Individual Utility Depends Only on Absolute Consumption

Robert Frank

» *The traditional economic approach states that an individual decline in income is the same as a collective decline by the same proportion. This is not only wrong but sometimes becomes an obstacle for much needed tax increases.*

Traditional economic theory assumes, preposterously, that a person's loss in utility when he alone suffers an income decline is the same as his utility loss when everyone's income declines by the same proportion. In fact, the person's loss in utility is much smaller when everyone's income declines.

Traditional theory's mistake is important because it causes people to overestimate the pain they'll suffer if they pay higher taxes in support of public goods. It is entirely natural to think that if you have less money, you'll find it more difficult to buy the things you want or need. That's because most of the events in life that cause us to have less money—think home fires, job losses, business reverses, divorces, serious illnesses, and the like—are ones that reduce our incomes while leaving the incomes of others unaffected. In such cases, we really do find it more difficult to buy what we want. Only half of the houses are in top-half school districts, for example, so we're less likely to be able to bid

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B.S. Frey, D. Iselin (eds.), *Economic Ideas You Should Forget*,
DOI 10.1007/978-3-319-47458-8_22

successfully on those houses if we have less money relative to others who also want them.

But it is a completely different story when everyone's disposable income goes down at once, as when we all pay higher taxes. Because across-the-board declines in disposable income leave relative purchasing power unaffected, they don't affect the outcomes of the bidding for houses in better school districts.

This is a garden-variety cognitive error. When we try to forecast how an income decline will affect us, we rely on the previous income declines that are most accessible in memory. And since most of the income declines we actually experience leave the incomes of others unchanged, we tend to forecast similar pain when thinking about the possibilities of a tax increase.

This cognitive error reinforces the tax resistance that has made it so difficult to restore our crumbling public infrastructure. Because across-the-board declines in disposable income don't affect relative purchasing power at all, prosperous families could actually pay higher taxes without having to make any painful sacrifices.