and the interaction between rational and non-rational influences in determining economic behavior. Richard Easterlin was the first modern economist to re-visit the concept of happiness, beginning in the early 1970s. More generalized interest took hold in the late 1990s the economics of happiness does not purport to replace income-based measures of welfare, but instead to complement them with broader measures of well-being. These measures are based on the results of large-scale surveys, across countries and over time, of hundreds of thousands of individuals who are asked to assess their own welfare.

A remarkable new development Economics has substantially changed over the last few years. There is a noteworthy development underway. The Economics of Happiness provides an innovative theoretical and empirical analysis of individual well-being. Based on these insights economics is likely to change considerably in the future. Standard economics is being transformed in three respects:

1. Happiness and life satisfaction are measurable, which allows us to proxy the concepts of utility or individual welfare in a satisfactory way. What was considered a revolution in the 1930s, when Sir John Hicks, Lord Lionel Robbins and others claimed that utility cannot and need not be measured, has been reversed. Measuring happiness has allowed us to extend economic theory into various new areas. For instance, it is now possible to identify biases in decision-making. Standard economic theory based on the concept of “revealed preference” equates the utility expected when deciding between consumption bundles with the utility actually experienced when consuming them. Happiness research shows that individuals make biased decisions when choosing between alternatives. As a consequence of these biases in judgment, they find themselves less satisfied with life than they could be according to their own evaluation (Kahneman and Thaler 2006; Stutzer and Frey 2007).
2. The economic analysis of subjective well-being teaches us how human beings value goods and services, as well as how they value social conditions. The effects of income, unemployment and other economic, social and genetic factors on well-being are empirically identified. The new insights include non-material values such as the value of autonomy and social relations with friends and family. Economic activity is seen as contributing to human happiness. This does not exclude that other goals such as loyalty, responsibility, self-esteem, freedom or personal development also matter.
3. Economic happiness research is relevant at two levels of policy, at the constitutional level where the rules of the game are determined and at the post-constitutional level where political decisions are taken within these rules. Happiness research shows that democracy and federalism are fundamental institutions that raise people’s life

satisfaction. In the current politico-economic process, the life satisfaction approach makes it possible to capture individuals' preferences and individuals' welfare for public goods in a novel way. Aggregate happiness indicators may also become a relevant input in the post-constitutional political discourse.

Happiness research in economics takes reported subjective well-being as a proxy measure for individual welfare. "Subjective well-being" is used in psychology for an individual's evaluation of the extent to which he or she experiences positive and negative affect, happiness or satisfaction with life. The economic study of individual happiness is based on recognizing that everyone has his or her own ideas about happiness and the good life, and that revealed behavior is an incomplete indicator of individual well-being.

The relationship between unemployment and unhappiness

The new classical macroeconomics argues that unemployment is voluntary: those not working just refuse to do so at the prevailing wage rate. An important reason why the reservation wage is higher than the prevailing wage is that unemployment benefits are too high. People prefer not to work and to cash in these benefits. Happiness research in economics offers a new approach to contribute productively to this debate about the individual and social costs of unemployment. Unemployment first of all reduces the individual well-being of those personally affected. In their innovative work for Britain, Clark and Oswald (1994, p. 655) summarize their results as follows: "Joblessness depresses well-being more than any other single characteristic including important negative ones such as divorce and separation." For Germany, based on individual panel data, Winkelmann and Winkelmann (1998) find a negative effect of personal unemployment on life satisfaction that would require a sevenfold increase in income to compensate. Importantly, in these two analyses, indirect effects (like income losses) that may, but need not, accompany personal unemployment are kept constant. Being unemployed therefore has psychic costs over and above the potential decrease in the material living standard. High unemployment rates also have non-negligible effects on people who are not personally affected by unemployment. Based on survey data from population samples from European Union member countries between 1975 and 1992, Di Tella et al. (2003) show that aggregate unemployment decreases average reported life satisfaction. The potential reasons include direct effects of unemployment on crime and public finances, but also workplace specific aspects like changes in working hours and salaries. Moreover, high unemployment also affects anticipated economic distress, as, for instance, the probability that a worker may himself experience a spell of unemployment in the future increases. A large literature documents the importance of self-reported job security on individuals' well-being (see, e.g., Green 2006). In an empirical study, Luechinger et al. (2010) isolate the latter source of reduced individual welfare: the negative anticipatory feelings of angst and stress due to economic insecurity. In order to distinguish between general negative externalities of unemployment and changes in economic risks to individuals, workers are studied in two sectors of the economy that differ fundamentally in their exposure to economic shocks – people working in the private sector and those working in the public sector. Public sector employees usually enjoy extended protection from dismissal and work in organizations that rarely go bankrupt. Thus, for institutional reasons these workers face a reduced risk of losing their jobs in comparison with workers in the private sector. In their study for Germany, they find that people working in the private sector are affected more strongly by general economic shocks than are those working in the public sector suggesting that a substantial fraction of the psychic costs brought about by general unemployment is due to increased economic insecurity. The discussion reveals that research on happiness has identified two major aspects that are largely neglected in standard economics. Unemployment is not simply an underutilization of resources and not simply a decision between choosing to stay employed (at a low wage), and becoming unemployed (with unemployment benefits). Individuals experience a loss in psychic well-being when being unemployed beyond the reduction in income involved. The utility losses experienced go beyond those who are actually unemployed. Individuals with a job are also negatively affected by a higher unemployment rate, an important reason being that they experience a rise in economic insecurity.

The Life Satisfaction Approach

One of the major contributions of happiness research directly relevant for public policy refers to the new instruments that enable individuals' preferences and individuals' welfare to be captured. As a consequence, insights of happiness research increase political competition in the current politico-economic process. There is a demand for happiness research by politicians, public officials and representatives of special interest groups as they hope to strengthen their position in the competition for votes or in bargaining for government policies. A case in point is information about the value of public goods and public bads for cost-benefit analyses. Within happiness research, a promising complementary method is emerging that avoids some of the major difficulties inherent in previous approaches. It is called the Life Satisfaction Approach. With reported subjective well-being as a proxy measure for individual welfare, public goods can be directly evaluated in utility terms. The marginal utility of public goods or the disutility of public bads is estimated by correlating the amount of public goods or public bads with individuals' reported subjective well-being. By measuring the marginal utility of a public good or the marginal disutility of a public bad, as well as the marginal utility of income, the tradeoff ratio between income and the public good can be calculated. The LSA has, for example, been used to value air pollution (Luechinger 2009; Welsch 2006), airport noise nuisance (van Praag and Baarsma 2005) and terrorism (Frey et al. 2009). Recent studies applying the LSA have already reached a high standard, and the preconditions for its application are better understood and formulated. What has so far been an academically driven development of a new method may soon become an empirical tool that is in demand in the political process.

Conclusion

The economics of happiness as an area in economics developed so far as a strongly empirical endeavor. It is spurred by the direct measurement of individuals' well-being. Thereby, economists built on instruments tested in psychology and included in many surveys by pollsters. While the various self-reported measures are the basis for the area's academic success, they are also still subject to many controversial discussions about the merits of the new approach in economics. Not all criticism is equally productive. Fundamental rejections of the new research tend to neglect a comparative perspective with past research and disregard the potential of happiness research to provide complementary insights. However, the skepticism has also motivated many productive analyses on the validity of the empirical measures has led to the development of new statistical tools to analyze survey data, has given rise to new measures of subjective well-being, and has invigorated the debate about welfare in economics.

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