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THE ECONOMICS OF HAPPINESS

Give Your Workers Something to Smile About

By BRUNO S. FREY

Who hasn't dreamed of owning a big luxury house in the country where you could relax by the pool and enjoy all that wide open space, rather than remain stuck in the poky city apartment you live in now? Surely that would result in a better quality of life, people reason.

Not necessarily. That city apartment is probably closer to work, while the sprawling manse would likely involve a much farther daily commute and could only ever be enjoyed on weekends. Which is better: a bigger house and a longer commute, or a smaller house and a shorter commute?

In making this trade-off, more often than

not, people overestimate the utility they will receive from goods serving extrinsic wants. In other words, they opt for the longer commute, believing that the pleasures of the dream home will compensate – and invariably suffer lower life satisfaction as a result. In a German study on this exact issue, it was found that people who commuted to work the sample mean of 22 minutes each way would need an additional 35 percent of their monthly income just to feel as satisfied with their lives as people who did not commute at all.

In study after study, people who spend more time commuting report lower life satisfaction. Neither a higher salary, nor a better living environment, nor a lower rent will

ever fully compensate for the burden experienced by commuting. Yet people consistently overestimate the future utility of extrinsic rewards, like better job offers and fancier housing options, and overlook intrinsic factors like the physical burden of commuting day in, day out, and the reduced time with friends and family which, in reality, that involves.

On one level, people know it won't be easy, but they do it anyway, opting again and again for more material goods, only to end up feeling less rewarded. Why is that?

A simple "consumption critique" is not enough to explain this phenomenon, because in talking about individuals not choosing what's best for them, what is "best" is still evaluated according to outside preferences. Why people find themselves worse off according to their own best interests requires a different analysis – one that new research on "happiness" is finally beginning to tackle.

When Will We Learn?

If the life goal of human beings is to be happy – indeed, the "pursuit of happiness" is enshrined in the U.S. Declaration of Independence – then a fuller understanding of which factors contribute to happiness is critical.

Recent research on the determinants of happiness appears to be at odds with long-held economic theories. The traditionally conservative bias of the economics field makes it all the more difficult for new findings to penetrate through the received wisdom.

Yet, for managers, the new learning coming out on happiness holds important implications for companies – when it comes to formulating organizational policies, for example, or

determining which institutional forms best enable individuals to increase their life satisfaction.

These issues occupied me in my work at the Institute for Empirical Research in Economics at the University of Zurich. It is a highly interdisciplinary group, which draws insights from psychology, sociology and political science, and is willing to depart from standard economics if useful. We aimed to apply happiness research to draw policy conclusions. I have also presented on this topic at many conferences and lectures around the world. This led to my appointment, in 2005, as Distinguished Fellow of the Center for Economic Studies' Institute for Economic Research (CE-Sifo) at the University of Munich, resulting in a lecture series and book. This article draws upon that material.

Traditional economics uses income as a suitable, though incomplete, proxy for welfare: The more you make, the happier you'll be. Assumptions such as this have informed economic theory for decades. But happiness, as we discover, depends on a multitude of factors other than money. It seems mundane to have to repeat the old chestnut, "Money doesn't buy happiness," but so few seem to have truly taken it on board.

Why is there little or no learning? Learning is a complex process. In general, people learn better if multidimensional choices are boiled down to essentially one dimension – which is why a simplified choice expressed solely in monetary terms is much easier for individuals to grasp. An elaborate process of mental gymnastics is required to make decisions for today, based on selective recall of experiences from the past, about something with untold consequences in the future. The ability to step back from your own decision-making activity in order to make an overall evaluation and undertake critical self-examination is extremely difficult and prone to errors.

It seems the one thing that we have learned to do well is coexist with an unsatisfactory state of affairs. A common example is that people often talk about their difficulties and mistakes in balancing work and personal life, yet they repeatedly make the same decisions that underestimate intrinsic attributes (non-material, leisure-time pursuits) relative to extrinsic attributes (more work, more pay, more material goods). Distorted decisions like these become accepted and preserved over time.

Where standard economic theories fall

■ EXECUTIVE SUMMARY

Economics is undergoing a remarkable new development, which may even be called revolutionary. This development is likely to change economics substantially in the future. New insights from happiness research are slowly being accepted in standard economics, a field which is traditionally conservative. If the goal of most human beings is to be happy, then a fuller understanding of which factors

contribute to well-being is critical, especially if recent findings on what determines happiness are at variance with standard economic theories. Happiness research is even more important in helping to determine which institutional forms best enable individuals to increase their life satisfaction. The author offers some policy areas for managers to consider, which may boost the happiness quotient of your company.

short is that they make assumptions based primarily on revealed behavior. Utility, therefore, is inferred by objectively observing the decisions that people make, rather than probing the underlying reasons why people make them. Happiness research, on the other hand, says that a more subjective parameter is needed. Although harder to measure, the psychologically sounder notion of individual well-being provides at least complementary, if not better indicators of life satisfaction than allowed by mere economic utilitarianism.

One example of a puzzle requiring further explanation is the well-established “Easterlin Paradox,” so named after the economist Richard Easterlin, who famously observed that even though the real income of countries has risen since World War II, the self-reported subjective well-being of the population has not increased; in some cases, it has even fallen slightly. Consider the United States: Between 1946 and 1991, per capita real income rose by a factor of 2.5, but over the same period of time, happiness, on average, stayed constant. Even more striking is Japan, where between 1958 and 1990 the relationship between income and happiness diverges like a pair of open scissors. Clearly, the tremendous rise in income and material goods there – the presence of an indoor toilet, washing machine, telephone, color television, car – was not accompanied by any increase in life satisfaction.

How is this possible? Happiness research offers possible explanations for this and other empirical puzzles.

ADJUSTING TO EXPERIENCES. The “Easterlin Para-

dox” does more than serve as a healthy reminder that there is more to happiness than income level alone. It also hints at the capacity of human beings to adjust to new experiences. Sure, additional material goods may have provided an initial extra boost of pleasure, but it wears off over time.

WANTS ARE INSATIABLE. As people adapt, they aspire to more. The more one acquires, the more one wants. This circle is never-ending.

SOCIAL COMPARISONS. Rather than make absolute judgments (“My life is, without a doubt, 100 percent better today than it was 50 years ago!”), people prefer to make relative comparisons. One Swiss study found that individual aspiration was closely tied to the average income levels of the community in which an individual lived. The richer one’s neighbor, the higher one’s aspirations.

These findings hold lessons for job promotions, as well as the acquisition of material goods. A promotion makes people feel good for a time, but also raises their expectations for more promotions. Once they have achieved something, they want to achieve even more. Also, when people project into the future, they predict that they will be better off than they are today, not realizing that their expectations will have adjusted over time, so that they will usually feel dissatisfied in the future.

Managers can look to such findings for new ways to manage the needs of their employees, instead of relying on the single, tired lever of income. Those managers who understand the “aspiration treadmill” tendencies of their employees could motivate those who feel “stuck” by encouraging them to look wider, say, by offering new challenges and projects. Alternatively, they could provide further training and development opportunities to raise the bar of achievement.

Processes Matter as Much as Outcomes

Another important driver of happiness is transparency. People like to know what’s going on, and they certainly do not like to be cheated. Research in 49 countries throughout the 1980s and 1990s shows that accountability and keeping corruption under control bring substantial benefits – in some cases, benefits greater than those derived from increased productivity or economic growth.

This does not mean that economic variables such as price stability and employment are not important for creating an atmosphere

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of well-being, but that simply focusing on instrumental outcomes alone, such as costs, benefits and monetary payoffs, tells only part of the story, a story in which non-economic variables play key roles in determining a happy ending. Furthermore, against a background of epic scandals, from Enron to Bernie Madoff, the renewed focus on improving corporate governance and increasing social capital would appear to be well-founded.

Given the current economic climate, we are starting to see greater acknowledgement of the idea that individuals enjoy *procedural* utility, quite apart from the concept of utility as it is practically used in much of economics. Procedural utility recognizes that people also value the conditions and processes that lead to outcomes, rather than narrowly focusing on instrument-oriented outcomes themselves. Yes, people care about outcomes, but they also have preferences for how these outcomes are generated.

This side has been largely neglected up until now, but is closely tied to happiness. While happiness may not be a realistic goal in itself, more the side product of a "good life," this different approach means that the processes and institutions under which people live and act are themselves independent sources of satisfaction.

As a concept, procedural utility injects a central tenet of social psychology into economics: People care about how they perceive themselves and how others perceive them. In their quest for self-determination, people look to relevant procedures that serve their basic needs for autonomy, relatedness and competence. Are they able to organize their own actions? Do they have control over their own environment? Do they feel connected to others? Are they treated with care and respect? Do they experience themselves as capable and effective in their orbit? By serving these innate needs, procedures, not the outcomes traditionally studied by economics, ultimately contribute the most to individual well-being.

Happiness at Work

Given that people evaluate actions taken toward them not only by their consequences, but also by how they are treated by others, procedural utility acquires great relevance when it comes to setting organizational policy. Institutions, through labor law and company statutes, have an indirect effect on individuals' well-being by motivating and restricting how people are treated on a regular basis in their daily working lives. If organizations bear in mind that people have preferences for the ways in which decisions are made, they can make a difference when considering the following aspects.

WAGES. It is well known that workers often resist nominal pay cuts. However, it depends on how these changes are communicated. It has been shown, for example, that employee reactions to pay cuts are less adverse if they feel that the process has been thoroughly and sensitively explained. In a British study, workers reported higher satisfaction when they were involved in compensation questions, with satisfaction equal for high-wage workers as for low ones.

With so many companies downsizing or freezing pay in response to the economic crisis, it would be a good idea for companies to give more thought and spend more time communicating the rationale behind each and every move they make, resulting in a better outcome for all.

HIERARCHY. In controlled empirical tests conducted in Germany, the U.K. and Switzerland, self-employed people reported higher job satisfaction. A similar phenomenon occurred after the fall of the Berlin Wall. Large numbers of people from former East Germany suddenly moved from government-controlled jobs into self-employment, and they reported higher job satisfaction than their counterparts who remained employed over the same period. Why?

The answer is that individuals prefer independence over subjection to hierarchical decision making. Hierarchy interferes with an individual's need for self-determination. Moreover, the freedom to act independently

carries value in itself, which is why self-employed people, who tend to earn less and work more than similar employed people, can say they feel more satisfied overall. Again, the idea that individuals only care about income is contradicted by much evidence that autonomy is preferable to more money, and people feel happier as a result.

Organizations should consider carefully the profound impact that their own hierarchical systems and structures may be having on the satisfaction of their employees. The way companies structure themselves may need to be changed. Meanwhile, improved communication might make up for any deficiencies in the current structure, which leads to the next point.

PARTICIPATION. Open communication is key. Individuals gain satisfaction from being involved and feeling included. For example, in the case of a company undertaking a project with negative side effects – say, building an airport near a residential area – a straightforward cost/benefit analysis would normally result in the company offering financial compensation to the losers. However, remedial action based solely on the price system rarely works; in fact, the individuals who stand to lose out tend to view monetary compensation as a bribe, something to which they fundamentally object. Bribery disregards people's sense of self as decent citizens, and so generates negative procedural utility. Indeed, empirical studies have shown that, rather than persuading people, monetary compensation has the opposite effect, and public support wanes.

A more effective approach would be to engage with the individuals affected, as they are more likely to accept a worse outcome if they feel they have been genuinely listened to and the process has done justice to their concerns. In the case of the airport, if the company offered to insulate homes as a means of protection against noise pollution, the opposing parties might be more amenable, largely because it shows some consideration of their unfortunate position and seeks to address their legitimate concerns.

When it comes to making unpopular decisions, one study ranked procedures in order of preference: Negotiations and bargaining came first by far, followed by a democratic referendum. Less than a third considered a decision by lottery as acceptable, and only a few saw the price system as an acceptable procedure. Now ask yourself, which is your company's first resort?

FAIRNESS. This is highly relevant in organizations: Fairness or justice matters for employees' behavior and satisfaction, especially in times of change such as these. Areas where fairness is of paramount importance are during mergers, layoffs, restructuring and strategic planning. Another area is human resources. Procedures for staff selection, performance evaluation and compensation need to be spelled out clearly. Organizational policies and rules need to have fair processes, with employees being given advance notice before major decisions are taken, along with the opportunity to have their say. Fair procedures help shape and resolve conflicts when bargaining with trade unions, too.

Without doubt, procedural utility is a relevant part of what is valued by individuals when they work in organizations. If this is so, the question arises: How should this change our understanding of the relationship between processes and outcomes? What is the right balance to be struck between "right procedures" and "good outcomes"? How can companies take into account pleasures and displeasures experienced through processes?

There are subtle cross-effects between outcome and process evaluations. In general, the quality of procedures is seen as more important when outcomes are bad, and less relevant when outcomes are good. In lawsuits, for example, people react negatively to unfair judicial procedures, especially when the verdict is against them; when the outcome is good, they care less about procedure, although they still care to some extent.

Take another example, that of pay determination. If you were paid less in a year because your performance was weak, but the process was extremely fair, would you be more satisfied with your pay? Yes, in part, because you would still favor a fair procedure over an unfair one. But there's a rub: If the procedure is fair, it means you have to acknowledge your responsibility for the unfavorable outcome, whereas if it was not, you could blame the authority for the bad outcome.

This reveals the subtleties between outcomes and procedures. In real life, the balance between outcomes and procedures frequently involves trade-offs and varies in relative strength depending on the case. Managers need to pay careful attention to the interplay between processes and outcome if they are to fruitfully integrate procedural utility into their existing economic approach.

People adjust to their baseline level of happiness, even after negative life events. Thus, those who face lower incomes because of the crisis will adapt and eventually be no less content than before.

Keep Smiling

Clearly, this research has much to tell us through its insights into the determinants and the nature of happiness. Summarized below are some of the main features, which, when viewed from the perspective of current, leaner times, provide learning as well as opportunities for change.

- Economic conditions are important, but so are non-material aspects. The current economic downturn may enable people to devote more of their newly freed-up time to being with families, friends and developing social ties. This, in turn, could help them recover faster or redefine their sense of happiness.
- People adjust to their baseline level of happiness, even after negative life events, although the speed of the adjustment varies according to income, employment and other factors. Thus, we could say that those who face lower incomes because of the crisis will adapt and will eventually be no less content than before.
- People compare themselves with others. While it is true to say that unemployed people are, generally speaking, less happy than employed people, unemployment lowers their happiness less if they are not alone with their particular fate, such is the power of reference groups. So, when unemployment is seen to hit many people one knows or hears of, both the psychological and social effects are mitigated. Self-esteem is better preserved because it becomes obvious that being out of a job is due more to general economic conditions than to one's own fault. Stigma and social disapproval are less prevalent if unemployment hits many other people at the same time. British data between 1991 and 1996 bears this out, finding that unemployed people suffered less when their partners and/or a large proportion of other people living in their region were also out of work.

This is not to say that it is better to lay off all your workers rather than just a few

employees, so that everyone can be equally miserable together, but rather to underscore the point that all happiness is relative. It also helps explain why people can remain optimistic in the face of unemployment rates of 20 percent.

But don't lose sight of the main point: that unemployment makes people unhappy, and people's propensity to identify with those around them means that the mere fear of being unemployed, or their worry for others who are unemployed, also results in their own unhappiness. Therefore, when laying off workers or offering people early retirement, one should always try to point them toward alternative job options or some meaningful occupation that will contribute to them finding happiness.

- Volunteering and helping others has been found to boost happiness substantially, as do religious engagement and constructive personal contacts. For those who find themselves with more time on their hands, these are some of the more constructive ways forward.
- Culture seems to have little effect on what determines happiness. This is good news, as it means that these findings are universally applicable and, therefore, easier to implement in this globalized age.

Happiness Policies

Based on these insights, the following are some policy areas to consider – with the caveat that these may not all be effective. As mentioned earlier, happiness largely depends on each individual. Moreover, despite empirical evidence that such policies might be good for them, people are slow to realize it. That said, these suggestions may increase all-around well-being, at work and play.

WORK FLEXIBILITY. This is the most effective measure, especially given the growing number of dual-income households. One policy would be to increase the availability of part-time job options. Another would be to redistribute work by matching needs and skills. Other measures are

creating additional jobs for the unemployed, enabling retired people to continue working, and coordinating work remits with a realistic amount of leisure time.

Making work from home a viable option for some jobs would be a welcome leap forward. For those who live farther away, this would have the added advantage of reducing commute days and the stress involved with that. It would fulfill a key human need for autonomy. Granted, we are a long way from this utopia, but companies should at least be inching in that direction.

LESS ADVERTISING ON TELEVISION. Research shows that extensive television viewing makes people less happy, as they compare themselves with impossible ideals. Reducing exposure to unattainable false goals by reducing advertising exposure, or encouraging responsible advertising, is another option to help boost the happiness quotient.

SAFEGUARD AND IMPROVE ENVIRONMENTAL CONDITIONS. One's environment affects one's sense of well-being. Managers have a responsibility to make sure that workplace surroundings are pleasant and safe. Health and safety rules offer guidance, but a responsible manager would adapt these guidelines to improve his or her own particular environment for maximum effect.

REDUCE TOO MUCH MOBILITY. Research indicates that moving around too much ends important social relationships and support networks. Instead of rewarding employees with long-term overseas placements and transfers, companies could focus their efforts and budgets toward fostering reliability and loyalty within offices.

A "HAPPINESS INDICATOR" FOR YOUR COMPANY. Since the late 1980s, the Himalayan Kingdom of Bhutan has, with considerable success, strongly supported the national equivalent of this type of indicator, by proposing Gross National Happiness (GNH) as an alternative to the traditional Gross National Product (GNP). GNH seeks to describe prosperity in holistic terms and to identify actual well-being rather than consumption. Basic happiness is measured by the quality of nutrition, housing, education, health care and community life.

Organizations could adapt a similar approach. A Happiness Indicator could work as an antidote to rankings based purely on financial results, which would grade your organization according to non-material aspects

of human welfare such as social relations, autonomy, self-determination and subjective evaluations of well-being.

INSTITUTIONAL DESIGN. Given that a hierarchy goes against an individual's desire for autonomy, companies could aim to set up flatter management structures with autonomous units. Within this, managers could be encouraged and trained to have a consultative style of decision making.

A Different Path

This is only the beginning. There is still much interesting work to be done to help us better understand sustainable happiness. Critics may argue that this is nothing new, but happiness research can be considered revolutionary for opening up avenues and redressing balances in economics that have so far been discounted or woefully incomplete.

One final thought: People are naturally status seekers who have traditionally sought to distinguish themselves by money, rank, authority or power – all things that the latest research reveals are not the paths to finding true happiness, and which the crisis has seriously undermined and eroded. Therefore, as we rebuild a new, post-crisis era, it makes sense to seek new dimensions for distinction, in creative and imaginative ways. Might "happiness" become the way that individuals, including managers and employees, seek to distinguish themselves – in other words, by leading a "good life" founded on much better policies and practices than what we have resorted to before?

More specifically, in the case of organizations, much of the responsibility to make this vision reality inevitably lies in the hands of the decision makers. There is enough evidence here to say that if top management could assume their share of the responsibility for ensuring well-being, they stand a strong chance of reaping real and enduring rewards. □

Tima Batstone served as editor for this article.

■ TO KNOW MORE

- *Happiness: A Revolution in Economics* by Bruno S. Frey (MIT Press, 2008) is a product of the Munich Lectures in Economics awarded by the Center for Economic Studies of the University of Munich.