THE BROOKINGS INSTITUTION

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THE UNIVERSITY OF WARWICK

ENGLAND, UK

Conference on

Why Inequality Matters:

Lessons for Policy from the Economics of Happiness

5th – 6th June 2003

at

The Brookings Institution

Washington DC

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THE UNIVERSITY OF WARWICK

Conference On

Why Inequality Matters:

Lessons for Policy from the Economics of Happiness

Contents:

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Brookings Warwick Conference 5th - 6th June 2003

Why Inequality Matters:

Lessons for Policy from the Economics of Happiness

Conference Agenda

Thursday 5th June

Time	Session	Presenter
9.30 - 9.45	Introduction	***Robert H. Frank*** (Cornell University) ***Carol Graham*** (The Brookings Institution) and ***Andrew Oswald*** (University of Warwick)
9.45 -10.45	"Individual Vulnerability and Social Structure: Social Capital, Health and Inequality"	***Richard Wilkinson*** (University of Nottingham Medical School)
10.45 -11.45	"Income, Happiness and Inequality as Measures of Welfare"	***Rafael Di Tella*** (Harvard Business School) and ***Robert MacCulloch*** (Princeton University)
11.45 -12.00	*Break*	
12.00 - 1.00	"American Inequality and its Consequences"	***Gary Burtless*** (The Brookings Institution) and ***Christopher Jencks*** (Harvard University)
1.00 - 2.00	*Lunch*	
2.00 - 3.00	"Do Cigarette Taxes make Smokers Happier?"	***Jonathan Gruber*** (Massachusetts Institute of Technology) and ***Sendhil Mullainathan*** (Massachusetts Institute of Technology)
3.00 - 3.15	*Break*	
3.15 - 4.15	"The Psychology of Why Inequality Might Matter, or Not"	***Ed Diener*** (University of Illinois)
4.15 - 4.30	*Break*	
4.30 - 5.15	"Are Positional Externalities Different from Other Externalities?"	***Robert H. Frank*** (Cornell University)
6.30	Conference Dinner	

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Why Inequality Matters:

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Friday 6th June

Time	Session	Presenter
9.15 -10.00	"Does Happiness Pay?" An Exploration Based on Panel Data from Russia	***Carol Graham*** (The Brookings Institution) ***Andrew Eggers*** (The Brookings Institution) and ***Sandip Sukhtankar*** (The Brookings Institution)
10.00 -11.00	"The Social Gradient in Health and Well-Being"	***Michael Marmot*** (University College, London)
11.00 -11.15	*Break*	
11.15 -12:15	"Lives or Life-Years?"	***Cass R. Sunstein*** (University of Chicago)
12.15 - 1.15	*Lunch*	
1.15 - 2.00	"Rank Dependence in Pay Satisfaction"	***Andrew Oswald*** (University of Warwick) ***Gordon Brown*** (University of Warwick) ***Jonathan Gardner*** (Watson Wyatt Ltd UK) and ***Jing Qian*** (University of Warwick)
2.00 - 3:00	"Interaction Goods: Behavior When Future Utility is Mispredicted	***Bruno S. Frey*** (University of Zurich) and Alois Stutzer (University of Zurich)
3.00 - 3.15	*Break*	
3.15 - 4.15	"Measuring the Quality of Experience"	***Daniel Kahneman*** (Princeton University) ***Alan Krueger*** (Princeton University) ***David Schkade*** (University of Texas) ***Norbert Schwarz*** (University of Michigan) ***Arthur Stone*** (Stony Brook University)
4.15 - 5.15	Closing Panel	***Henry J. Aaron*** (The Brookings Institution) ***Roland J.M. Benabou*** (Princeton University) ***Angus Deaton*** (Princeton University) ***Christopher Jencks*** (Harvard University)

"Individual Vulnerability and Social Structure: Social Capital, Health and Inequality"

Richard Wilkinson
University of Nottingham Medical School

Abstract

This paper offers an approach (derived more from monkeys than Marx) to understanding the power of inequality. In so doing it explains why more unequal societies, or the more unequal of the 50 US states, have lower social capital, higher rates of violence, and worse health.

Individual psychosocial risk factors for poor health show that we are highly sensitive to the social environment and quality of social relationships. Why are we particularly sensitive to low social status, weak social affiliations and stress in early life? What do they tell us about ourselves and about human sociality? And how do they interact with the wider social structure in modern societies?

I will show that people in more hierarchical and unequal societies are less likely to trust each other, are more violent, and are less likely to be involved in community life. The data suggest that social relations are better where income differences are smaller. If this is right, health in societies with more inequality may suffer not only from a bigger burden of low social status and relative deprivation, but also from the impact of a poorer quality of social relations. Despite recent criticisms, the evidence continues to suggest that greater income inequality is harmful to population health.

Why do inequality and the quality of social relations move inversely in society, and why, at the individual level, are social status and friendship such powerful risk factors for health? The key is to understand the evolutionary power of the Hobbesian problem of the potential for conflict (the "warre" of each against all) over access to scarce resources between members of the same species. Whether this problem is resolved in terms of dominance relations ("pecking orders") which determine access to scarce resources on the basis of power, or whether it is resolved on the more cooperative and egalitarian basis of friendship, food sharing and reciprocity, the nature of social relations has always been crucial to human welfare. Our minds have been honed to be sensitive and attentive to these dimensions of our social environment.

“Income, Happiness and Inequality as Measures of Welfare”

Rafael Di Tella
Harvard Business School

and

Robert MacCulloch
Princeton University

Abstract

It has been argued that happiness has been flat in the presence of growing GDP, mainly because people care about relative income. An alternative explanation is that GDP is an incomplete indicator of welfare (as argued, for example, by the United Nations). We find that the happiness responses of almost 400,000 people living in the OECD during 1975-97 are correlated with the usual arguments of a standard utility function. Happiness is positively correlated with an individual’s income, even after controlling for country and year dummies. It is also positively correlated with life expectancy. Happiness is negatively correlated with the average number of hours worked, measures of environmental degradation, divorce rates and crime. The estimated effects separate across groups as suggested by the theory. For example, the rich suffer environmental degradation more than the poor. The approach allows us to put an approximate dollar value to social changes that have been hard to quantify in prior work. Based on their change and impact on happiness, the biggest contributors to happiness in our sample have been the increase in income and the increase in life expectancy. Interestingly, if income is not a good predictor of welfare, then other moments of the distribution of income, such as income inequality, may be less informative than previously assumed. A simple and rough measure of happiness inequality for the US is flat during a period of rising income inequality. Our results suggest that it may be worth revising the use of income inequality as a measure of the distribution of welfare in society.

“American Inequality and Its Consequences”

Gary Burtless
The Brookings Institution

and

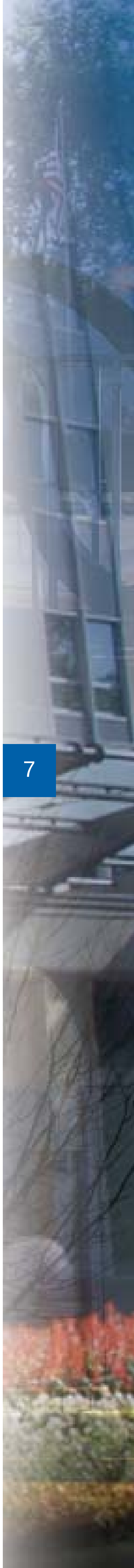
Christopher Jencks
Kennedy School of Government, Harvard University

Abstract

This paper describes how the distribution of income has changed in the United States since the 1970s, why it has changed, and why it is more unequal than the distribution of other rich democracies. It then assesses evidence on whether changes in economic inequality affect four other things that Americans care about—economic growth, equality of opportunity for children, longevity, and the distribution of political influence.

We conclude that inequality probably does not have a consistent effect, either positive or negative, on economic growth in rich democracies. We show that college attendance became more related to parental income as economic inequality increased in the United States. Nonetheless, evidence does not show that a father’s economic status has more influence on his children’s economic prospects in the United States than in other rich countries where incomes are more equal. Increases in economic inequality probably slowed the rate of improvement in longevity, but the effect is uncertain and small, probably only a few months. We also consider the impact of economic inequality on the distribution of political power. We argue that increases in economic inequality tend to increase the political power of the rich, at least in the United States.

Overall, we conclude that the effects of inequality on economic growth, health, and equality of opportunity are modest and uncertain in rich countries. We worry most about the possibility that changes in the distribution of income have led to changes in the distribution of political power both because such a change undermines the legitimacy of the political system and because it can make the increase in economic inequality irreversible. But although we worry about these risks, we have no way of knowing how great they are. We conclude that citizens of the United States and other rich countries should decide how much economic inequality they are willing to tolerate largely on the basis of what they think is just, not on the basis of its alleged beneficial or adverse effects.



"Do Cigarette Taxes Make Smokers Happier?"

Jonathan Gruber
MIT and NBER

and

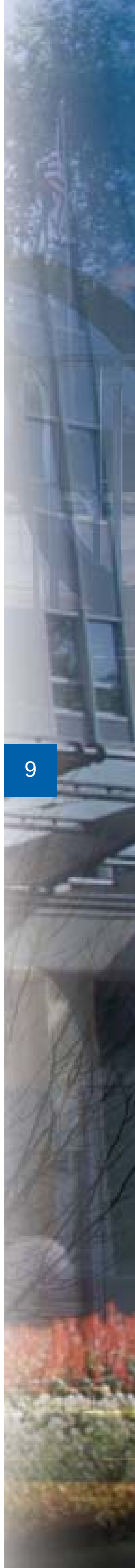
Sendhil Mullainathan
MIT and NBER

Abstract

Some policy makers justify cigarette taxes by arguing that they actually make smokers better off. This argument has been hard to evaluate because behavioral data, such as that showing reduced cigarette consumption following a tax hike, cannot resolve the issue of whether smokers are made better off by the reduction or not. In this paper, we directly assess the effect of cigarette taxes on well-being, using subjective well-being data. We model the differential impact of excise taxes on those with a propensity to smoke, relative to others, in order to control for omitted correlations between happiness and excise taxation. Using US data on happiness and state-level changes in excise taxes, we find consistent evidence that excise taxes make those who have a propensity to smoke happier. To assess robustness, we repeat the exercise using Canadian data, which has independent information on well-being and also much larger tax changes, and find the exact same pattern. Moreover, these impacts are present for cigarette excise taxes, but not for other excise taxes. These results suggest that the welfare effects of cigarette taxation are far more complex than simple rational economic models might predict.

“The Psychology of Why Inequality Might Matter, or Not”

Ed Diener
University of Illinois and the Gallup Organization



Abstract

In analyzing the impact of inequality on feelings of well-being, there are a number of psychological factors that must be considered beyond social position and contrast effects. First, there are many available standards of comparison; the standing of others is only one among many relevant criteria. Further, there are an endless number of attributes on which one can compare. Thus, psychological processes governing salience become primary. Second, the outcomes of inequality are likely to depend on the type of utility being considered and on the measures used. Assessments of ongoing feelings during activities are likely controlled by different processes than are the choices of activities and the recall of feelings during those activities. Inequality can have very different effects on ongoing experience and on satisfaction judgments. Third, personality differences can lead to inequalities, and the outcomes of personality can be misinterpreted as due to positional differences. However, social position can lead to increased approach behaviors and successful outcomes. In other words, we must be careful to consider causal pathways in which happiness and other personality characteristics lead to success, and in which status increases further goal striving. Finally, exposure to superior others is likely to have benefits as well as costs. Thus, psychological models of the effects of inequality on well-being must become much more intricate.

“Are Positional Externalities Different from Other Externalities?”

Robert H. Frank
Cornell University

Abstract

A “nice” suit is one that compares favorably with those worn by others in the same local environment. More generally, a positional good is one whose utility depends on how it compares with others in the same category. A positional externality occurs when new purchases alter the relevant context within which an existing positional good is evaluated. For example, if some job candidates begin wearing expensive custom-tailored suits, a side effect of their action is that other candidates become less likely to make favorable impressions on interviewers. From any individual job seeker’s point of view, the best response might be to match the higher expenditures of others, lest his chances of landing the job fall. But this outcome is inefficient, since when all spend more, each candidate’s probability of success remains unchanged. All may agree that some form of collective restraint on expenditure would be useful.

In such cases, however, it is often impractical to negotiate private solutions. Do positional externalities then become legitimate objects of public policy concern? In attempting to answer this question, I employ the classical libertarian criterion articulated by John Stuart Mill, who wrote the state may not legitimately constrain any citizen’s freedom of action except to prevent harm to others. On the basis of a variety of market evidence, I argue that many positional externalities appear to meet Mill’s test, causing not just negative feelings but also large and tangible economic costs to others who are ill-equipped to avoid them. I also discuss an unintrusive policy remedy for positional externalities, one modeled after the use of effluent charges to curb environmental pollution.

"Does Happiness Pay? An Exploration Based on Panel Data from Russia"

Carol Graham, Andrew Eggers, and Sandip Sukhtankar

Economic and Governance Studies Programs

The Brookings Institution

Abstract

This paper uses panel data from Russia to identify "residual" happiness levels that are not explained by the usual demographic and socioeconomic determinants of happiness. We then test whether our residual happiness variable has causal properties in addition to those of the observed demographic and socioeconomic variables on future income. We find that both residual happiness and positive expectations for the future in the initial period are positively correlated with higher income in future periods. People with negative perceptions of their own progress and with higher fear of unemployment increase their incomes less, on average. Psychologists attribute stability in happiness levels over time – analogous to the "residual" happiness levels that we identify - to positive cognitive bias, such as self-esteem, control, and optimism. The same factors may enhance individuals' performance in the labor market.

“The Social Gradient In Health And Well-Being”

Michael Marmot
University College, London

Abstract

I wish to argue that health is a robust measure of well-being in society. Inequalities in society play out in inequalities in health. We see this in the social gradient in health within countries and we see it in the inequalities in health among countries. For example, some observers of the East European scene predicted the collapse of communism. The basis of this was the appalling health record which observers attributed to the fragmentation of society under the Soviets. The further decline in life expectancy in Russia can be attributed to the social and economic disruptions affecting Russia after 1990.

Those interested in happiness may also be concerned with health because the two are linked. In the Whitehall II Study of British civil servants, using longitudinal data, we showed that poor health was a stronger predictor of life satisfaction than was life satisfaction a predictor of subsequent poor health.

The determinants of health may be similar to the determinants of other measures of well-being of the population. Data from Whitehall and other studies, including Eastern Europe, show that income *per se* is not a predictor of ill health. It would appear that other factors related to position in the social hierarchy are more important. Those that we have highlighted are degree of control, reciprocity as measured by effort-reward imbalance, and social participation. These vary by place in the hierarchy and are importantly related to health.

The link between psychosocial factors and ill health is plausible biologically. We show clear social gradients in plasma fibrinogen and metabolic syndrome and in functioning of hypothalamic-pituitary-adrenal axis and the autonomic nervous system. There are thus plausible pathways linking social and environmental conditions to pathophysiology and to health and well-being.

“Lives or Life-Years?”

Cass R. Sunstein
University of Chicago

Abstract

In protecting safety, health, and the environment, government has increasingly relied on cost-benefit analysis. In undertaking cost-benefit analysis, the government has monetized mortalities averted through the idea of “value of a statistical life” (VSL), currently assessed at about $6.1 million. Many analysts, however, have suggested that the government should rely instead on the “value of a statistical life year” (VSLY), in a way that would result in significantly lower benefits calculations for seniors (and higher benefits for children). Some economists have objected to VSLY on the basis of findings that people’s willingness to pay to reduce risks does not to fall with age: People who are fifty or sixty are not willing to pay less for risk reduction than people who are twenty or thirty. I argue that economists are wrong to invoke these findings against VSLY. A program that saves young people produces more welfare than one that saves old people. If the willingness to pay criterion does not reveal this fact, the problem lies in the willingness to pay criterion, not in VSLY. The real issue with VSLY is ethical, not economic; it involves ethical limits on the pursuit of social welfare. For example, it is possible that welfare would be promoted with higher monetary values for the lives and life-years of whites or males than those of African-Americans or women; but government should not discriminate in this way in regulatory policy. Hence the question is whether VSLY discriminates against older people in an ethically indefensible way. I conclude that it does not.

"Rank Dependence in Pay Satisfaction"

Gordon Brown, Andrew Oswald, Jing Qian
University of Warwick

and

Jonathan Gardner
Watson Wyatt Ltd UK

Abstract

What makes workers happy with their pay? In this paper we show that pure 'rank' matters. It is currently believed that satisfaction is determined partly by an individual's absolute wage (say, 30,000 dollars a year) and partly by the individual's relative wage (say, 30,000 dollars compared to an average in the company or neighborhood of 25,000 dollars). Our evidence suggests that this is inadequate. We show that models developed independently within psychology motivate a different "Economic Psychophysics" account, according to which utility and hence satisfaction is gained by the ranked position of a wage within a comparison set (say, whether the individual is number 4 or 14 in the wage hierarchy of the company). We report two experimental studies, and an analysis of a survey of over 16,000 employees' wage satisfaction ratings. They provide evidence for rank-dependence of wage satisfaction.

“Interaction Goods: Behavior When Future Utility is Mispredicted”

Bruno S. Frey and **Alois Stutzer**
University of Zurich

Abstract

Individual decision-making and behavior involve the prediction of utility that we are about to experience in the future. This is a difficult task. People make mistakes, but they learn from them and make no systematic errors, according to our strong belief in consumer rationality. However, research in psychology documents a large number of systematic mistakes. For example, people underestimate adaptation to changes in their living conditions. This kind of preference change has rarely been studied in economics. It has been found that people overestimate the future utility of higher income. However, no systematic effects on behavior and no negative effect on overall well-being are to be expected if people *equally* underestimate adaptation for *all* goods.

We propose that there are systematic differences as to how difficult it is for people to predict future utility across different kinds of goods. There are “*interaction goods*” that serve intrinsic needs and that people do not get used to. People tend to underestimate future utility from these goods. As interaction goods provide renewed experiences, the construction of their predicted utility from memory is only possible to a limited extent. Consequences for behavior result when people have to trade off these “interaction goods” against material goods that mainly serve extrinsic desires. People tend to spend too much of their resources and time on material goods and too little on “interaction goods”. Moreover, they end up at a lower level of utility or subjective well-being.

The proposition is tested for people’s commuting behavior which captures the trade-off between spending time with friends and family (short commute) and having a better paid job and or a larger house in the suburbs (long commute). It is predicted that people choose to spend too much time on commuting and that they are not fully compensated for the burden of commuting. These predictions are difficult to test with data on observed behavior. Compensating wage differentials, for example, give no indication of whether compensation is complete. We take reported subjective well-being as a proxy for people’s utility level. This allows us to test whether people only choose to commute longer distances when they are compensated. We find, however, that people who spend more time commuting are systematically less satisfied with their life, i.e. that they are not fully compensated for commuting between their home and place of work. Further analyses indicate that there are systematic differences across people. People who have more pronounced extrinsic life goals choose to spend more time on commuting and are compensated to a lower extent than people with less pronounced extrinsic life goals.

We submit that individual behavior and well-being is better understood when people’s predictions on future utility from different kinds of goods are incorporated. Due to systematic misprediction, people tend to underestimate future utility from “interaction goods” and spend too little time and resources on them relative to material goods that serve extrinsic desires.

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Independent research shaping the future

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In its conferences, publications, and other activities, Brookings serves as a bridge between scholarship and policymaking, bringing new knowledge to the attention of decision makers and affording scholars greater insight into public policy issues. The Institution's activities are carried out through three research programs (Economic Studies, Foreign Policy Studies, and Governance Studies), as well as through the Center for Public Policy Education and the Brookings Institution Press, which publishes about fifty books a year.

The Brookings Institution traces its beginnings to 1916, when a group of leading reformers founded the Institute for Government Research (IGR), the first private organization devoted to analyzing public policy issues at the national level. In 1922 and 1924, one of IGR's backers, Robert Somers Brookings (1850-1932), established two supporting sister organizations: the Institute of Economics and a graduate school bearing his name. In 1927, the three groups merged to form the Brookings Institution, honoring the businessman from St. Louis whose leadership shaped the earlier organizations.

Today, Brookings is financed largely by an endowment and through the support of philanthropic foundations, corporations, and private individuals. The Institution's funds are devoted to carrying out its own research and educational activities. Brookings also undertakes some unclassified government contract studies, reserving the right to publish its findings from them.

A Board of Trustees is responsible for the general supervision of Brookings, approval of its areas of investigation, and for safeguarding the independence of its work. The Institution's president is its chief administrative officer, responsible for formulating and setting policies, recommending projects, approving publications, and selecting staff.

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THE UNIVERSITY OF WARWICK

The University of Warwick is one of Britain’s leading universities. Although only 40 years old, it is now consistently ranked in the top half dozen universities in Britain. It is research led and is committed to providing undergraduate and postgraduate teaching of the highest quality. Sited on the southern side of Coventry where the city meets the County of Warwickshire, the University is the place of study for 17,904 undergraduate and postgraduate students and employs more than 3,800 staff across a range of University departments.

The establishment of the University of Warwick was given approval by the government in 1961 and received its Royal Charter of Incorporation in 1965. The University initially admitted a small intake of graduate students in 1964 and took its first 450 undergraduates in October 1965. 16% of the student body comes from overseas and over 114 countries are represented on the campus. From its beginnings, the University has sought to be excellent in both teaching and research. In the results of the 2001 government’s Research Assessment Exercises announced in December 2001, Warwick was placed fifth with over 90% of its staff working in departments rated 5 or 5*, the top two grades. The University has 29 academic departments and over 40 research centres and institutes, in four Faculties: Arts, Medicine, Science and Social Studies. The new Medical School, a collaborative venture with the University of Leicester took its first students on an innovative 4-year accelerated postgraduate programme in September 2000.

Warwick marked its strategy with a wish to be enterprising and outward-looking from its foundation. It sought to match academic excellence with relevance, a policy which was not always popular in the late 1960s and early 1970s but which has become one of its hallmarks and recently led Prime Minister Blair to say that “Warwick is a beacon among British Universities for its dynamism, quality and entrepreneurial zeal” and President Clinton to give his last major policy address on the campus in December 2000.

The Department of Economics has an international reputation for research in several areas of economics, including microeconomic theory, macroeconomics, industrial economics, labour economics, public economics, applied and theoretical econometrics and economic history. It is one of only four UK economics departments to achieve the maximum 5* rating in the most recent (2001) national Research Assessment Exercise. The Warwick Economics department was recently ranked No. 2 in the UK by The Times Good University Guide.

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