Behavioural Economics

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Outline

Absolute-Income Hypothesis
Extreme Income Rises
Easterlin Paradox
Cross-Country Data

Reference-Income Hypothesis

Rank-Income Hypothesis

Absolute, Reference, or Rank?

Behavioural Economics

PSYC3310: Specialist Topics in Psychology

Seminar 10: Happiness and Utility

CSIRO-UWA
BEL
Behavioural
Economics
Laboratory

Today

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Absolute,
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- Happiness and Utility in the standard economic model
- Utility maximisation (**1**), beliefs (**3**), and preferences (**4**)

$$\underset{x_i^t \in X_i}{\max} \quad \sum_{t=0}^{\infty} \delta^t \quad \sum_{s_t \in S_t} p(s_t) \quad U(x_i^t \mid s_t)$$

(1)   (2)   (3)   (4)

- Standard economic model:
  - the absolute-income hypothesis
- Behavioural economic alternatives:
  - the reference-income hypothesis
  - the income-rank hypothesis

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- Standard economic model:
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- According to the standard economic model, happiness is derived from utility—the more utility one has, the happier one should be

- If people are rational, then they should always make decisions that maximise their expected utility

- If people are indeed rational, then happiness can be defined as *what people do*—**revealed preference**

- Utility maximising behaviour implies that people will always do what gives them the most happiness and utility

- Happiness is derived from utility, and a key source of utility is income derived from work

- According to the standard economic model, the greater one's absolute level of income, the happier one should be—the absolute income hypothesis

- Within the same society, richer people will be happier than those will lower incomes

- In support of this notion, there is a positive correlation between money and happiness, but the relationship is only small (Howell & Howell, 2008)

- These results do not necessarily reflect a simple causal relation between absolute income and happiness

Does Absolute Income Predict Happiness?

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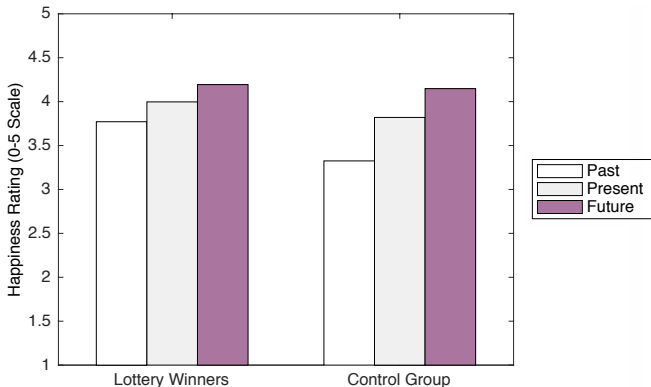Outline

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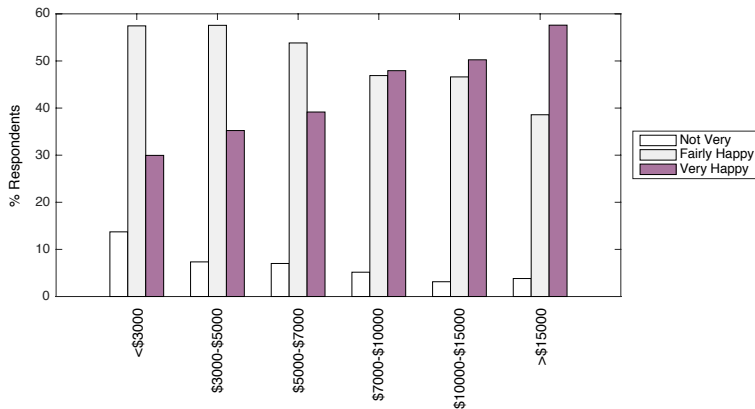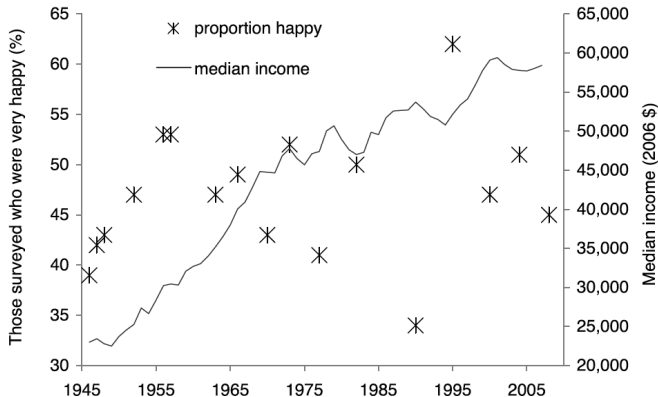
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Source: Brickman, Coates, and Janoff-Bulman (1978)

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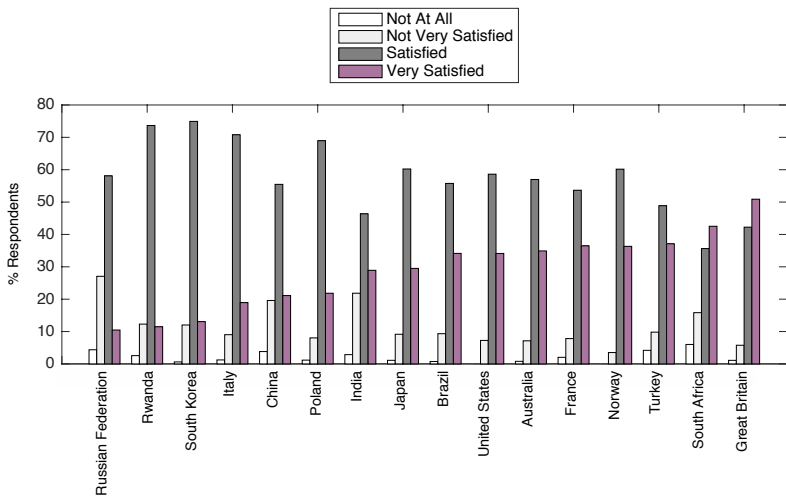@uwa.edu.au

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Source: Easterlin (1974)

Does Absolute Income Predict Happiness?

Source: Easterlin (1974), Gallup and US Census Bureau.

Does Absolute Income Predict Happiness?

Source: World Values Survey (2005)

- There is evidence that being among people with higher incomes than oneself can reduce happiness (Blancher & Oswald, 2004; Clark et al., 2008; Clark & Oswald, 2006)

- Suggests an individuals utility is determined by income relative to some peer-reference group

- The dominant model of income comparison is the reference-income hypothesis

- People care about how their income compares with the norm of a relevant social comparison group

- Individuals gain utility to the degree that their income exceeds the average of their reference group

- They lose utility to the degree that their income falls below the average of their reference group

- An alternative to the reference-income hypothesis is that utility is based on an individual's ranked position within a comparison group—rank-income hypothesis

- People gain utility from occupying a higher ranked position within an income distribution, rather than from either absolute income or their position relative to a reference income

- An income of $150,000 per year confers more utility if it is the highest ranked income in a distribution than if it is, for example, only the seventh-highest ranking income

- Ranked position of an income will be highly correlated with the position of that income relative to a mean

- Evidence supporting the reference-income hypothesis may better understood by a rank-income account

What Determines Happiness? Absolute Income, Reference-Income, or Rank-Income?

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- Speaker 1
  - Does wage rank affect employees' wellbeing?
- Speaker 2
  - Rank of Income, Not Income, Affects Life Satisfaction
- Speaker 3
  - Relative rank and social norm effects in judgements of anxiety and depression symptom severity
- Speaker 4
  - Why does income relate to depressive symptoms? Testing the income rank hypothesis
- Speaker 5
  - Income inequality and status seeking
- Speaker 6
  - Money, wellbeing, and loss aversion