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What affects happiness: Absolute income, relative income or expected income?

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Abstract

This study probes the reasons why increased income does not enhance happiness based on the effects of relative income and expected income. The study analysis is based on results from the *Taiwan Social Change Survey* from 1999 to 2002, using an ordered probit model. The findings demonstrate that the Taiwanese people are happier with an increase in absolute income. However, the marginal effect is reducing. In addition, relative income and expected income meet the expectation, indicating that people's happiness is not only related to absolute income, but also closely associated with the average income found in society and expected income.
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Keywords: Happiness; Absolute income; Relative income; Expected income

1. Introduction

In the early 19th century, certain researchers treated "the principle of utility" as "the greatest happiness principle" and suggested that people's behavior should focus on "maximum utility," which leads to future "utilitarianism."[2] The proposition for welfare economics has been based on the positive relation between "income" and "happiness." Thus, the higher the income, the happier

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[2] The concept was proposed by Jeremy Bentham and John Stuart Mill who suggested that people's behavior is motivated by happiness and emphasized that people's behavior enhanced happiness. However, indicating that people's behavior

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people will be; the lower the income, the less happy people will be. Income is an important factor in consumer activity and thus, economists have treated economic growth as a critical index in discussing public policy. Much of the literature demonstrates that increased income enhances people's happiness (Ferrer-i-Carbonell, 2005; Hagerty & Veenhoven, 2003).

However, is the relationship persistent? Easterlin (1974) was the earliest scholar to pose this question. He suggested that people are not happier in wealthier countries. A positive relation between income and happiness should exist. However, this is not seen in practice because economic growth is not equal to social welfare; thus, people are not necessarily happier with economic growth. In the literature, the phenomenon is also called the "Easterlin paradox." Sen (1993) also emphasized that life quality and satisfaction cannot be simply enhanced by income and economic growth. Research indicates that in many developed nations, such as the United States, Britain, or Japan, the average income is twice as much as 50 years ago; however, people are less happy (Blanchflower & Oswald, 2004; Layard, 2005; Oswald, 1997). The results indicate that for most people, an increase in income does not necessarily enhance happiness.

Why does an increase in income not lead to an equal degree of enhanced happiness? One of the most important factors is that people compare themselves to other people. The absolute level of income is not what most, but rather one's position relative to other people (Frey & Stutzer, 2002; Stutzer, 2004). The critical factor refers to the relative reduction of income, or "relative income effect." The previous positive relation between income and happiness was based on the concept of "absolute income." When other conditions are fixed and people's incomes do not increase as fast as overall incomes, people will typically be less happy.[3] An increase in relative income means a richer society. When a person's absolute income is fixed, he will be less happy because of relative reduced income. Thus, although an increase in absolute income enhances people's happiness, an increase in overall societal incomes reduces happiness (Easterlin, 1995). Considerable literature contains similar statements after including the effect of relative income (Dean, 2007; Diener & Oishi, 2000; Hagerty & Veenhoven, 2003; Tao & Chiu, 2009; Tsou & Liu, 2001). The findings not only clearly distinguish the effects of absolute income and relative income on happiness, but more specifically elaborate the "Easterlin paradox" phenomenon.

In addition to relative income effect, an "expected income effect" is also a critical factor on people's happiness. If relative income refers to the comparison between people and others, expected income is the comparison between people and others who have similar conditions. People expect their income to be according to their conditions. The expectation depends on the incomes of people with similar objective conditions in society. The expected income effect means that when people's expected incomes are higher than actual incomes, an increase in actual income will not necessarily enhance happiness. People will not be satisfied simply by an increase in actual income. Their satisfaction depends on the gap between actual income and expected income. Thus, when actual incomes are lower than expected incomes, people will be less happy; inversely, when actual incomes are higher than expected incomes, people will be happier.[4] However, Frey and

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reduced happiness is incorrect. Happiness is not only related to personal behavior, but also associated with those influenced by the behavior. Mill further suggested that human behavior only aims to acquire happiness. Thus, enhancing happiness is the criterion by which to judge people's behavior.

[3] Solnick and Hemenway (1998) tested students at Harvard University and inquired about the following two situations based on the same price index. "Please choose from 'you earn USD 50,000 a year, whereas others only earn US$25,000' and 'you earn US$100,000 a year and others earn US$ 250,000."'. The results show that most students selected the former.

[4] Expected income effect is similar to "hedonic treadmill" or "hedonic adaptation" proposed by Brickman and Campbell (1971), who suggested that people's expectation level increases with the increase in actual achievement level. Thus, they would not be satisfied.

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