

The role of income aspirations in individual happiness

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Abstract

Does individual well-being depend on the absolute level of income and consumption or is it relative to one's aspirations? In a direct empirical test, it is found that higher income aspirations reduce people's utility, *ceteris paribus*. Individual data on reported satisfaction with life are used as a proxy measure for utility, and income evaluation measures are applied as proxies for people's aspiration levels. Consistent with processes of adaptation and social comparison, income aspirations increase with people's income as well as with the average income in the community they live in. © 2004 Elsevier B.V. All rights reserved.

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1. Introduction

How are income and consumption related to individual well-being? Economics takes it as self-evident that higher income and consumption provide higher utility. Moreover, it is assumed that people's satisfaction depends on what they have in absolute terms.¹

In contrast, research on individual happiness has found patterns in reported subjective well-being that are at odds with this view. There is systematic evidence that people in industrialized countries are not becoming happier over time, despite economic growth (e.g. Blanchflower and Oswald, *in press* and Easterlin, 1974, 1995). However, people with a

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¹ There are, of course, scientists who oppose this notion. Frank (1985a, 1999), Galbraith (1958), Hirsch (1976), Scitovsky (1976), and more recently Schor (1998), who have studied consumer culture, particular in the United States, emphasize the important role of socially formed aspirations and expectations for consumer satisfaction.

higher income than others in their society *do* report higher levels of happiness. Both observations can be explained by introducing income aspirations in people's utility function that capture their concerns for relative income as well as their adaptation to previous income level (Easterlin, 2001a). Even though income aspirations seem to play an important role in individual welfare, they have not been empirically analyzed in a direct way so far.

In this paper, using a new, more direct and general approach, the effect of income aspirations on people's utility is empirically tested. This is made possible with a unique data set that includes individual data on reported satisfaction with life as a proxy measure for utility, as well as income evaluation measures as proxies for people's aspiration levels. There is evidence that higher income aspirations reduce satisfaction with life, *ceteris paribus*.

Two processes are theoretically put forward as forming individual aspirations. First, there is individuals' adaptation to repeated stimuli, as provided by people's consumption habits. Whereas additional material goods and services initially provide extra pleasure, their effects wear off over time. Thus people get used to their consumption and income level. Second, there are social comparisons with relevant others. It is not the absolute level of income that matters most, but rather one's position relative to other individuals. Socially comparative or even competitive processes in consumption complement processes of hedonic adaptation. Together, it is suggested that they make people strive for ever higher aspirations.

Here the determinants of income aspirations are empirically studied. The econometric results show that consistent with processes of adaptation, income aspirations increase with personal income. For the analysis of relative income concerns, individuals' aspirations are merged with data on aggregate income in the community where people live. The results indicate that (i) a higher average income in the community increases people's levels of aspiration, and (ii) the estimated effects are larger for people who interact with other community members.

Finally, a potential endogeneity bias in people's reported aspiration levels is addressed in a two-stage estimation approach of reported satisfaction with life. Estimates of a full and a reduced model support the basic result that higher income aspirations reduce individual well-being, *ceteris paribus*.

The paper proceeds as follows. Section 2 outlines the theoretical framework for the study of the effect of income aspirations on individual well-being. It introduces reported subjective well-being as a proxy measure for utility and puts forward three testable propositions that are derived from a relative utility concept. In Section 3, the empirical analyses are conducted. Section 4 draws conclusions.

2. Income aspirations and individual happiness

Human beings are unable and unwilling to make absolute judgments. Rather, they are constantly drawing comparisons from their environment, from the past or from their expectations of the future. Thus, we notice and react to deviations from *aspiration levels*.

There are two main processes that form individuals' aspirations and create the relativity in people's utility evaluation.

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