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HAPPINESS AND PARETO

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Abstract:
While the utilitarian notion of 'happiness' is unsatisfactory, widespread interest in the subject suggests that economists are recognising the importance of *relative* income status, particularly in the US and the UK where income inequality has increased greatly. If relative income matters, one must reconsider the notion of a Pareto improvement, which is basic to public policy decisions. By the same token, distributional issues are central to any discussion about the costs and benefits of growth, an issue suggested not merely by the 'happiness' literature but by much recent writing on social capital, co-operative survival strategies the like. Nor is there a simple trade-off between efficiency and equity, since the two may be complementary. The neo-classical theory of factor rewards cannot justify current inequality since, upon closer examination, it is tautological and incoherent. The conclusion is that economists would do better to seek guidance on distributional matters from Rawlsian-type political theory.

1. Happiness

Richard Layard's book in 2005 on the 'new science' of happiness was an economics best-seller. In a nutshell, his argument is that as rich societies get richer, they don't become any happier---or, to use a fancier phrase, their 'subjective well being' (SWB) doesn't improve. Of course, it can be argued that many economists (and other social scientists) have been saying this for years. When a very poor society gains extra income, it is likely that some people are raised out of poverty---and most would agree that this is a good thing. But when a very rich society gains an extra unit of income, that extra income is likely to produce a lesser benefit, or in some cases, no benefit at all. Most economists agree on that this principle of 'diminishing marginal utility of income' applies to national income as well as to individual income. Indeed, most economists---at least those who give introductory courses to first year students---point out that national income measurement is a crude proxy of welfare, and that it needs to be supplemented by other indices, the best-known example being the UN's Human Development Index (HDI).[1] Saying that getting richer doesn't always make you much happier is a variant on this theme.

The philosophical basis of Layard's work is to be found in 19th century utilitarianism, the

principles of which strongly influenced the early development of neo-classical economics in general, and 'welfare economics' in particular. The 19th century Italian economist, Vilfredo Pareto, is one of the founders of welfare economics, that branch of the discipline which analyses when and whether a change in public policy is a good thing. Pareto taught at the universities of Turin and Lausanne, and is credited with spelling out the conditions under which resources in a pure free-market are 'optimally' distributed; ie, when, under given tastes and techniques, the market is producing maximum output with given resources and no-one can be made better off unless someone is made worse off. (He is also said to have remarked that 80% of Italy was owned by 20% of the population.) Presently, I discuss whether 'Pareto optimality' is a helpful notion in a world where one's income and consumption status is judged relative to others, but for the moment it will be convenient to return to the story of 'economic happiness.'

For some years there has been a branch of social science called 'hedonics,' or the study of what makes us happy, and there is even a *Journal of Happiness Studies*. Daniel Kahneman, a psychologist who strongly influenced Layard, won a Nobel prize for his work on what people 'maximise' when they make financial decisions. However, there are at least two problems with maximising 'happiness'. First, classic utilitarianism is unhelpful about distributional issues. Unless one first *assumes* that extra units of happiness---call them 'utils' if you wish---are of diminishing marginal utility (which Jeremy Bentham did not), one cannot distinguish between a society in which each of 1000 citizens possesses one util and a society in which one person alone has 1000 utils and the rest have none. Even then, as Sen has argued, interpersonal comparisons of SWB between rich and poor may be highly misleading.[2] Secondly, the notion of happiness is notoriously slippery; like the proverbial hippopotamus sloshing about in glorious mud, it is far easier to sing about than to analyse.

Psychologists make quite a useful distinction between three levels of happiness.[3] Level-one involves the emotion of pleasure or joy which we all know; the smile which accompanies meeting an old friend, the delight at playing with one's children or the simple pleasure of reading a good book or watching a beautiful sunset. One could

multiply the examples, but the salient point is that happiness is a momentary emotion we all experience, recognise and can share. Level-two happiness is more cognitive and reflective. Looking back over today's efforts at writing or last night's dinner with friends at home, I am happy because, on balance, I feel it was successful and pleasurable.

Level-three happiness is even more reflective. On balance, am I happy with my life, with the state of politics in the world, or with the trajectory of life, the universe and all that? Level-three happiness is not about an emotion, or even the result of a reflection on a limited number of events. It is more about life as a whole, about generally feeling 'good in one's skin' as the French say or perhaps even about having attained a broad, mature emotional balance which according some cultures is associated with tranquillity and wisdom.

The point to grasp here is that psychological studies of happiness based on survey data generally refer to the second level. When people say they are happy, they usually don't mean that they are experiencing a feeling of intense pleasure at the very moment the interviewer puts his or her question (still less, that they have lots of 'utils'). Nor do respondents generally interpret psychologists' questions as pertaining to the attainment of the Buddhist state of nirvana. The questions are usually phrased is such a way as to elicit clear, contextually relevant responses about level-two 'happiness'. Note that what Layard calls 'happiness', another well-known economist, Robert H Frank, calls 'subjective well-being' (SWB), which is the more usual phrase used by psychologists to refer to level-two happiness. Nevertheless, hedonic measures are always problematic with respect to the type of questions asked, the way they are asked, the socio-economic status of the respondent and so forth. Social scientists involved in such studies doubtless do their best to control for the various types of bias that can affect survey results, but measurement in social science is notoriously trickier than in the physical sciences. With these qualifications in mind, let's proceed to the business at hand.

2. Money can't buy you love

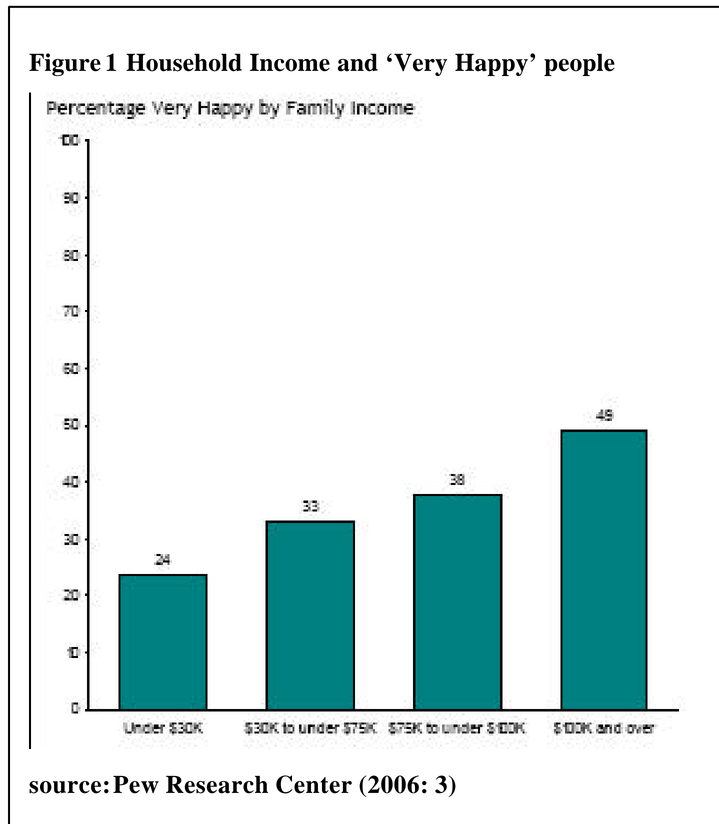


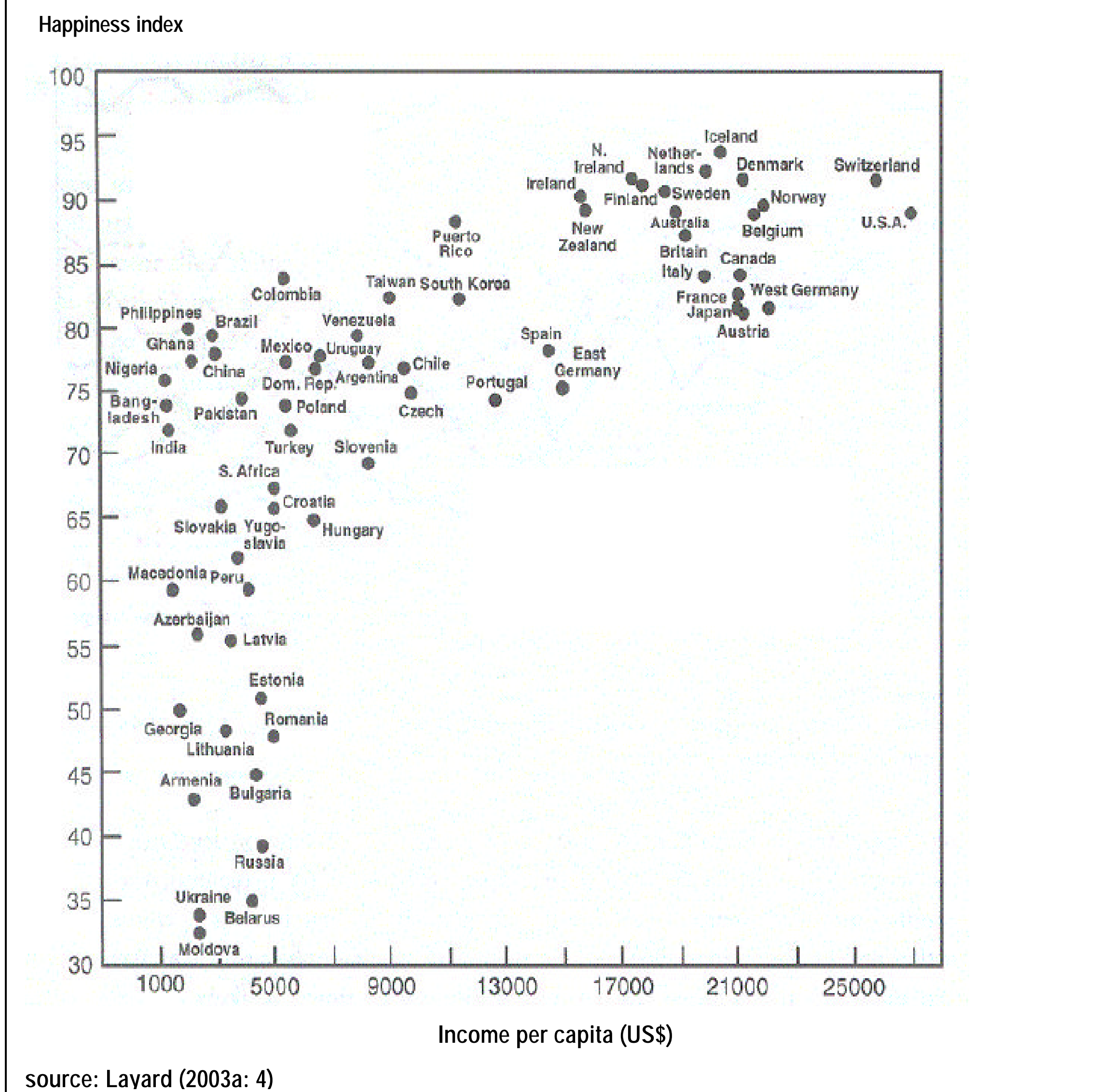
Figure 1 Household Income and 'Very Happy' people

source: Pew Research Center (2006: 3)

There may be an element of truth in the old chestnut that if money can't buy you want you want, you've been shopping in the wrong place. Nevertheless, there are numerous studies by psychologists, economists and others showing that becoming richer does not seem to make us happier, or at least not if we are already well above the poverty line. Broadly speaking, survey evidence reveals that as per capita income rises from the very low levels found in parts of the Third World to levels typical of semi-industrialised countries, people are generally 'happier', but once a country has become relatively prosperous, a further rise in the standard of living generates no corresponding increase in satisfaction.

On the other hand, as shown in Figure 1, in America the rich seem to be happier than the poor, which is perhaps not so surprising. The diagram, taken from a 2006 study by the Pew Research Center, shows the percentage of households reporting themselves to be 'very happy' rises with their income position. But the reader should be cautious: there are similar studies showing either no change in happiness as income rises, or suggesting that as income rises, people may even become *less* happy.

Figure 2 Income level per head and reported happiness



source: Layard (2003a: 4)

Figure 2 shows a 'happiness index' (as measured by the *World Values Survey*, 1990-93) plotted against levels of per capita income (measured in purchasing power parity US dollars). Clearly, people from poor countries feel themselves better off as they move up the income scale. But beyond some level of income---about US$15,000 per head in the diagram---getting richer doesn't seem to affect happiness very much. Crucially, this result ---that as people in rich countries get richer, they don't gain in happiness (and sometimes actually lose)---holds for cross-sectional and time-series (longitudinal) data,

and for both Britain and America. When ‘happiness’ is plotted against income for the past 50 years---a period over which real income both in the UK and the United States has risen more than fourfold---a similar result obtains. People consider themselves ‘no happier’ although their standard of living (including life expectancy, health, nutritional status, survival rate of children and so on) is vastly higher. Why is this so?

One answer might be that as income increases, so too does extra effort and work-related stress. While there is casual evidence for this hypothesis---eg, traders and financial analysts in the City of London may earn a lot of money but suffer too from early ‘burnout’---the weight of evidence points overwhelmingly in the opposite direction. The incidence of physical and mental illness is considerably higher amongst those in poorly paid, low-status jobs. Even today, in all the rich OECD countries, the poor are at great risk and die younger than the rich.

Another answer, an argument unpopular amongst many economists today but put by Alfred Marshall at the end of the 19th century, is that extra money income has ‘diminishing marginal utility’; ie, an extra sixpence may mean nothing to a king, but to Mr Micawber it represents the difference between misery and bliss. The more money we already have, the less we value an extra pound, dollar or euro---indeed if one already owns several Rolls Royces (the Sultan of Brunei is said to own 350)---what pleasure can there be from buying yet another? Indeed, this was the main justification for progressive taxation first proposed by Adam Smith and implemented throughout the developed world in the first half of the 20th century. The few economists, like Lionel Robbins at the LSE in the 1930s, who resisted progressive taxation did so on the grounds that we could not prove scientifically that an extra unit of income was less valuable to a millionaire than to a pauper, an argument which is still kicking around today.

3. Happy relative to when and to whom?

The most satisfactory answer to the question of ‘why we are no happier’ is generally given by psychologists. They point out that an individual’s ‘happiness’ cannot be defined

in a manner which leaves out his or her social context. We derive satisfaction from our situation because we make comparisons in at least two different ways; we compare our current situation with our past situation, and we compare our current (and past) situations with those of others. We tend to derive satisfaction if our status has improved within our peer group---and economic status is one of the dimensions of perceived social status. Equally, we derive satisfaction from being better off today than we were yesterday---although far less so from being better off today than we were a decade ago.

Take the point about time-comparison first. Why are we happier if we have recently been made better off, and less so the further in the past was our change in fortune? An important part of the answer lies in the fact that we adapt to a change in fortune. If we buy a new and bigger car, the novelty value will be strong at first but will wear off as time passes. A year from now we will have got used to our new car, and two years from now it will no longer be new. Our new-found satisfaction soon wears off, and to renew it we must trade-in the old and keep purchasing, as indeed we are urged to do by ceaseless and ubiquitous advertising for every manner of new gadget.

When I see a picture of myself taken at my desk many years ago, I marvel at the fact that I once had to bash away on a portable typewriter and correct my mistakes with typing fluid. My experience of computers then was going to the university computer centre with a stack of punch-cards and marvelling at the huge IBM 360/65 on which, with luck, the cards might be processed within a day. Today, both my laptop and my desktop computers are many times faster than was the old university mainframe, and infinitely more convenient to use----not just for solving mathematical problems but for word processing, surfing the Internet and a myriad of other uses quite unimaginable at the time. In short, part of the reason we feel little extra satisfaction today from being far richer than a generation ago is that we have adapted to our new material goods and comforts which, in effect, we take them for granted.

Comparisons made within our peer group are equally important. When I was a student, I did not need a new car or a new laptop---still less the latest pair of Reeboks, Levi jeans or

mobile phone---because none of my friends owned those things. Then, just as now, we tended to judge our standard of living not in absolute terms but relative to that of our peers. But not only do our personal peer groups change over time, so do peer groups in general. Fashion industry advertisers make millions by convincing young people that it's cool to wear this or that brand, particularly when the accessories are advertised by superstar footballers, basketball players or other celebrities.

Perhaps what is most important to note about comparisons made with our peer group is that we derive our relative status from it. Put most simply, if Joe Bloggs's brother-in-law gets a hefty salary rise and Joe does not, he may feel that his relative status has fallen---or equally important, Joe's wife may feel unhappy. Indeed, it is generally recognised amongst labour economists that trade unions are often more concerned with maintaining their members' income position relative to that other skilled workers than with the absolute size of their increase in wages. The welfare economist's basic principle that a Pareto improvement is a desirable outcome---that as long as one person's income rises and everybody else's stays the same, society is better off---is not only deeply misleading, it flies in the face of today's evidence about how we perceive our well-being. Relative income matters!

4. Keeping up with the Joneses

As long as our peer group is relatively modest in its perceived needs, the pressure to keep up with the Joneses is reasonably benign. But as anybody who has raised children and/or observed their changed spending patterns over the past two decades knows, we (in Europe and America) live in a culture where the pressure to keep up has greatly increased---as has the potential social stigma associated with failing to do so. Our children's generation is probably the first to have been specifically targeted for its disposable income.

We have moved towards an 'aspirational' culture, one in which our aspirational consumption horizons are continuously being widened.[4] Moreover, this seems to be as true for the rich as it is for those who live on modest incomes. Take holidays: two

generations ago, only the very well-to-do 'toured' continental Europe; today, average working class families are looking beyond going to Ibiza, next year to Disneyworld in Florida and the year after that perhaps Sydney or Phuket. Equally, the reasonably rich who last year perhaps were thinking of a cruise on the QE2 observe the very rich hiring a NetJet to fly to some private and exclusive holiday island. With an aspirational culture comes the notion of an 'aspirational income'---the income we would need to feel that we can satisfy our desires.

The numerous surveys asking people what they feel they need to earn all reveal an interesting pattern. Aspirational income tends to rise in line with actual income. If you earn £20,000 per annum, you understandably may feel that £25,000 is what you really need to meet your needs, but if you earn £200,000 a year, survey evidence suggest that you will feel you can only survive on £250,000. Frank reports for example that for workers in New York City, their estimates of a 'minimum comfort' budget have approximated about half of the US per capita income level over the whole of the twentieth century.[5] As a country's income rises, our peers are better off and our view of the basic necessities we require, our 'minimum comfort' income, rises accordingly.

What all this means is that today, almost irrespective of our position in the income ladder, we are likely to feel we need more, and therefore to work even longer hours to get it. However, once we have more income, we soon adapt to our new living standard, take it for granted and feel we need to earn even more. Equally, the more you earn, the more I feel I must earn even more. Once on the 'hedonic treadmill'[6], not only do we need to run ever faster to stay in the same place, but there seems to be no getting off.

At the same time, one must be careful not to moralise about consumption, as though consumption were itself a bad thing and the solution to the anxiety and stress of status-seeking were simply to change one's lifestyle; to step off the hedonic treadmill. Doubtless modern techniques of marketing and advertising help internalise consumption norms, just as these same techniques play on the perception that maintaining one's socio-economic status requires buying the latest Reeboks for the kids, an ever larger television,

car, house or whatever. But we cannot therefore simply dismiss it as 'turbo-consumption' driven by the moloch of capitalist greed. Neal Lawson, once advisor to Gordon Brown, appear to do just this:

> Welcome to the consumer society and the world of the turbo-consumer. It's a world driven by competition for consumer goods and paid-for experiences, of hi-tech and high-end shopping signals that have become the means by which we keep score with each other. … On these terms the new poor are falling far behind in an age when keeping up is everything. … So if you want the causes of crime then look no further than the impulse of the poor to belong and be normal. So strong is this urge that the failed consumer will lie, cheat and steal to "earn" the trappings of success. In the world of the "me generation", people become calculating rather than law-abiding in their overwhelming desire to be normal. This is crime driven by the rampant egoism of turbo-consumerism, where enough is never enough. And precisely because of its competitive nature, consumer-driven crime cannot be switched off through tougher laws.[7]

What's wrong here is not that the new poor are driven by rampant consumerism, it's that they are poor; or to paraphrase Bill Clinton, 'it's inequality, stupid!' Certainly, consumers may be short-sighted in their purchases, unduly influenced by advertising or subject to peer-group pressures to 'keep up.' But what is alarming is that the poor fall far behind because they have unequal access to education, decent housing, well-paid jobs and, in general, to the opportunities traditionally taken for granted by the middle-classes.

Consumption is driven by many things, such that for most people most of the time the decision to purchase is entirely legitimate. We have access to a variety of goods---from washing machines to mobile phones---which are technologically far superior to those we could buy ten or even five years ago, assuming we could buy them at all. The migration of textile manufacturing to China and other parts of the Third World may mean that some workers in the West lose jobs, but Chinese peasants gain jobs in urban industry, western workers find new employment and western consumers benefit from the stable prices made possible by low wages in the periphery. Many of the components in my computer's motherboard are likely to have been assembled in Taiwan or The Philippines. But I could certainly not be wiring this book without it, or for that matter without high-

speed internet access and a host of other goodies the modern world affords a family living in relatively prosperous circumstances in Europe or America. The reader will forgive this apparent digression, but it serves to make the point that attacking consumerism *per se* is hardly the point in rich societies where many people remain poor and opportunities for advancement are so unequally distributed.[8]

5. Addicted to Work?

The 'hedonic treadmill' provides a partial explanation of why we sometimes feel ourselves to be addicted to work. In the Anglo-Saxon world at least, the term 'work-life balance' has gained wide currency recently. It seems to imply that we work too much and leave insufficient time for family, friends and leisure pursuits---that we must re-establish a more satisfactory balance between the apparent need for greater material comfort for which we work, and our emotional and spiritual needs as social beings.

Indeed, the evidence of the hours we work is worth considering. Americans work far more hours per year than Europeans, and amongst European countries, the UK tops the list in hours worked per annum. This was not always true. In 1960, average hours worked were about the same in the USA as in Germany, France and the Benelux countries. Today, the data show clearly that while the average American worked about the same number of hours per year in 2001 (1821 hours) as he or she did in 1979----just over 1800 hours per year---- the average European worked fewer hours. For the Eurozone, the average number of hours worked per year has fallen from about 1750 in 1979 to about 1500 today.[9]

Some economists treat national differences in hours worked as reflecting 'social choice'.[10] But the high and growing number of hours worked in the USA and the UK are not in any sense a reflection of different countries' leisure preference. Not only do Americans work longer hours per year, they work more years than their average EU counterpart. This in part reflects the fact that the average European has longer paid holidays and is more likely to have more generous retirement arrangements. It also tells us something about relative poverty on both sides of the Atlantic. A larger number of

Americans fall below the poverty line than in Europe---reflecting far greater inequality in the USA---and many of the poor have no access to the social and/or health insurance generally taken for granted in continental Europe. Such people have little 'choice' about the optimal trade-off between work and leisure; they work long hours merely to survive.

Economists are addicted to abstracting sociological phenomena in the form of simple models. One such 'textbook' model is that minimum wage legislation severely limits the supply of relatively low-skilled and part time jobs available in the service sector. In consequence, since industrial employment is universally on the decline, the unskilled in America hold down some form of job while Europeans swell the ranks of the unemployed.[11] Since numerous studies show that the employed are always happier than the unemployed, it appears to follow that Americans benefit from their more 'flexible' labour market. On closer examination, however, this argument turns out to be nonsense. A number of European countries, particularly in northern Europe, have stronger employment protection laws, a higher minimum wage and an unemployment rate which is either comparable to, or lower than, that of the US.

Another economist's abstraction which purports to explain this difference merits more careful attention. Psychologists regularly report that people are more 'rivalrous' about income than they are about leisure. In other words, if you and I are neighbours and your income goes up by 10% while mine stays constant, I will feel unhappy. But if your holiday allowance goes up by 10%, I am unlikely to lose much sleep over it. If this is true, then your extra income carries an 'external cost' (ie, a cost not registered by the market) for me, but your extra leisure time does not. In effect, the market overvalues the social benefit of extra income relative to leisure, and so the market mechanism cannot be relied upon to strike a socially optimal balance between work and leisure. This argument provides a powerful---and often overlooked---justification for setting a legal limit to the working week and providing everyone with annual paid holiday leave.

6. A Weakening Social Fabric

There is a good deal of evidence that as job stress increases, as geographical mobility

increases and traditional social bonds loosen, and as income inequality increases and the subjective perception of social status declines for those less high on the income ladder, social satisfaction falls; ie, society becomes 'less happy'. The classic study of weakening social fabric is Robert Putnam's *Bowling Alone.* Layard, Putnam and others have argued that if people live where they grew up, close to their parents and their old friends, they are more likely to be happy. On the other hand, if people are highly mobile, they feel less bonded to the people among whom they live; crime appears to be lower when people trust each other, and that people trust each other more if fewer people are moving house and the community is more homogenous.

Figure 3 Percent of population in Britain who think most people can be trusted

Year	%
1959	56
1981	43
1995	31

Source: Layard (2003c), Table 3.

Consider the accompanying data. In Britain in the middle of the 20th century, over half of people surveyed felt that 'most people can be trusted'; by the end of the century, this figure had fallen to less than one-third. Similarly, in the United States in 1951, when people were asked whether their lives were as 'as good, honest and moral as they used to be,' about half of all people respondents agreed; by 1998, only about one-quarter agreed. Naturally, such evidence is less 'hard' than, say, measuring the incidence of crime or mental illness. But it does tend to confirm the intuitively plausible hypothesis that, in the Anglo-Saxon world at least, a combination of factors---all-pervasive individualism, geographical mobility, lack of job satisfaction and insecurity, social inequality---has left people less trustful of one another.

A somewhat more complex argument has to do with the relationship between social trust, co-operation and the cash nexus. An interesting Swiss experiment suggests that individuals assume collective responsibility when called upon to do so as citizens rather than as 'consumers'. In the early 1990s, citizens in Swiss cantons were asked to vote on whether they would be willing to have a waste dump in their community. Two social scientists did an attitude survey revealing that, although such a dump might be toxic and

would almost certainly lower property values, about half of respondents thought it their duty as citizens to approve the proposal.[12] Now for the interesting bit! The respondents were then asked whether they would accept the waste dump if they were given an annual payment equivalent to just over what the average Swiss would earn in a month. Although it was expected that this payment would provide an additional incentive, the proportion approving the dump fell from 50% to 25%.

The apparent paradox illuminates the manner in which we perceive our interests as citizens and as consumers. As responsible citizens, a considerable proportion of respondents would accept putting up with an annoying civic duty. But when offered a cash incentive, these good burghers in effect were being told to put aside their role as citizens and see themselves instead as consumers, the economist's utility-maximising agent weighing up extra inconvenience against extra cash. In this role, for most respondents the cash reward on offer was insufficient. There is doubtless a moral here for those politicians who see collective services as commodities to be packaged and sold to 'customers' rather than citizens; to those who would 'modernise' the public realm of collective goods by introducing greater consumer choice in an artificially created market.

Psychologists' surveys yield all manner of interest findings. A particularly well-know example (one of my favourite) involves a group students at Harvard University who are asked to choose between the following two worlds:

- World A: You earn $50,000 and others get half that;
- World B: You get $100,000 but others get double that.

Most preferred world A. But then they were asked to choose between two further worlds:

- World C: You get 2 weeks holiday and others get half that;
- World D: You get 4 weeks holiday but others get twice that.

Most preferred D. In the first case, the choice of A in preference to B suggests that we are less concerned with the absolute level of income we earn, and more with our income

status relative to others; one may be poorer in World A, but one is at the top of the ladder. In the second case, the absolute length of holiday outweighs the relative status of getting shorter holidays than others. This result may in part reflect the high value Americans place on leisure time because, unlike income, they have so little of it. But, mainly, it suggests that income status is a far stronger social marker than leisure status.

But think a bit more about the above. Although these students were not economists, they thought very much like 'textbook economic man'. Their choices were clearly not made on altruistic grounds. In the example above, the utilitarian should prefer those outcomes where the collective benefits from both the highest income and longest holidays: ie, choices B and D. But market-driven individual choice does not necessarily lead to 'the greatest good for the greatest number'; once again we are talking about the difference between choice in the individual and collective spheres. What people choose as consumers may differ from what they chose as citizens, and as the sphere of collective choice is narrowed or eliminated, social policy must suffer.

7. Happiness and Utilitarianism

Layard, although he recognises that happiness is an elusive concept, is unapologetically utilitarian---in my view, unacceptably so. He argues that people, once they are well-off, get very little satisfaction from growing richer. Logically, this is a variant of Marshall's 'diminishing marginal utility of money income' discussed above; ie, the richer you are, the smaller the satisfaction of receiving an extra unit of income. At the same time, Layard espouses strict utilitarian principles. 'The good society is the one where people are happiest' he says, '[a]nd the right action is the one which produces the greatest happiness.'[13]

Various objections can be raised to the notion that maximising happiness is either definable or useful. For one thing, happiness is not easily measured; indeed, if defined narrowly enough to be measurable, it may be trivial. The academic psychologist Daniel Nettle expresses the dilemma clearly:

> The problem with the concept of happiness is trying to make it do enough without making

> it do too much. If we define it narrowly as a certain type of feeling or physiological state, then we can, in principle, measure it objectively, but it is too trivial a thing to be the foundation of all public life and private decisions. On the other hand, if we define it broadly as something like 'the elements of the good life', then it is so broad as to beg the question, and certainly too broad to be measured in national statistics. Yet we intuitively feel there is something called happiness, something unitary but not trivial, concrete enough to strive for yet broad enough to be worth striving for. [Nettle, D (2005: 5)]

The utilitarian principle enjoining us to strive to attain 'the greatest good for the greatest number' is even more problematic since, unless carefully qualified, it can lead to impossible dilemmas: for example, torturing a prisoner may yield information that will save a hundred innocent lives, but does that justify the use of torture? A non-hypothetical and still-controversial example is the argument in favour of dropping the atomic bomb on Hiroshima and Nagasaki in 1945---that it was justified because it led to an immediate Japanese surrender, thus saving millions of lives. Clearly there are a very large number of such examples, real and hypothetical, suggesting that Bentham's 'felicific calculus' is flawed.

The above are fundamental objections to Layard. At first, it seems odd that he adopts the Utilitarian injunction because of his dissatisfaction with the selfish individualism of *homo economicus*, or textbook man. Look a bit more closely and you will see that Layard's 'happiness' appears suspiciously similar to neo-classical 'utility,' and that maximising total happiness (what welfare economists call a 'social welfare function') in the manner he proposes raises a number of well-known problems of rationality, transitivity and majority voting first explored by Nobel-laureate Kenneth Arrow.[14]

What are these problems? Put most simply, assume there are three individuals (A, B and C) who maximise their own utility (or happiness) and four alternative ways of dividing $100. The alternatives are:

1. A gets nothing; B and C get $50 each;
2. B gets nothing; C and A get $50 each;
3. C gets nothing; A and B get $50 each;

4. divide the $100 equally amongst A, B and C who get $33 each.

It will be apparent that in our three-person world there must always be a majority against the egalitarian choice (ie, choice 4). The above is a simplified example of what economists know as the 'Arrow Impossibility Theorem.' Although solutions to this paradox have been found by adding a variety of qualifiers (such as 'weak' and 'strong' preference orderings), the Impossibility Theorem is just as fatal to Layard's goal of maximising happiness as it is to neo-classical welfare economics in general. As Joan Robinson once quipped, marginal utility is defined as an extra unit of happiness, while extra happiness is defined as marginal utility—an entirely circular state of affairs. To arrive at the egalitarian outcome which Layard wants, one must step outside of the world of Utilitarian 'felicific calculus' altogether into one in which social solidarity and altruism are central values.

In fairness, Layard does briefly step out of the utilitarian world when discussing the work of Robert Axelrod, an American political science known for his work on the social evolution of co-operation. There is a famous game in the social sciences called the 'prisoner's dilemma' in which two isolated prisoners can either act on the basis of their self-interest alone, which results in each getting a prison term, or co-operate and go free. The prisoners are isolated, so each must 'guess' what the other will do. Economists usually assume that each prisoner 'guesses' that the other will act selfishly, so making an unfavourable outcome to the game inevitable. Axelrod[15] has shown that when subjects are allowed to play the game repeatedly, they will ultimately converge on co-operation as their optimal survival strategy, and that this convergence is actually helped by occasional instances of selfishness in which non-co-operation results in punishment. But having considered Axelrod, Layard eventually returns to Utilitarianism using the following argument. I leave it to the reader to judge its merits:

> In the West we already have a society that is probably as happy as any there has ever been. But there is a danger that Me-First may pollute our way of life, now that divine punishment no longer provides the sanction for morality. If that happened, we should all be less happy. So we do need a clear philosophy. The obvious aim is the greatest happiness of all – each person counting for one. If we all really pursued that, we should all be less selfish, and we

> should all be happier. [Layard (2003c: 20)].

8. Efficiency versus Equity

The crucial weakness of Layard's book is that the author says almost nothing about redistribution. Having spent 250 pages arguing that: (a) more money does not buy prosperous people more happiness; and that, (b) we should seek the greatest happiness for the greatest number; Layard conspicuously fails to close his syllogism by arguing that income and wealth should be taxed at much higher rates. Instead, he posits that redistribution has an efficiency cost; ie, taxing the rich will affect their incentive to work, and thus slow down growth. If redistribution involves a trade-off between a larger pie and a more fairly distributed pie, then the economist must therefore use cost-benefit analysis to determine the optimal trade-off for every public policy measure.

> The pie shrinks as it becomes more equally distributed. At some point this efficiency cost of further redistribution will outweigh the gain in fairness. At this point we should stop any further equalisation, even though the rich man's dollar is still less valuable that the poor man's dollar… It is against that background that cost-benefit analysis of other government policies has to be done … If we then analysed all the possible policy changes one by one, we would ultimately arrive at the best possible outcome, given our initial resources [Layard (2005: 136-37)].

This is a disappointing conclusion to say the least. There is plenty of evidence to suggest that efficiency and equity may be positive, not negative, correlates (about which also see Chapter 9). Secondly, it is quite impractical, if not absurd, to suggest that cost-benefit analysis using income weights could be applied to every public policy measure. Cost benefit analysis is sometimes used for large public sector projects, but hardly ever with income weights.[16] The use of such weights has been aptly described as 'redistribution by stealth' by various cost-benefit specialists.[17]

Put simply, economists posit an equity-efficiency trade-off when deriving an upward sloping labour supply curve: the more you get paid, the more 'leisure' you are willing to give up in order to produce more output. There are several problems here. One is that the slope of the curve is hypothetical; one can just as logically assume that more labour will

be available at a constant price (as for example does Arthur Lewis in his famous article on economic development with an unlimited supply of labour). Another problem is that very high CEO rewards, as I have argued in a previous chapter, can neither be assumed to correspond to an equilibrium between supply and demand, nor to reflect the CEO's 'marginal' contribution to output. The market for CEO remuneration is quite simply inefficient. Under such conditions, even assuming labour supply generally to be upward sloping, redistributing income from overpaid CEOs in the US and UK to workers would bring about an efficiency gain rather than an efficiency loss.

Equally, there is no evidence that redistribution---say back to the equality levels last seen in 1970---would have a significantly negative impact on growth. No-one currently arguing the case for redistribution would suggest that we should move to a perfectly egalitarian utopia. The current debate is about making income tax more progressive---so that total tax incidence becomes progressive---and about changing the even-more-unequal distribution of assets. Post war Britain from (say) 1950 to 1973 was both more equal and grew just as fast. Several EU countries at present have a lower Gini coefficient and are growing at least as fast as (and more sustainably than) Britain and the USA. Frank (1999), amongst others, sets out a strong case for a return to progressive taxation and sets out a proposed consumption tax scale with a top rate of 70%..

Indeed, there are various studies suggesting that growth and inequality are negatively correlated in developed countries. Corry and Glyn (1994), surveying the post-war experience of OECD countries and dividing their data into pre- and post-1970, show that growth was higher and inequality lower in the former. Another study in Glyn and Miliband (1994), using a dataset drawn from the World Bank and the OECD for industrialised countries and covering the period 1979-90, found that more egalitarian countries generally have a higher rate of labour productivity. Alesina and Rodrick (1992) study 65 countries and find that where the top 5% and the top 20% receive a high share of income, growth is less strong than where more goes to low- and middle-income groups.[18] Frank (1999) argues that the evidence is now so strong as to be conclusive.

There are further weaknesses in Layard that deserve mention. For one thing, if the trade-off between equity and efficiency is accepted as self-evident, one can easily go on to accept a number of other related neo-liberal views; eg, the Laffer-type argument that lowering taxes can be self-financing; that trade union attempts to bid up real wages are self-defeating and so on. For another, the view that money does not buy happiness is a two-edged sword. While it may appear to promote the case for greater equity, it can equally be used to enjoin the poor to accept their allotted circumstances and to hope for happiness in the afterlife.

What Layard does suggest is that in order to reduce unhappiness, our societies need more psychotherapy.[19] I shall not consider the arguments for and against his proposals for tackling the mental health problem, except to say that the problem is undoubtedly serious and growing, and that it is clearly linked growing job stress, status anxiety and deteriorating social service provision. Such problems cannot be tackled without facing up squarely to the re-mergence of vast inequality in Britain and the US. The following passage from Glyn and Miliband makes the point succinctly:

> [W]elfare … depends on relative material circumstances as well as absolute levels of consumption. A sense of inferiority and social exclusion, which relative material deprivation engenders, clearly imposes huge social burdens on those affected. But their responses, which may include mental and physical illness and anti-social forms of behaviour, can in turn impose heavy costs on the rest of society in the form of health care costs, crime prevention and so forth … [R]edistribution can release society from some of these costs of exclusion, as well as liberating the economic potential of those excluded … [Glyn and Miliband (1994: 14].

9. Welfare Economics and Redistribution

Economics is probably the only branch of the social sciences in which an explicit trade-off is said to exist between equity and efficiency; perhaps this is why Mrs Thatcher renamed the old Social Science Research Council and believed, following Keith Joseph, that all forms of social welfare expenditure should be subject to cost-benefit analysis. In this section I shall argue that the standard theoretical justification for believing in such a

trade-off is logically incoherent.

Orthodox theory holds that the distribution of income results from the efficient working of the market—more specifically the labour market in which each is paid his or her marginal value product---and that the market should not be tampered with unless some form of market inefficiency (say, an externality) can be shown to exist. The assumption that the labour market functions perfectly is quite a strong one, but let us accept it for the moment. More specifically, welfare economics tells us that there is such a thing as a Pareto optimum: a point at which the optimality conditions are fulfilled by the equation of price ratios with subjective and technical rates of substitution for all pairs of individuals, goods and factors of production (sometimes called the *optimum optimorum*). Such a point is specific to a given set of equilibrium prices, and this set in turn is specific to a given income distribution. Any departure from such a point will, by definition, reduce efficiency and welfare.

Taking matters a bit further, students of welfare economics will be familiar with the Edgeworth box-diagram which, for any pair of individuals A and B, shows the locus of Pareto efficient points for all distributions between them, or what is familiarly known as the 'contract curve'. Any move off the contract curve violates Pareto efficiency conditions and is by definition unacceptable. Any movement along the contract curve, although it changes the distribution of income between A and B, does not violate Pareto efficiency. It follows that, as long as changes in the income distribution take place along the contract curve, we must be indifferent between any distribution of income between A and B, equal or unequal.[20] When generalised to all pairs of individuals, the contract curve becomes multidimensional. To any distribution---in some finite but very large set of efficient distributions---there corresponds a specific set of efficient prices, such that the set of all such efficient prices must be of cosmological dimensions. A moment's reflection will suggest that the orthodox neo-classical theory of factor rewards is circular; one must assume a distribution of income in order to arrive at a unique set of efficient prices, but if one must first assume an income distribution to arrive at factor rewards, one cannot claim that factor rewards *determine* the distribution.

Economists concerned with public policy have, for the most part, accepted the neo-classical theory of income distribution while acknowledging that in practice, policy changes that affect relative prices and/or the income distribution may not meet the conditions of strict Pareto optimality. A few economists---Hicks, Kaldor and Scitovsky are the best known---have proposed that when policy moves affect the income distribution, one should ask whether 'the gainer can compensate the loser and still be better off?' Such 'compensation tests' may be of theoretical interest, but since economists have never agreed on whether compensation should be hypothetical or actual, such tests are of no practical significance. Others have proposed games theoretical constructs under the banner of establishing a 'social welfare function', but such construct have proved neither fully logically consistent nor capable of resolving the distributional problem. The best that can be said of welfare economics is that it is theoretically at an *impasse*; few economic courses today bother to teach it. Its applied branch, cost-benefit analysis, was extended in the 1970s in order to explicitly incorporate explicitly redistributional ends by means of weighting income gains and losses according to which income class they accrue, but this extension has been so rarely applied as to make it practically insignificant.

Consider, too, what recent research on the effect of inequality tells us about equity and efficiency. In welfare theory, any move along the contract curve is a zero-sum game (A's gain is B's loss); since there is no efficiency loss, A and B continue to divide the same total pie. But any move off the contract curve is inefficient in the sense that the pie is reduced in size. Or put the other way, if we are not on the contract curve, any move back onto it will be Pareto efficient in the conventional sense. But this does little justice to a variety of other possibilities.

Suppose us to start from a position off the contract curve, a plausible hypothesis in any word where growth shifts the production possibility frontier outward and price adjustment is less than instantaneous. How do we share out the increase in output resulting from getting back on it? Pareto optimality tells us that even if all the extra

output is arbitrarily assigned to B thus leaving A no better off, we can posit a welfare gain. Sociologists and psychologists would cite experimental evidence suggesting that as a result of A's arbitrary reward, B is *relativel*y worse off. Or again, suppose B initially to be far poorer than A, but in consequence of As gain the two are made equal. A's gain (materially, in self esteem and so on) might greatly outweigh any loss of status felt by A, who was previously richer. Or again, supposing A to have some degree of altruism, he or she might feel more comfortable in a situation where B was lifted out of poverty. We can posit any number of outcomes, some of which will involve a gain in efficiency more than offset by an equity loss (a negative sum game) or both an efficiency and equity gain (a positive sum game). The salient point is that welfare economic theory provides no clear guidance here.

Finally, let us relax the assumption that labour markets are efficient, a step which seems justified both because the neo-classical theory of factor rewards is logically flawed and because it bears little relationship to the empirical evidence cited in earlier chapters suggesting a break in the link between wages and productivity. After all, it is very difficult to defend the efficient labour market assumption in Britain and America where, for more than a generation, enormous gains have accrued to those at the apex of the income distribution while a quarter of the population lives below the poverty threshold.
It should be apparent that we cannot relax this assumption while continuing to claim that greater equality necessarily entails an efficiency loss. The following quote from the introduction of Glyn and Miliband (1994) is instructive, particularly in light of the latter's association with the New Labour project:

> [W]hile it has become conventional wisdom since the late 1970s to assert that advanced industrial societies face a severe 'trade-off' between equality and efficiency, the empirical research suggests that the assumption is at best unproven, and at worst wrong. …[W]hilst some redistributive policies may have some disincentive effects, the effect on efficiency is [usually] only a small percentage of the sum redistributed…. It is perfectly sensible to frame redistributive policies so as to minimise such effects, but it cannot possibly be argued that a priori they undermine egalitarian policies.[21]

It is not enough to say that the society in which we live is unjust without providing some alternative benchmark. I shall not attempt here to give more than a crude definition of what I consider a 'distributionally fair' society---crude because it implicitly conflates 'society' with the nation state (thus ignoring international redistribution) and fails to consider fairness between generations (which would mean looking at the inheritance of wealth, the environment and so on). Clearly, no-one, and certainly not Marx, intended that 'distributional fairness' should imply a utopia in which wealth and income are forever distributed in perfectly equal shares.

The definition offered by the widely-respected American political philosopher, John Rawls, in his 1971 book, *A Theory of Justice*, is a good starting point. Rawls's view of a just society makes individual liberty is the over-riding principle, and resource endowments are so distributed as to be acceptable to a potential new entrant to society whose social position is unknown to her or him before entry---or behind what he calls the 'veil of ignorance.' Rawls thought that an individual behind such a veil would prefer a society with an egalitarian distribution of initial endowments, although he allowed that a degree of inequality might subsequently emerge. However, Rawls posited a fundamental trade-off between efficiency and equity; moreover, it was for Rawls a sufficient condition of 'fairness' that any improvement in ones position not leave anybody absolutely worse off, what economists call this a 'Pareto improvement.' One should add that Rawls, in contrast to many economists, was not a utilitarian; his notion of distributional justice does not depend on maximising 'utils' or subjective well-being.

Two points about 'justice as fairness' are far clearer today than they were 50 years ago, when *A Theory of Justice* was first published. First, in a 'knowledge based' economy, there may be no trade-off between efficiency and equity; indeed, as I have argued, the two are complements, not substitutes. The second point concerns how much we judge our welfare relative to others; ie, if one person is made better off, all others will be *relatively* worse off by definition. If *relative* deprivation concerns us—and I have argued that it must----a 'distributionally fair' society must include more than merely reasonably equal

endowments and opportunities; it must include a constraint on inequality; ie, the distribution of wealth and income.

10. Conclusions

I have argued that Layard's concept of happiness, by his own admission based on a utilitarian view of society's maximand, is deeply flawed. Not only is it internally inconsistent, but it begs the crucial issue of distributional equity. In Britain and the United States far more than in other advanced countries, a highly inegalitarian distribution of wealth, income and therefore opportunity mocks the very notion of meritocracy, or of 'fairness'---a term I much prefer. After all, when speaking of developing world, no-one would argue that a peasant in a village in Africa or India has the same 'opportunity' to get ahead in life as the average middle-class member of a rich Western country. Everyone would accept that a child is deeply disadvantaged if he or she is from a village in which there is no electricity and running water, where the nearest clinic or school is several kilometres away and where life expectancy is less than 40 years. That is not to say that no individual can never escape from such an environment, but rather that the probability of doing so is drastically reduced by the initial conditions described. Similarly, it should be obvious that a representative child growing up in Harlem or Hackney is seriously disadvantaged compared to one in Westchester Country or in Surrey.

Evidence reviewed by Wilkinson (2005) on mortality, life expectancy, literacy and various other social indices all points in the same direction: the steeper the inequality gradient, the more unequal the playing field. In order to live in a 'meritocracy,' young adults must start life with a reasonable chance---note that I say 'reasonable', not 'perfect' chance---of competing successfully, or advancing on the basis of some fortuitous combination of brains, determination and hard work. Not only are such conditions absent in America and Britain, but both societies seem to be moving further away from ever providing 'equal opportunity.' This is true both in a material and ideological sense.

Materially, inequality has grown hugely and now approaches levels last seen in the

1930s. Ideologically, the neo-liberal concept of personal responsibility has served as a means of privatising the notion of collective action. First under Reagan and Thatcher, and more recently under the New Democrats and New Labour, it has become increasingly common to hear that the poor must be motivated to work, cured of 'welfare dependency', made to get on their bikes and so forth. It should be obvious that 'getting on your bike' is not a solution if a growing number of qualified people are competing for a limited number of jobs. In the same vein, 'curing' welfare dependency by making all benefits contingent on being in employment not only assumes that an adequate number of jobs exist, but that the extra income earned can be used to fully offset the deleterious effects of devoting fewer hours to the care of one's children. And while a more flexible and deregulated labour market is though to 'encourage' the poor to worker harder, often for lower pay, no such logic is applied to the captains of industry. Far from weaning them off the sort of welfare that a 6- or 7-figure salary confers, we are told that growing filthy rich is glorious, that top people need further financial incentives if they are to create shareholder value and that only by continuing to provide these in abundance can we meet the challenge of globalisation.

I have argued, finally, that the body of economic theory used to rationalise inequality---centrally, the neo-classical theory of factor rewards and the corollary assumption of a trade-off between equity and efficiency---is empirically flawed and logically incoherent. Strictly speaking, it is not necessary to invoke the principle of 'diminishing marginal utility of income' nor excoriate consumer demand theory in order to defend greater equity. Equity is fundamental to social solidarity; it lies at the heart of what we understand to be a 'fair' society, as argued for example by John Rawls. At the same time, empirical evidence (or lack of it) is relevant. There is no evidence to support the view that CEO rewards are either determined in some good approximation of a perfect labour market or that their pay reflects marginal productivity. The evidence points almost entirely the other way, namely, to the fact that German and Japanese executives perform at least as well as their American and British counterparts who are paid a great deal more; or again, to the observation that relatively egalitarian Nordic countries where welfare standards are high and wage-salary differentials low are at least as dynamic as the Anglo-

Saxon countries.

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Endnotes:

[1] The HDI was developed in the early 1990s and is used in the annual *Human Development Report* published by UNDP.
[2] See Sen (1987).
[3] In this section I rely heavily on the excellent discussion to be found in chapter 1 of Nettle (2005).
[4] The notion of 'aspirational' or 'positional' goods is originally from Fred Hirsch (1976); Hirsch further qualifies 'positional goods' as goods in fixed supply which can be 'consumed' only a few times or even once in a lifetime; eg, a Harvard or an Oxbridge degree, a country mansion, a bottle of rare wine and so on.
[5] See Frank (1999: 74).
[6] See Layard (2005: 48).
[7] See Neal Lawson, 'Turbo-consumerism is the driving force behind crime' *The Guardian*, June 29, 2006.
[8] I am indebted to Jennifer Shaw of the University of Sussex for comments on the 'drivers' of consumerism. For the sake of brevity I have omitted a critical discussion of the notion that the 'range of choice' of public goods should be market-driven, that super-casinos expand choice and so on.
[9] See OECD *Employment Outlook*, July 2002.
[10] For example, see Turner (2001).
[11] A recently published variant on this sort of argument is Alesina A, Glaeser E and B Sacerdote (2005).
[12] The survey, by Frey and Oberholzer-Gee, is reported in a number of articles and books; I have used B Schwartz, 'Stop the Treadmill', *London Review of Books*, 8 March 20
[13] See Layard (2003c: 16).
[14] See Arrow (1963).
[15] See Axelrod (1984).
[16] Some 30 years after the appearance of the textbook written by Little and Mirrless (1974) recommending the use of a 'free foreign exchange' numeraire and explicit intra-temporal distribution weights, the World Bank has adopted the former convention but still not the latter. Nor, to my knowledge, has any national planning authority.
[17] See Irvin, G (1979).
[18] The evidence, including the above sources, is set out at some length in chapter 15 of Frank (1999).
[19] See Mental Health Policy Group (2006) *The depression report : a new deal for depression and anxiety disorders.* Project Report. Centre for Economic Performance, London School of Economics and Political Science, London, UK. (aka, the 'Layard Report on Mental Health')
[20] The basics are to be found in most textbooks on Welfare Economics, but I have always found Maurice Dobb's (1973) *Theories of Value and Distribution since Adam Smith* to be particularly helpful.
[21] See Glyn and Miliband [eds] (1994), *Introduction*, pp. 2 and 13-14.