

# Happiness

A Revolution in Economics

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The MIT Press  
Cambridge, Massachusetts  
London, England

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Set in Palatino by SPi Publisher Services, Puducherry, India. Printed and bound in the United States of America.

Library of Congress Cataloging-in-Publication Data

Frey, Bruno S.

Happiness : a revolution in economics / Bruno S. Frey, in collaboration with Alois Stutzer ... [et al.].

p. cm. — (Munich lectures in economics)

Includes bibliographical references and index.

ISBN 978-0-262-06277-0 (hardcover : alk. paper)

1. Happiness—Economic aspects. 2. Economics—Psychological aspects. I. Title.

BF575.H27F74 2007

330.01—dc22

2007038248

10 9 8 7 6 5 4 3 2 1

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## Research on Happiness

Happiness is considered by many to be the ultimate goal in life; indeed, virtually everyone wants to be happy. The American Colonies' Declaration of Independence takes it as a self-evident truth that the "pursuit of happiness" is an "inalienable right" comparable to life and liberty. In the late 1980s, the fourth king of Bhutan, Jigme Singye Wangchuck, enunciated "Gross National Happiness" as the principle guiding force in his country (Ura and Galay 2004).

Economics is—or should be—about individual happiness. In particular, the question is: How do economic growth, unemployment, inflation, and inequality, as well as institutional factors such as good governance, affect individual well-being?

For a long time, economics has taken income as a suitable though incomplete proxy for human welfare. Happiness research shows that reported subjective well-being is a far better measure of individual welfare. "Reported subjective well-being" is the scientific term 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. They are separable constructs, and the precise terminology will be used whenever specific empirical research is reported. In general, however, as in the literature, the terms 'happiness', 'well-being', and 'life satisfaction' are used interchangeably.

### 1.1 Why Study Happiness?

There are various important reasons for economists to study happiness, in addition to intrinsic interest in the subject.

### *Identifying the Determinants of Happiness*

Why do people experience a particular level of satisfaction with the life they lead? Happiness depends on a large number of determinants. Therefore, one of the most important tasks of happiness research is to isolate what conditions affect individual and social well-being, and to what extent.<sup>1</sup> It is important to emphasize that economic happiness research is not restricted to the influence of economic factors on subjective well-being. Indeed, one of the most important findings has been that non-material aspects of a person's life—in particular, social relations among family members, friends, and neighbors—are important.<sup>2</sup> Happiness research endeavors to determine quantitatively the relative importance of genetic, personality, socio-demographic, economic, cultural, and political factors. The genetic and personality factors that determine subjective well-being are largely outside the scope of economics. But they are nonetheless important, not least because the precision of the econometric estimates of the effects of the other determinants depends on the possibly confounding role of personality differences. However, research—e.g., that of Helliwell (2006b)—suggests that the influences of demographic, economic, and political factors on happiness are not greatly affected by personality differences. Nevertheless, it is important to keep in mind that there are specific cultural definitions of happiness, and that the motivations and predictors of happiness may differ between cultures (Uchida, Norasakkunkit, and Kitayama 2004). The same holds for possibly different interpretations of numerical scales in different societies.

### *Understanding the Nature of Happiness*

The idea that individuals have happiness as their ultimate goal in life is not undisputed. Happiness is not necessarily the only goal that matters. For instance, Social Production Function Theory (Lindenberg 1986, 1990; Lindenberg and Frey 1993) identifies two ultimate goals

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1. This is a major theme throughout the book. Particular emphasis is placed on income (chapter 3), unemployment (chapter 4), inflation and inequality (chapter 5), democracy and federalism (chapter 6), self-employment and voluntary work (chapter 7), marriage (chapter 8), television viewing (chapter 9), and terrorism (chapter 12).

2. On "relational goods," see Bruni and Porta 2007 or Gui and Sugden 2005. A higher level of such social capital (Putnam 2000) has been shown to increase life satisfaction considerably (Helliwell and Putnam 2005; Björnskov 2003; OECD 2001; Powdthavee 2007).

that all human beings seek to optimize (physical well-being and social well-being) and five instrumental goals by which they are achieved (stimulation, comfort, status, behavioral confirmation, and affection). Other authors—among them Ryff (1989) and Lane (2000)—consider values such as responsibility, personal growth, purpose in life, mastery of one's environment, self-directedness, and loyalty to other people important. Some scholars argue that long-term happiness is on the same level as higher-order goods, such as health, entertainment, or nutrition (Kimball and Willis 2006). Liberal thinkers argue that personal freedom is even more important than happiness, and even that individuals should have the option of being unhappy. This may have the added benefit that people do not become too complacent and keep aspiring to achieve more. In this sense, unhappiness may even be productive.

Happiness is not a static goal that individuals are able to attain by aspiring to it. Rather, happiness is a by-product of a "good life" (*eudaimonia*, or civil happiness, as expounded by Aristotle) producing satisfaction over the long run. Those who try to achieve happiness by purposive action are unlikely to attain sustained happiness. Evolutionary theory tells us that humans did not evolve to be happy but to survive and reproduce (Camerer 2007; Camerer, Loewenstein, and Prelec 2004; Rayo and Becker 2007).

Despite these reservations, happiness is undoubtedly an overriding goal in most people's lives. This becomes clearer when the question is reversed: Who really wants to be unhappy in life? It is, in any case, crucial to inform people about the relationship between various actions and their well-being. But it should be left up to each individual how, and to what extent, he or she wants to make use of that knowledge.

Three concepts or levels of happiness can usefully be distinguished (Nettle 2005):

Momentary feelings of joy and pleasure, referred to in psychology as positive and negative affect. These feelings are often called "happiness."

Overall contentment with life, which is normally called "life satisfaction."

The quality of life achieved by developing and fulfilling one's potential, which has been called *eudaimonia* or "the good life."

Another issue is whether people's instantaneous level of happiness can be captured by self-reported measures of well-being. Is there a difference between people's hedonic experiences and their explicit reflective

appraisals of experiences in reported subjective well-being (Schooler, Ariely, and Loewenstein 2003)? People sometimes are fully engaged in challenging activities and gain great pleasure from them. They are then subject to a “flow” experience (Csikszentmihalyi 1990). When people are in such a state, they do not assess and are unable to report their well-being. This means that there are limits to the measurement of instant utility. New insights will be available when we know more about correlations between reported subjective well-being and physiological measures of well-being. Correlations over time and across individuals would allow us to study people with different frames of reference. Time series for physiological measures would allow us to assess whether people change their reference standards in self-reported happiness over time. In view of the possible shortcomings of current happiness measures, it should be kept in mind that the required quality of happiness data depends on its intended use. When considering the measures of happiness, one should always take into account what they are to be used for. In many cases, even incomplete measures of happiness are useful. Moreover, the quality of the happiness data should be compared against alternative concepts of measuring people’s level of well-being.

The success of happiness research for economics will be determined by the extent to which the findings can be integrated into established economic theory. There seem to be two main ways for research on happiness to contribute to the core of economics in the future. First, there is our understanding of utility; second, there is theory testing (discussed in the next subsection).

Econometric and experimental research methods, using proxy measures for well-being, can inform economics about a concept of utility with more psychological content. This understanding of experienced utility is closer to people’s well-being than revealed behavior. There have already been a considerable number of contributions along this line. (For reviews, see Frey and Stutzer 1999; Kimball and Willis 2006.) The most important work has been done by Kahneman and co-researchers (1991, 1997, 2006), by the Leyden group around van Praag (1971, 1993, 1999), and by Easterlin (1995, 2001, 2003). A psychologically sounder notion of individual well-being challenges various basic assumptions of the economic approach incorporated in utility theory.

The following questions are relevant:

*Do people consciously maximize their utility?* This question is rarely asked; it is usually taken for granted that they do. Often the belief that

the pursuit of happiness is the main source of human motivation is even viewed as a moral obligation in Western societies (i.e., as prescribed by their values). In particular, economics is based on conscious rational choice. However, such an approach has been criticized as unscientific. When modern economics was founded, William James (1890) and other psychologists argued that scientists should take all possible motives into account in their theories. People's behavior does not necessarily always aim at maximizing utility; it might be an impulsive act, or it might follow a sense of obligation. (For an overview of this debate, see Lewin 1996.) That people explicitly follow the goal of maximizing happiness should not just be assumed; it should be open for empirical research. (See, e.g., Kitayama and Markus 2000.)

*Should people try to maximize their utility?* This question is asked because people's attempts at assessing their own level of utility may be self-defeating. Hedonic introspection can reduce individuals' sensitivity to their own hedonic experience. It tends to undermine the utility that people want to achieve. Several empirical studies (e.g., Lyubomirsky and Lepper 1999) find that happy people are less introspective than unhappy people. The explicit pursuit of maximum happiness then hampers the ability to achieve it. A neat illustration is offered by Schooler, Ariely, and Loewenstein (2003), who studied the "costs of trying to have a good time" on New Year's Eve 1999. In a questionnaire sent by e-mail before the big event, Schooler et al. asked 475 people how large a celebration they were planning, how much they expected to enjoy it, and how much money and time they were expecting to spend on it. After the event, people were asked the same questions with regard to their actual experiences. They found that those people who expected a great party were more likely to be disappointed than those who expected only a small celebration or none at all. The difference between experienced and expected enjoyment was negatively correlated with people's anticipation and with the time they expected to spend on preparations. The active pursuit of happiness may also be self-defeating, because people have faulty theories about happiness. People who see the source of a good life more in terms of financial success consistently report lower self-esteem, vitality, and life satisfaction (Kasser and Ryan 1993; Diener and Oishi 2000; Kasser 2002).

*Do people have preferences for processes apart from outcomes?* In the assessment of institutions, it is important to understand whether

processes themselves are a source of utility. Recommendations for institutional design may be quite different if people appreciate autonomy, participation, or self-determination independent of outcome. Data on subjective well-being allow direct empirical investigations of these aspects as a source of people's well-being. (This is discussed in chapter 10.)

*Can people successfully predict their future utility?* Standard economic theory assumes that there are no systematic deviations between the utility predicted when choosing between alternative goods and the utility experienced when consuming the goods in the future. Scitovsky (1976, p. 4) criticized this view as "unscientific" because "it seemed to rule out—as a logical impossibility—any conflict between what man chooses to get and what will best satisfy him." In many carefully carried out experiments and surveys, psychologists studied how successful people are in forecasting the utility they are about to experience. (For a review, see Loewenstein and Schkade 1999.) They found that people often held incorrect intuitive theories about the determinants of happiness. Most importantly, people underestimate the speed with which they adapt to new experiences. As a result of these misguided predictions, there are systematic errors in decision making. When deciding between alternatives, extrinsic attributes are more salient than intrinsic attributes. People therefore underestimate the future utility produced by intrinsic attributes. As a result, they devote too little time to family members, friends, and hobbies. They overestimate extrinsic attributes and therefore put too much effort into acquiring income and gaining status, which makes them worse off overall. (See chapter 11.)

### *Testing Economic Theories and Predictions*

With a proxy measure for utility at hand, it is possible to discriminate between competing theories that make the same predictions of behavior but differ in what they put forward as people's utility level. This kind of test may become a powerful tool in the process of falsifying theories. Some examples illustrate the potential use of happiness research for this purpose.

- Several theories try to account for labor supply and unemployment over the business cycle. In New Classical Macroeconomics, where a per-



fect labor market is assumed, individuals are assumed to adjust their labor supply over time in response to changes in wages and in interest rates. If they are unemployed, it is voluntary. According to this view, the loss of income due to unemployment is voluntarily chosen, and unemployed people suffer no utility loss. In contrast, New Keynesian Macroeconomics attributes involuntary unemployment to price and wage rigidities. Unemployed people would be willing to accept a job at the current wage rate, but cannot find one, and suffer a utility loss if they lose their job.

- From the behavior of unemployed people, it is difficult to assess how well these two models of the labor market perform. However, individual reports of subjective well-being provide information about the utility level of unemployed people. It can be studied whether unemployed people are better or worse off than people with the same income but less leisure time. It is one of the most robust findings in research on happiness in economics that unemployed people suffer large non-pecuniary costs. (See chapter 4.) This finding is at odds with the idea of voluntary unemployment.

- Social norms affect unemployed people's behavior (Stutzer and Lalive 2004). Stronger social work norms in a community significantly reduce the duration of unemployment of fellow residents who are looking for a job. This finding does not allow us to assess whether a stronger social work norm is effective as a result of social sanctions, or whether, in a community with a stronger social norm, unemployed people get social support and information that enable them to find a job more quickly. However, the two scenarios lead to different predictions about unemployed people's well-being. While they are expected to be better off if they get social support, they probably suffer even more when a stronger social norm to work primarily means social sanctions. The measured life satisfaction of unemployed people across Swiss communities is consistent with the latter view.

- Economic models can make systematically different predictions about the effect of excise taxes on people's utility, though they all predict that people reduce their consumption when a good is taxed. Normally, one assumes that people will be opposed to having a tax put on the goods they consume, because they suffer a utility loss. However, their utility rises when the tax helps them to overcome a bad habit. For consumption activities (smoking, drinking, eating chocolate), people may advocate "sin taxes" to overcome their weakness of will. Research on happiness

can contribute to this debate. It allows us to directly study the effect of taxes on people's subjective well-being. In two longitudinal analyses across the United States and Canada, Gruber and Mullainathan (2005) performed such a test with data from the General Social Survey. They analyzed the effect of changes in state tobacco taxes on the reported happiness of people who were likely to be smokers. They found that a real cigarette tax of 50 cents rather than the current 31.6 cents significantly reduced the likelihood of unhappiness among predicted smokers. This result favors models of time-inconsistent smoking behavior in which people have problems with self-control.

- Many theories in regional, urban, and public economics assume that arbitrage across markets and across space are expected to equalize a person's utility level, *ceteris paribus*. For example, people are prepared to accept spending more time commuting only if they are either compensated by a higher salary or if they benefit from cheaper housing. Thus, there is a strong notion of equilibrium underlying economic models of location and federal competition. With data on subjective well-being, the prediction of equalized levels of utility can be tested directly. On the basis of seven waves of the German Socio-Economic Panel, a negative partial correlation between commuting time and life satisfaction was found (Stutzer and Frey 2007a). For standard economics, this result is a paradox.

### *Isolating the Consequences of Happiness*

Persons who are satisfied with the life they lead can be expected to act differently than persons who are dissatisfied. Happy people are more optimistic, more sociable, and more enterprising, and they tend to be more successful in their private, economic, and social activities. As a consequence, they are happier in their marriages as well as in their jobs. Moreover, they can be expected to have a longer time horizon and to be willing to take more risk, which may make them more successful entrepreneurs (Bosman and van Winden 2006). So far, most of the research on the consequences of happiness for behavior has been done in the field of psychology, where there is a large experimental literature identifying a relationship between positive and negative affect (i.e., mood, emotions, feelings) and decision making (Hermalin and Isen 1999; Isen 2000; Lyubomirsky, King, and Diener 2005). In particular, even relatively small changes in happiness can markedly influence everyday thought

processes. For example, positive affect tends to increase a person's willingness to help others. Happier people have been found to gain higher pleasure and/or lower psychic costs from aiding others (Isen and Levin 1972) and to be more creative (Isen, Daubman, and Nowicki 1987). Moreover, affective states serve important informational and motivational functions (Schwarz 1990).

Economic modeling of decision making has, so far, essentially ignored the role of affect. Economists have analyzed the adverse consequences of strong emotional states (arousal) and visceral influences on cognitive abilities (MacLeod 1996; Kaufman 1999; Loewenstein 1996, 2000). Other economists have focused on "rationalizing" emotions (Frank 1988; Romer 2000). Their goal is to explain why evolutionary forces have produced particular emotions.

### *Is Happiness a Cause, or an Effect?*

The same factors may be determinants or consequences of happiness. Thus, being unemployed makes people unhappy, but unhappy people are less active and enterprising and are therefore less likely to find employment. Similarly, marriage may increase happiness, but happier persons are more likely to be married because they are more attractive partners. Identifying the direction of causality is important, as it is a precondition for trying to increase happiness by policy intervention. However, it is difficult to identify causal effects, and the economic approach to happiness is subject to the same econometric challenges faced by studies that examine the determinants of behavior, including the possibility of omitted variables and the possibility of endogeneity bias.

### *Helping to Make Sense of Paradoxical Observations*

Standard economics finds it difficult to explain various empirical puzzles. A particularly important paradox needing explanation is that, in several countries, real income has risen drastically since World War II, but self-reported subjective well-being of the population has not increased, or has even fallen slightly. In the United States, for example, between 1946 and 1991, per-capita real income rose by a factor of 2.5 (from approximately \$11,000 to \$27,000 in 1996 dollars), but over the same period of time happiness, on average, remained constant. This well-established finding of happiness research has been called the "Easterlin Paradox"

(Easterlin 1974, 1995, 2001; Kenny 1999; Blanchflower and Oswald 2004b; Diener and Oishi 2000) and the “Happiness Paradox” (Pugno 2004a, 2007). Higher income is positively associated with people’s happiness. Yet over the entire life cycle, happiness changes very little. The insights of happiness research that help us to understand these observations are put forward in chapter 3.

Another paradox is that, although work has been considered a burden since ancient times, empirical research on happiness strongly suggests that being unemployed, even when the loss in income is taken into account, depresses well-being markedly.

### *Improving Economic Policy*

In most cases, it is impossible to make a Pareto-optimal policy proposal, because any social action entails costs for at least some individuals. Hence, an evaluation of the net effects, in terms of individual utilities, is needed. Economic policy must deal with tradeoffs, and macroeconomics deals particularly with tradeoffs between unemployment and inflation. Using data on reported life satisfaction for twelve European countries in the period 1975–1991, it has been calculated that a 1-percentage-point increase in the unemployment rate is marginally compensated for by a 1.7-percentage-point decrease in inflation (Di Tella, MacCulloch, and Oswald 2001). This result deviates significantly from the “Misery Index,” which, for lack of information, has simply been defined as the sum of the percentages of unemployment and annual inflation. Another tradeoff that can be calculated from estimated happiness functions is the compensating variation for being unemployed versus holding a job. For the twelve European countries just referred to, a move from the lowest income quartile to the highest would not be enough to offset the adverse effect of unemployment, which suggests that unemployed people suffer high non-pecuniary costs.

Economic policy is concerned in part with how institutional conditions on happiness (for example, the quality of governance and the size of social capital) affect individual well-being. Research in 49 countries in the 1980s and the 1990s suggests that there are substantial well-being benefits from improved accountability, effectiveness, and stability of government, the rule of law, and the control of corruption. The data show that the effects flowing directly from the quality of institutions are often much larger than those flowing through productivity and economic growth (Helliwell 2003). Some findings of happiness research add

more precise knowledge to what have become standard views in economics; other findings contradict them. One finding is the consistently large influence of non-economic variables on self-reported satisfaction. This does not mean that income, employment, and price stability are not important, but it does suggest that the recent interest in good governance and in social capital is well founded. The findings of happiness research also enrich our knowledge of the effects of discriminating with respect to gender, ethnicity, race, and age.

## 1.2 The Literature

For centuries, happiness has been a central theme of philosophy.<sup>3</sup> For a long time, the empirical study of happiness has been the province of psychology (Argyle 1987; Csikszentmihalyi 1990; Michalos 1991; Diener 1984; Myers 1993; Ryan and Deci 2001; Nettle 2005). There have also been important contributions by sociologists (Veenhoven 1993, 1999, 2000; Lindenberg 1986) and political scientists (Inglehart 1990; Lane 2000).<sup>4</sup> Only recently has psychological research been linked to economics. The early contribution of Richard Easterlin (1974) was noted by many economics scholars, but at the time it found few followers. The same may be said of Tibor Scitovsky's book *The Joyless Economy* (1976).<sup>5</sup> General interest among economists in the measurement and the determinants of reported subjective well-being was raised by a 1993 symposium in London, the proceedings of which were later published in the *Economic Journal* (Frank 1997; Ng 1997; Oswald 1997) and elsewhere (Clark and Oswald 1994, 1996). In the late 1990s, economists began to publish large-scale empirical analyses of the determinants of happiness in various countries and periods.

Happiness research excels in its interdisciplinary orientation. Scholars from various disciplines may emphasize one aspect more than another. Economists are particularly interested in the economic determinants of happiness and their consequences for economic policy, but their research

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3. On how philosophers have dealt with the topic of happiness, see McMahon 2006; Bruni 2006. On the contributions of Aristotle, Bentham, Mill, and Kant, see also Bruni and Porta 2007; Sugden 2005; Nussbaum 2007; Nussbaum and Sen 1993.

4. Notable forerunners of sociological and political science research on happiness are Cantril (1965) and Brickman and Campbell (1971).

5. Even earlier, Bernard van Praag and his group in Leyden developed the concept of individual welfare functions based on reported subjective evaluations (van Praag 1968, 1971). However, their insights have seldom been taken up in interdisciplinary happiness research.

goes well beyond that. Conversely, psychologists focus on mental processes but have made major contributions to how economic factors (particularly income) affect subjective well-being. (See, e.g., Diener and Biswas-Diener 2002.) In current happiness research, in contrast with other areas of the social sciences, the integration among disciplines often goes so far that it is not possible to identify whether a particular contribution is due to an economist, a psychologist, a sociologist, or a political scientist. This is no small achievement, especially in view of the generally increasing differentiation of economics from the other social sciences.

In this book I do not intend to provide a general survey of happiness research. Lane (2000), Frey and Stutzer (2002a), and Nettle (2005) have already written books on the subject. Survey papers have been contributed by Ng (1978), by Diener, Suh, Lucas, and Smith (1999), by Easterlin (2004), by Frey and Stutzer (2002b, 2004b, 2005a,b), by Diener and Seligman (2004), and by Di Tella and MacCulloch (2006). There are useful collections of articles (e.g., Strack, Argyle, and Schwarz 1991; Kahneman, Diener, and Schwarz 1999; Easterlin 2002; Huppert, Kaverne, and Baylis 2004; Bruni and Porta 2005, 2007). There are important monographs focusing on various aspects of economic happiness research (e.g., Graham and Pettinato 2002a; van Praag and Ferrer-i-Carbonell 2004; Layard 2005; Bruni 2006). Research is being published in many different journals, and there is a specialized *Journal of Happiness Studies*.