Rethinking the Relative Income Hypothesis

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Abstract

This paper focuses on the understanding of the effect of relative income on health. Traditionally, relative income was expected to have a negative association with individual health by means of negative psychological effects. However, some studies report a positive effect or even no significativity. In other words, the empirical evidence is not conclusive.

In order to explain these results disparity in the previous literature, I use new evidence regarding the effect of income comparisons on individual well-being within a reference group, which might generate both, satisfaction and discontent. Thus, I expect that income comparisons might affect health through psychological well-being in both directions as well, depending whether the comparisons are “upwards” -individuals compare themselves to better off- or “downwards” -individuals compare themselves to worse off-, and not only through negative psychological effects, as it was suggested initially.

Thus, the aim of this paper is twofold. First of all in order to shed light on previous research discrepancies, I focus on the relationship between relative income and health based on a relative income measure, which allows us to distinguish between the effect of “upwards” and “downwards” income comparisons on health.

Secondly, I take into account the panel dimension of the data to control for unobserved heterogeneity, in order to correct for income endogeneity after a POLS transformation. This econometric technique transforms our ordered health variable (self-assessed health) into a “pseudo” continuous variable as proposed by Van Praag and Ferrer-i Carbonell (2004). Thus, traditional panel econometric techniques can be applied.

The analysis is based on the German Socio-Economic Panel (SOEP), which includes longitudinal income and health data for the period 1994-2008.

Preliminary results show that relative income is more relevant for health than absolute income. Income comparisons within group, both “upwards” and “downwards”, are statistically significant. These results might explain initial result disparities. Moreover, they are in the line of those who claim that individuals take advantage of belonging to a richer reference group.