



Income and happiness across Europe: Do reference values matter?

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ABSTRACT

Using cross-sectional data from the first two rounds of the European Social Survey (ESS), we examine the relationship between income, relative income and happiness across 19 European countries. We find that a positive and statistically significant relationship between income and happiness does exist, but such a relationship is weakened by reference income. We also find that while reference income exerts a negative impact on happiness in the case of Western European countries, its effect is positive in the case of the Eastern European countries, a finding that is consistent with the 'tunnel effect' hypothesis. This suggests that for Eastern Europeans reference income is likely to be a source of information for forming expectations about their future economic prospects, rather than a yardstick measure for social comparisons.

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1. Introduction

The relationship between income and happiness continues to attract attention among social scientists, including economists, who, rather than using the more holistic approach adopted in other social sciences, tend to model utility as a monotonically increasing function of, and often synonymous to, absolute income. However, in recent years, such a conjecture has been subjected to the scrutiny of a substantial volume of empirical evidence, with mixed results. For instance, while cross-sectional studies tend to support the hypothesis of a causal relationship between income and happiness (a proxy for utility), there is a great variation in the strength of such a relationship across income groups. Generally, the correlation between income and happiness is weaker in cross-sectional studies that use national averages of income and happiness scores or in studies that control for education, unemployment and other moderating factors that could mitigate the strength of such a relationship (see, e.g., Diener, Sandvik, Seidlitz, & Diener, 1993; Frey & Stutzer, 1999; 2002; Heady, 1991; Oswald, 1997). In contrast, any positive correlation, as revealed in cross-sectional studies, is largely absent in time series studies. These usually find that happiness, in developed countries at least, has reached a plateau despite a continuous growth in real income. In the same vein, there is little evidence of a life-cycle trend in happiness even though income and economic circumstances change.¹

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¹ The lack of any significant correlation between changes in income and changes in happiness form the basis for the 'Easterlin Paradox' (Easterlin, 1995, 2001), which has been the motivating hypothesis behind a substantial volume of empirical work.

In this paper, we focus on the cross-sectional relationship between income and happiness using data for 19 European countries from the first two rounds of the European Social Survey (ESS). Previous studies are based mostly on data from a single country, those exploring this relationship in a comparative context being rather sparse. Senik (2008) is a notable exception, providing comparative evidence on the relationship between income, reference income and well-being using a variety of data sources for Western Europe, Eastern Europe and the United States, including data from the first round of the ESS survey. In the same spirit as Senik (2008), the aim of this paper is to explore the relationship between income, relative income and subjective well-being in a comparative European context. Using reported happiness and life satisfaction scores as measures of subjective well-being, we find that absolute income has indeed a strong positive effect on well-being.² Marginal effects based on the estimated income coefficients in our regressions imply that an increase in income from the lowest to a middle income group increases life satisfaction scores by 0.71 points, which is comparable to an increase in life satisfaction scores caused by a marginal improvement in respondents' health. However, we also find that the strength of the relationship between income and happiness is weakened by reference income. While reference income per se has a negative impact on life satisfaction, it also reduces the absolute income effects across all income bands. Performing separate analyses for Eastern European countries, we find evidence that the reference group's income exerts a positive influence on individual life satisfaction, a finding which lends support to Hirschman's (1973) 'tunnel effect' conjecture. This refers to the phenomenon that in uncertain and adverse situations people often interpret any positive signals that they can observe around them to predict an improvement in their own situation to occur sooner or later. Therefore, it seems that in Eastern European countries reference income does not influence individuals' well-being through social comparisons, but rather through their informational content, which is used in order to form expectations about future income and economic situation.³ Our findings, based on an additional round of data from the ESS and using different measures of reference income, are consistent and supplement Senik's (2008) findings, thus offering additional empirical support for the existence of an East–West divide across individuals' perceptions of reference income as a source of social comparisons or of information about future economic prospects.

The layout of the remainder of the paper is as follows. Section 2 reviews the existing empirical evidence on the relationship between happiness and income, paying particular attention to evidence based on cross-sectional studies. Section 3 describes the data and the empirical framework for the present study. Section 4 presents the main empirical findings. To check their robustness, Section 5 summarises the results of estimating life satisfaction equations using alternative specifications. Section 6 concludes.

2. Income and happiness – existing evidence and explanations

In a seminal study, Easterlin (1974) provides early empirical evidence for the US showing that income growth does not lead to higher levels of happiness, a finding further supported by subsequent studies based on time series data.⁴ In contrast, cross-sectional studies tend to support the existence of a positive, albeit generally weak, relationship between income and happiness. At the household or individual level, a positive and statistically significant correlation is found, with estimated correlation coefficients between 0.12 in Diener et al. (1993) and about 0.2 in Easterlin (2001). The strength of the relationship between income and happiness becomes even more contentious once the sample of households is divided into income sub-groups. As Argyle (1999, p. 356) suggests, the positive relationship between happiness and income only holds for the lower end of the income distribution, whilst Glatzer (1991) finds no clear income effect on life satisfaction between the second and fifth income quintile in Germany. For cross-sections of average life satisfaction and average income across developed countries, it is found that the effect of income on happiness is weak across countries with an average annual income level above \$10,000 (e.g. Diener & Suh, 1999; Frey & Stutzer, 2002). Against the background of such a controversy regarding the strength of the relationship between income and happiness, the study by Frijters, Haisken-DeNew, and Shields (2004) is particularly noteworthy in concluding that, after all, income does buy happiness, especially in Eastern European countries.

A number of alternative explanations have been proposed for the apparently contradictory, or at least mixed, results in the empirical literature. The *absolute income hypothesis* states that the level of utility varies positively with the level of income up to a threshold level beyond which utility remains largely invariant. This characteristic of utility reflects the assumption that once a person's basic material needs are satisfied, other aspects of life rather than further improvement in material well-being predominantly determine the person's sense of happiness. This hypothesis is generally consistent with the

² While many studies assume happiness and life satisfaction to be synonymous, there is considerable evidence suggesting that they are not strongly correlated (see Cummings, 1998). In general, life satisfaction refers to cognitive states of consciousness, whereas happiness is emotional and mainly concerns intimate matters of life. Indeed recent evidence (e.g., Gundelach & Kreiner, 2004) reinforces Michalos's (1991) view that while happiness and satisfaction form part of a subjective well-being construct, it is heuristically useful to measure and analyse them separately. In this paper, we used both "Happiness" and "Life satisfaction" scores as measures of subjective well-being and as dependent variables in our estimations. The results are very similar using either measure and therefore we only report the "Life satisfaction" results. The "Happiness" regression results are available upon request. Throughout the paper we use the terms "Happiness" and "Life satisfaction" interchangeably.

³ Senik (2004b) is the first to test formally the 'tunnel effect' hypothesis using large-scale data.

⁴ For a critical evaluation of time series studies on income and happiness, see Hagerty and Veenhoven (2003). They also improve the statistical power of previous tests and find evidence of a positive link between national income and national happiness, with some evidence that such a link weakens in the long-run.

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