

CPI Bias and Happiness

Our nominal income rises every year. But what about our real income – our “standard of living”? In order to answer that question, we have to accurately measure inflation. If we understate inflation, we’re getting richer at a slower pace than we think. If we overstate inflation, we’re getting richer at a faster pace than we think.

Most economists, sadly, just forget about the issue and pretend that standard measures of inflation are solid. Most specialists, however, have long believed that the standard CPI does indeed overstate inflation- and this consensus keeps getting stronger. CPI Bias is alive and well, so we’re materially much better off than we think. “There is no Great Stagnation” – say it non-ironically, as you should.

On reflection, however, there is a shocking implication. Happiness researchers – yes, even Justin Wolfers! – have almost uniformly found little effect of income on happiness. If official statistics understate real income growth, what should we conclude?

Simple: *Income’s effect on happiness is even smaller than it looks!* According to Winship, for example, U.S. real income from 1969-2012 plausibly rose not by 16% (the standard estimate) but 45%. Yet our happiness still barely budged.

How is this possible? The leading possibilities:

1. *Hedonic adaptation.* As Epicurus would predict, human beings quickly psychologically adapt to greater riches. The more you have, the more you take for granted.
2. *Relative income.* Another possibility is that human beings mostly care about how much they have *compared* to others. So it doesn’t really matter if the price index says we’re 45% richer or 16% richer; either way, what we really want is to be in the top 1%.
3. *False consciousness.* If you keep falsely telling people their income is stagnant, they’ll believe you and feel disappointed.

Where, though, does the truth lie?

The overwhelming factor, in my view, is hedonic adaptation. Materially, Americans are far better off than they were during my childhood in the 1980s. Yet hardly anyone *appreciates* the wonderful new and improved products they’ve received.*

The relative income story, in contrast, is frail indeed. Why? Because income has little effect on happiness *even at a single point in time*. As I explained in my discussion with Wolfers, his results imply that raising happiness by one standard deviation requires an

increase in annual income of over \$800,000. So stop conflating indifference with envy.

What about false consciousness? I doubt it's a huge factor, because most of us lack the patience to heed so-called "opinion-makers." The people too pragmatic, and the pundits are too boring. Still, I can easily believe that doomsayers make us feel 10% poorer than we really are. And in a well-functioning culture, I can easily believe that honest recognition of our good fortune could multiply this effect by negative one. In other words, a shift from our pessimistic narrative to an optimistic one would make us feel about 20% richer than we currently do. (Remember, though, how small a change in happiness that implies!)

At this point, I can picture Tyler Cowen remarking, "You're a bigger pessimist than I am. According to you, we're richer than we think, but riches don't matter much for happiness, so who cares?" The whole point of optimism, though, is to say, "You may not be happy, but you should be." If you want to meme that as, "Optimism is pessimism about the dangers of pessimism," so be it.

* Aside: Thank you, oh great producers, for the wonderful new and improved products I have received at your hands. For verily you have redeemed my adulthood from the gray bleakness of my youth, and blessed me with vibrant abundance.