

# National welfare and individual happiness: Income distribution and beyond

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Available online 5 May 2007

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## Abstract

This paper begins by observing that both national welfare and individual happiness are determined by more than just absolute income. Relative income is a crucial input to happiness, but according to accumulating evidence from “behavioral” economists, so also are status, endowments, cultural context, and even income in kind. These findings have policy implications that can be profoundly disturbing to many economists if they take them seriously. The paper concludes with suggestions for research. An appendix outlines a simple framework for research on the relationship between happiness, absolute income and relative income.

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*JEL classification:* F4

*Keywords:* Income distribution; National welfare; Happiness; Positional goods; Endowment effects; Goods-in-kind

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## 1. Introduction

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<sup>1</sup> One recent reference among thousands on this subject is Kahneman, Krueger, Schkade, Schwartz, and Stone (2006).

**Box 1.**

Financial Times, November 2, 2006.

Democrats retreat from free-trade record

By Edward Luce and Krishna Guha

In the six years since George W. Bush took office, the forces of economic populism in the U.S. have been gradually rising largely because of the stagnating incomes of America's middle classes. After adjusting for inflation, the median American household is earning less than it was in 2000. According to a recent poll, three-quarters of Americans say they are either worse off or no better off than they were six years ago.

Financial Times, February 13, 2007

Why America will need some elements of a welfare state

By Martin Wolf

Is globalization a leading cause of rising inequality in high-income countries? The outcome of the debate on this question may determine whether the U.S. will remain open to trade. If policymakers do not craft an imaginative response, protection against imports may be the outcome, regardless of its (non-existent) merits. Ben Bernanke, chairman of the U.S. Federal Reserve, laid out the issues in a thought-provoking speech last week.\* He embedded his analysis in three principles: "That economic opportunity should be as widely distributed and as equal as possible; that economic outcomes need not be equal but should be linked to the contributions each person makes to the economy; and that people should receive some insurance against the most adverse economic outcomes, especially those arising from events largely outside the person's control"

## 2. Relevance

In the U.S., Democrats plan to make income distribution a top issue in the 2008 elections.<sup>2</sup> The starkest statistics that highlight the issue are these: since 1995, U.S. labor productivity has increased by more than 15%. But real incomes in the bottom half of the distribution have either barely increased or declined. During the past decade, the gap between mean and median income, long since the widest in the rich world, has widened still further (see [Box 1](#) ).

Internationally, income distribution is also worsening within countries that have "globalized". Virtually all countries that have opened up to international trade and capital flows in recent decades

<sup>2</sup> One indication of how the wind was blowing early 2006 was the founding of the "Hamilton Project", a Washington-based think tank that is supported by Robert Rubin and other moderately right-of-center Democrats. Its mission is to devise market-friendly policy proposals to address, *inter alia*, income distribution, job security and pension reform, and, implicitly, to usurp the left wing of the party, which is flirting with proposals like trade barriers against China which could kill the globalization goose that has laid so many golden eggs.

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