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Accident victims who suffer severe injury often become accustomed to their new circumstances after a period of depression. Similarly, lottery winners frequently return to a baseline happiness level after a time of euphoria. Although the capacity to adapt to changing circumstances has a powerful effect on well-being levels, this feature of the human condition is overlooked by the standard neoclassical model of choice which asserts that utility depends only on consumption. This article argues that the neoclassical model, which measures wellbeing by absolute consumption levels, fails to account for contributions to quality of life arising from both the human capacity to adapt and relative consumption.

Despite the fact that psychologists and certain economists have recognized the fundamental relationship between human well-being and sensitivity to change, such insights have yet to make their way into mainstream economic theory. Psychologist Harry Helson underscored the adaptive powers of the human nervous system in his pioneering book, *Adaptation-Level Theory*,[1] which noted that local conditions are relevant to how a given stimulus is perceived. For example, a resident of Havana feels cold on a 60º F day, while a resident of Montreal may find the same temperature warm. A different contextual point is made by economist Tibor Scitovsky who has argued that improving conditions, rather than merely good conditions in some absolute sense, contribute significantly to experienced pleasure.[2] The plausibility of these ideas militate against prevailing economic doctrine, which assumes that only absolute consumption levels are relevant to an individual's utility function. Standard models ignore the significance of relative consumption, even though consuming more than we did in the past, and more than others in similar circumstances, is an important source of satisfaction.

Consider the implications of introducing context into positive and normative economic analysis. In positive analysis, the consumer's frame of reference is significant with respect to both her own consumption over time and her consumption relative to that of others. With regard to the former, the permanent income hypothesis suggests that consumption should be equalized over time to maximize utility. This assertion is based on the implicit assumption that a given level of consumption produces a constant level of utility. By disregarding context, such a view fails to explain or predict that people may demand rising, rather than constant, consumption profiles. A better view considers the influence of previous consumption levels, providing a clear theoretical explanation for the obvious fact that people want to increase their consumption levels over time. Such a consumption pattern could be achieved by saving during the early years and dissaving during the later years, but in practice most people are unable to save sufficient amounts. Instead, people commonly seek out jobs with rising wage profiles. The desire for rising

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consumption profiles thus can explain the fact that in many occupations wages rise more steeply than productivity over the life-cycle.

Similarly, positive economic analysis would benefit from incorporating the effects of relative consumption on individual well-being. Traditional theories of savings predict no relationship between savings rates and income. Duesenberry argued that a relative income hypothesis, by contrast, implies that savings rates will rise with income. Strong empirical evidence from cross-section studies confirms that savings rates do rise with income.[3] Nevertheless, there is little attention given to the relative income hypothesis in leading intermediate macroeconomics textbooks.

Positional issues may also influence the distribution of wages within firms, as well as the distribution of total compensation between money wages and fringe benefits. Concerns about position may also prevent price increases which would remove excess demand in certain markets.[4] Alan Blinder has suggested that they may even explain the persistence of unemployment in the labor market.[5]

Incorporating contextual considerations would have enormous consequences for normative economic analysis. The most prominent implication would be the rejection of the first theorem of welfare economics, which asserts that competitive equilibrium will be Pareto optimal. Efficiency is no longer guaranteed once relative consumption is accepted as an argument in the utility functions of individuals. If relative consumption is important, each person's consumption imposes negative externalities on others. As a result, excessive resources will be diverted to producing and acquiring positional goods. People will consume too much and save too little. Competitive labor markets may also lead to inefficient outcomes, as people accept undesirable job conditions in order to compete for positional goods.

An appreciation of context would also benefit public policy, for example in analyses of tax incidence and of economic growth strategies. Traditional supply side arguments for reducing taxation on efficiency grounds miss the potential efficiency gains from taxing positional consumption. Since the acceptability of schools, houses, wardrobes, cars, vacations, and other budget items are determined by how much others are willing to spend, many such positional consumption goods appear more attractive to individuals than to society. Reducing the appeal of these goods through taxation will enhance a zero welfare and generate more federal revenues. Consider a young man in a country in which the custom is to spend two months salary on a diamond engagement ring. If he makes $36,000 a year, then he is bound by custom to pay $6,000 for a ring with a rather large diamond or else be considered a cheapskate. From a social perspective, it would be better if there was a 500 percent tax on what is now a smaller $1,000 diamond. With the tax, everyone would be buying smaller diamonds, while continuing to satisfy the custom of spending two months income. In this scenario, the young man suffers the same amount of economic hardship, his fiancée is no worse off, and the government receives a windfall; the only loser may be the deBeers diamond cartel of South Africa.

Contextual issues also affect the analysis of policies to spur economic growth through increased savings. The United States, which has the lowest savings rate of any industrialized country. Raising savings rates would lead to higher consumption after a period of adjustment; it is the

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lower consumption during the adjustment period that creates the practical barrier to achieving higher savings. But given the powerful human capacity to adapt, if everyone simultaneously adopted a savings rate that reduced everyone's consumption levels by, say, ten percent, the lower consumption level would quickly become the norm. The utility of the lower, but more rapidly rising, consumption level would soon overtake that of the relatively static level of consumption we now enjoy.

One theme persistently emerges from many of these examples: a level consumption stream at a given present value delivers less satisfaction than a rising consumption profile of similar total value. Rational utility maximizers can take advantage of this in two ways: by incrementally increasing the quality level of their purchases and by manipulating their consumption-based comparison group. The former strategy will lead to more benefits than following the standard "optimal" procedure, which requires the purchase of a higher quality level whenever its marginal utility compares favorably with other consumption opportunities. For example, if a $5,000 pair of stereo loudspeakers is ultimately your most favored choice, given your tastes and income, your lifetime satisfaction may be higher if you move to that quality level in stages, rather than all at once. Since much of the satisfaction to be derived from the $5,000 speakers stems from the difference in quality between it and your earlier set of speakers, adaptation to the new quality level will quickly eliminate this source of satisfaction. With respect to this latter strategy, individuals may exchange status in one area of life for improvement in another that delivers more value. For instance, an individual who enjoys socializing with friends and family need not acquire a high-ranked position among co-workers, seeking instead a wage premium as a lesser-ranked worker in a highly productive firm.

As all these examples suggest context matters for human satisfaction. Nonetheless, economists have been reluctant to incorporate context into models of consumption, perhaps because it conflicts with their "insistent preference for simple models of behavior". But increased complexity is justified by the greater explanatory power of models incorporating contextual features.

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1. Harry Helson, Adaptation-Level Theory (New York: Harper and Row, 1964).
2. Tibor Scitovsky, The Joyless Economy (New York: Oxford University Press, 1976).
3. James Duesenberry, Income, Saving, and the Theory of Consumer Behavior (Cambridge: Harvard University Press, 1949).
4. See Robert H. Frank, "Are Workers Paid Their Marginal Products?", American Economic Review (September 1984, 74, 549-71); "The Demand for Unobservable and Other Nonpositional Goods," American Economic Review (March 1985, 75, 101-16); Choosing the Right Pond (New York: Oxford University Press, 1985); Passions Within Reason (New York: W.W. Norton, 1988).
5. Alan Blinder, "The Challenge of High Unemployment," American Economic Review: Proceedings (May 1988, 78, 1-15).

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