

Testing the Rationality of Life Satisfaction Forecasts:  
Micro Evidence from the German Socio-Economic Panel.

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22/02/2010

Abstract

In this paper I test the rational expectations hypothesis (REH) using a unique data set on expected and current subjective life satisfaction from the German Socio-Economic Panel (SOEP). Considering the economic literature on REH testing and psychological evidence on so called hedonic forecasting, this paper derives a test of the REH that allows for both possible sources of biased expectations – biased expectations of future choice or market variables *and* of the future utility function. I use 17 waves of the SOEP (1991-2007) and match self-reported expected life satisfaction with its later self-reported realizations, generating 136,000 individual forecast errors of 24,000 individuals. These forecast errors are regressed on different sets of socio-economic variables at the time of the prediction, with a focus on age and current life satisfaction. I find economy-wide shocks in the transition period after the German reunification (1991-1993) and during Germany's New Economy stock market bubble (1998 – 2001). Further, results suggest significant micro-heterogeneity, with significant coefficients of age and current life satisfaction. The young and the very satisfied tend to positive errors (i.e. they are on average too optimistic) and while the elderly and the very unsatisfied rather commit negative errors (i.e. too pessimistic). These effect patterns occur separately of each other and persist if various socio-economic controls are included. Different specifications suggest that these effects are not driven by macro shocks, cohort effects, unobservable time fix effects or panel attrition, nor do they depend on cardinality of life satisfaction reports. A test of the model's predictive power shows that future average forecast errors can be predicted well by age and current life satisfaction. Finally related evidence from the Cantril 1960 surveys is presented, suggesting that the estimated patterns are not unique to Germany in the '90s but present in various countries over the past 50 years.

Keywords: Life Satisfaction Forecasts, Rational Expectations Hypothesis, Life Cycle, SOEP

JEL Classifications: C23, D03, D48, I31

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