On knowing economics before criticising economics [1]

Written by **Tim Worstall** [2] | Friday 28 September 2012

So we've another of these fellahs trying to tell us that economics has got it all wrong. You know the sort of thing: economics doesn't consider pollution or other externalities. When half the subject in recent decades seems to have been about that very point. Or that it doesn't consider value to people properly, only thinks of what can be counted in lucre. When the very definition of economic value is the value to people, both monetary and non-monetary. Here's we've the wallah from the Institute for New Economic Thinking over in the US insisting that we've got to change economics once again [3]:

> But what happens when economists' implicit value assumptions break down? Take, for example, the so-called "Easterlin paradox," which teaches that when a person's income rises beyond what's necessary to meet their basic needs it does not increase their happiness. This doesn't match the standard capitalist economic assumption that rising personal wealth leads to increased individual fulfillment. Yet it's been proven time and again. And economics ignores this. Our textbook models remain unchanged.

There's two slight problems to this interesting little thesis. The first being that no one at all ignores the Easterlin Paradox. M'Lord Layard (as an LSE Professor and Labour Peer, ignoring the Old Etonian and Head of Pop bit, about as establishment a figure as it is possible to be) has based much of his happiness economics on this very point. The Spirit Level depends upon it and it's most certainly taught in an undergraduate degree in the subject. So to say that economics ignores this thus we must think again is a little odd. Almost as if the writer doesn't know that standard economics already incorporates what he says it does not.

The second little problem is of course that the Easterlin Paradox is in fact wrong. There is most assuredly a declining marginal utility to money. That last £10 of a £1,000 a day income brings less joy than the first £10 of a £10 a day one most certainly. This on its own leaves room for taxation, moving that £10 from a lower utility use to a higher one if that's what you're looking for. But declining marginal utility, a truth, is not the same as zero marginal utility, the claim. We actually find that there is indeed something of a break point, but that extra joy is still there, it just rises with the log of income rather than the amount.

So perhaps we should rethink economics and root out all of those conclusions that rely upon the Paradox being true after all.

My own assumption about what is really going on in the Paradox is that it isn't actually the level of income at all that makes the difference. It's the growth or not in it. In an economy that's humming along at the standard frontiers of technology pace of 2-3% then people are about as happy as economic growth is going to make them. Zero growth makes people less happy than this optimal rate: and a shrinking economy makes people very unhappy indeed as can be seen all over Southern Europe right now (note that if Easterlin were actually correct then falling incomes above that basic needs level would not make people unhappy. Not something I think we're currently seeing really). Happiness is thus correlated with the rate and direction of change of income, not the level of it.

But as I say, that's an assumption of mine, not something I'd really like to have to prove.

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