

- » Incentives
- » Inflation expectations
- » Intergenerational links in earnings
- » Weight and well-being

## Incentives

**Abhinav Muthoo** is director of the Economic Research Institute and chair of the Department of Economics

People respond to incentives. The current credit crisis, for example, has a lot to do with regulators and firms providing inadequate or badly designed incentives to financial sector employees. Until recently, policy makers did not recognize this or chose to ignore it. The financial regulations and institutional framework shape the incentive structure that “players” in financial markets face. These now need to be redesigned.

While economics is concerned with the allocation of scarce resources, it is equally about incentives. Laws, regulations, norms, and institutions create incentives for people to behave in one way rather than in some other way. Economists study the positive question of what incentives are created by different rules, norms, and institutions.

Economists also study the normative question of what rules, norms, and institutions can provide “good” incentives that lead people to behave in ways that are desirable. For example, divorce rates have increased in several countries. To address this problem, economists study how divorce legislation and social policies shape incentives for couples to seek divorce rather than make a

marriage work. Of course, this problem is about more than just incentives, but incentives have a big role to play.

The world faces serious problems such as poverty and deprivation, poor health and education, economic and social backwardness, violence and political instability. All require careful design of the laws, regulations, and institutions that create incentives for the various players – politicians, bureaucrats, managers, employees, firms, and NGOs – to behave well.

In addition, we should not forget that incentives that are provided to some people may affect how they provide incentives to others. For example, the bonuses that rewarded bank employees for selling mortgages to people who have turned out to be unable to afford them were shaped by the encouragement that politicians and regulators gave to bank executives to undervalue the risks in the housing market.

In sum, incentives matter. Much of economics is about incentives. The current disarray in the world economy shows we need better understanding of how incentives work, how they are established, and how they are passed on in regulated markets and organizations.

## Inflation expectations: forecasters’ views on the credibility of UK monetary policy

Since 1996, the Bank of England has carried out a quarterly survey of economic forecasters. **Gianna Boero, Jeremy Smith, and Kenneth Wallis** have analysed the results to assess respondents’ views on the central bank’s commitment to fighting inflation.

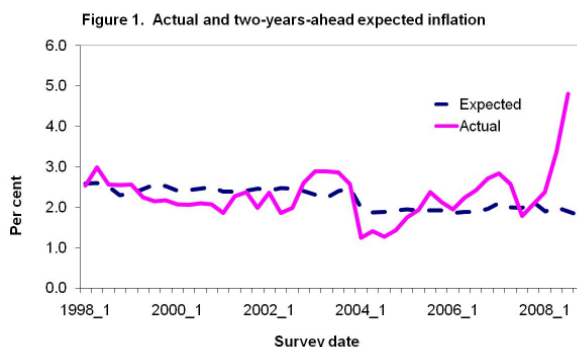
When the Bank of England was given operational independence to set monetary policy in 1997, it quickly gained the credibility to fight inflation and thereby reduced economic uncertainty. What’s more, our research finds that after an initial period in which the Monetary Policy Committee (MPC) gained credibility, the Bank was perceived by independent forecasters as being more credible than the US Federal Reserve in its commitment to tackling inflation.

### Independent economic forecasters trust the Bank of England to tackle inflation

As inflation reaches levels not experienced for several years and with strong recessionary fears in financial markets and the wider economy, the MPC’s credibility to meet its inflation target is being tested. But the evidence suggests that forecasters still trust the central bank to tackle inflation. In the Bank’s most recent quarterly survey, completed on 29 October 2008, expected inflation two years ahead has not responded to this year’s inflationary experience, but remains close to the Bank of England’s target, as shown in Figure 1.

Overall, the survey average forecast of inflation two years ahead has stayed close to the official inflation target irrespective of the actual inflation being experienced at the time the forecast was made. (The inflation variable shown is the official targeted variable at the time: the retail prices index, RPIX, target 2.5%, until the end of 2003; and the

consumer prices index, CPI, target 2%, thereafter.) This means that the City and other forecasters have believed and continue to believe the MPC’s commitment to fighting inflation.



This is important since if inflation expectations are moderate, then wage claims and price increases will be less severe than they would otherwise be. So controlling inflation expectations is crucial to controlling inflation itself.

Since 1996, the Bank of England has carried out a quarterly survey of economic forecasters from the City and independent think-tanks. This assesses how they think inflation will develop in the future, and the summary results are published in the Bank’s quarterly *Inflation Report*.

Because the survey asks respondents for their views on the probability that inflation will be within a variety of different ranges – for example, between 1% and 1.5%, 1.5% and 2%, etc. – it can be used to assess uncertainty about future inflation.

We have had access to individual responses to the Bank's survey for the period 1996-2005, analysis of which shows how the MPC, newly established following Labour's victory in the May 1997 general election, quickly obtained credibility.

---

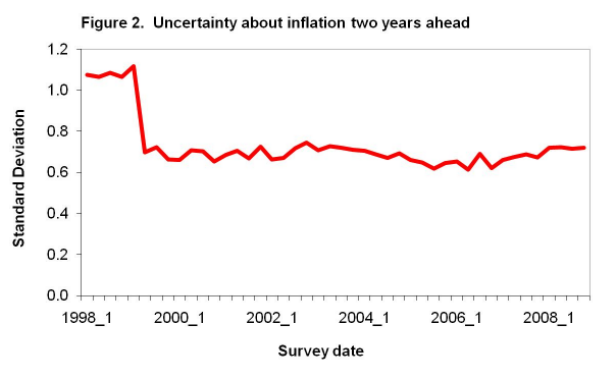
## UK uncertainty about the prospects for inflation has been consistently below US levels

---

Our survey-based measures of uncertainty extend the evidence on credibility presented in Figure 1. Figure 2 shows how uncertainty about inflation prospects two years ahead was sharply reduced after an initial period of learning and gaining credibility on the commitment of the MPC. It has been remarkably undisturbed since the turn of the century and, perhaps more remarkably, it has been undisturbed throughout 2008.

Comparisons with a similar source of data on US inflation expectations show that after this initial credibility-gaining period, UK uncertainty about inflation prospects has been below the US level.

This provides further evidence that “inflation targeting has helped to confer tangible benefits,” as argued by the Governor of the Bank of England in his 2005 Mais lecture. He cited the falling volatility of expected UK short-term nominal interest rates over this period, relative to the United States, as evidence that inflation expectations are better anchored under inflation targeting than they were before.



Although the article describing our research findings (published in the *Economic Journal*) is based on a period that ends in November 2005, Figures 1 and 2 use more recent information (up to the end-October survey summarised in the *Inflation Report* published on 12 November 2008). They show no diminution in forecasters' confidence in the MPC's ability to control inflation.

### Publication details

The paper on which this summary is based was published as “Uncertainty and Disagreement in Economic Prediction: The Bank of England Survey of External Forecasters,” by Gianna Boero, Jeremy Smith, and Kenneth Wallis, in the *Economic Journal* 118 (July 2008). Our summary is updated from the Bank of England's latest figures, published on 12 November 2008.

### The authors

Gianna Boero, Jeremy Smith, and Kenneth Wallis are respectively Associate Professor and Professor of Economics and Emeritus Professor of Econometrics at the University of Warwick.

---

## Intergenerational links in earnings: the impact of marital sorting and household labour supply

There is growing evidence of comparatively low intergenerational mobility in the UK and the United States. **Robin Naylor** and colleagues examine the role played by people choosing spouses like themselves and the decisions that couples make about the female partner's participation in the labour market.

Family background is an important determinant of economic well-being in adulthood. Children of rich parents not only inherit more wealth than children of poor parents, they also tend to have higher earnings themselves. What's more, this ‘intergenerational earnings persistence’ is often compounded by “assortative mating” or “marital sorting” – people's tendency to find husbands or wives with similar socio-economic characteristics to their own.

The strength of the links between the earnings of parents and their children – the degree of “intergenerational earnings mobility” – varies over time and across countries. In a new study, we present comparable evidence on intergenerational earnings mobility for Denmark, Finland, Norway, the UK, and the United States, with a focus on the role of gender and marital status.

We confirm our previous finding that earnings mobility in the Nordic countries is typically greater than in the United States, with the UK somewhere in between. But we also find that, in contrast to single people and married men, the earnings mobility of married women appears to be similar across the five countries.

When measuring outcomes in terms of married women's own earnings, the link between their earnings and their parents' earnings seems to be as weak in the United States as in the other countries. This stands in contrast to the relative immobility (stronger intergenerational links in earnings) of other groups in the United States.

But if outcomes are measured in terms of the earnings of whole households, intergenerational earnings mobility in the Nordic countries exceeds that in the UK and the United States for both men and women, single and married. The reason for this is that, in the UK and the United States, married women with children and with husbands from affluent backgrounds tend to have lower labour supply than in the Nordic countries.

---

### In the United States, women who marry rich men are relatively likely to opt out of the labour market, despite their own typically high earnings

---

In other words, women who marry rich men seem to respond to the high wages of their husbands by working fewer hours or withdrawing from the labour market altogether. It is the combination of assortative mating and households' labour supply responses that weakens the association between married women's own earnings and their parents' earnings.

We examine empirically how patterns of mobility by gender and across countries are attributable to differences in intergenerational transmission of earnings capacity, family labour supply and the extent of assortative mating.

The results show that the intergenerational transmission of human capital (educational attainment) is fairly similar across the five countries. But because the returns to

schooling differ across countries, the channel of human capital transmission leads to greater intergenerational earnings persistence in the UK and the United States than in the Nordic countries. In terms of earnings capacity, mobility is similar for men and women in all five countries.

As evidence of assortative mating, we examine the educational attainment of partners and find strong correlations within couples in all countries. Marital sorting tends to be slightly more prevalent in the UK and the United States.

---

### Men's earnings are highly correlated with those of their parents-in-law, especially in the United States

---

We also find a strong correlation between individuals' own education and that of their parents-in-law. Here, there is variation both by gender and across countries, with the correlation with the education of parents-in-law especially strong for men in the United States.

This pattern is reflected in our finding that men's earnings are highly correlated with those of their parents-in-law, especially in the United States. In contrast, the correlation between married women's earnings and the earnings of their parents-in-law is weaker in the United States than elsewhere.

These patterns of intergenerational mobility seem to reflect variations in family labour supply decisions across countries. We attribute the relatively weak correlation between married women's earnings and those of their parents-in-law in the United States to the fact that the effects of assortative mating are being offset by the effects of household labour supply decisions. Although women who marry rich men typically have high earnings potential themselves, they tend to choose low or no participation in the labour market.

As evidence of this, we present findings on the influence of the earnings of parents and parents-in-law on the labour supply of married men and women. In all countries, own parental earnings are positively associated with labour supply for men and single women. The same positive association holds for married women in the Nordic countries.

But in the UK and the United States, married women's labour supply is negatively associated with the earnings of both their own parents and their parents-in-law. This effect can be traced to relatively affluent households with children, where labour supply decisions seem to follow traditional gender patterns of within-family specialisation more than in the Nordic countries.

Thus, for married women, measures of mobility based on their own earnings are misleading indicators of the intergenerational transfer of welfare for the purposes of comparisons both within and across countries. Better measures would be based on combined family earnings or mobility in earnings potential.

#### *Publication details*

"Marital Sorting, Household Labor Supply, and Intergenerational Earnings Mobility across Countries," by Oddbjørn Raaum, Bernt Bratsberg, Knut Røed, Eva Österbacka, Tor Eriksson, Markus Jäntti, and Robin Naylor, is published in the *Berkeley Electronic Journal of Economic Analysis and Policy* 7(2): Article 7. Weblink: <http://www.bepress.com/bejeap/vol7/iss2/art7>.

#### *The authors*

Robin Naylor is professor of economics at the University of Warwick. Oddbjørn Raaum, Bernt Bratsberg and Knut Røed are at the Frisch Centre for Economic and Social Research at the University of Oslo. Eva Österbacka and Markus Jäntti are at Åbo Akademi University. Tor Eriksson is at Aarhus University.

---

## Weight and well-being: is obesity socially contagious?

How much of the rise in obesity is a result of people subconsciously "keeping up with the weight of the Joneses"? **Andrew Oswald** and colleagues find evidence that well-being is correlated with a person's body mass index, and that weight perceptions are influenced by comparisons with others.

The citizens of the rich countries of the world are approximately ten kilos heavier than they were a few decades ago. Some writers argue that this dramatic rise in obesity has been generated by falling food prices. But it is not easy to see how this trigger can be large enough to match the data – and the puzzle remains of why, if fatness is a response to greater real purchasing power, we routinely observe that rich people are thinner than poor people.

Other commentators speak of an obesity "epidemic," language that is evocative of the idea that fatness can spread from one person to another. Is it possible that weight gains can spread through a population in a way reminiscent of a contagious disease?

---

### More than one third of Europe's population view themselves as overweight

---

The starting point for our exploration of this question is the idea that people care about their status and position in society. We consider the possibility that just as people's happiness may depend on their relative income, so it may depend on their relative weight.

Personal appearance is immediately observable to others, and people have to compete for job promotions, sexual partners and much else. This means that choices about physical characteristics such as body weight may be determined – whether consciously or unconsciously – in a way that depends on other people's choices.

Studies have suggested that it is psychologically preferable to be unemployed in areas where there are many other jobless people. This is presumably for reasons of reduced stigma. For equivalent reasons, it may be easier to be fat in a society that is fat.

We document international patterns in well-being, weight, dieting and people's perceptions of being overweight, drawing on data from the Eurobarometer surveys, the German Socioeconomic Panel and three British data sets – the 1958 and 1970 birth cohort studies and the Health Survey of England.

Although much remains to be understood, we find evidence that comparisons and relative weight do matter – that people's body mass index (BMI) is influenced to some degree by their relative BMI. This is consistent with the idea that there can be a 'keeping up with the Joneses' effect, which manifests itself as a kind of obesity imitation or contagion.

---

### Highly educated people are the most likely to see themselves as overweight

---

Our study reaches a number of specific conclusions. First, we find that more than one third of Europe's population view themselves as overweight. In the entire sample of nearly 30,000 people – roughly 1,000 randomly selected individuals in each of 29 countries – 31% of men and 43% of women say their own weight is too high. For

any given BMI value, women are much more prone to feel overweight than men.

Moreover, individuals' perceptions depend on their socio-economic characteristics. For example, highly educated people are the most likely to see themselves as overweight once BMI is held constant. This suggests that people have different comparison groups, with the highly educated holding themselves to a thinner standard.

For European women, there is evidence that weight dissatisfaction and overweight perceptions depend not just on their own BMI, but also on their BMI relative to other people. The same may be true of dieting decisions.

Data on the nature of the relationship between people's BMI and their well-being suggest a mixed picture. In some cases, the effect is negative, confirming the presumption in much medical and psychological research that a high BMI is bad for physical and mental well-being.

But in other cases, the effect seems to be positive. This is a puzzle, suggesting the need for much more longitudinal research on the links between BMI and well-being. We are a long way from a deep causal understanding of the links between body weight and mental well-being.

But we do uncover some evidence in the German data that is consistent with comparison effects. For men in Germany, life satisfaction is greater among those who live in places where other people tend to be fatter.

All of these results should be viewed with caution. But there are some grounds to take seriously the possibility of socially contagious obesity.

#### Publication details

"Imitative Obesity and Relative Utility" was prepared by David Blanchflower, Andrew Oswald and Bert Van Landeghem for the NBER Summer Institute on Health Economics held in July 2008. The paper is available from:

<http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/oswald/ao23julyobesity08.pdf>.

#### The authors

David Blanchflower is Bruce V. Rainer Professor of Economics at Dartmouth College and an external member of the Bank of England's Monetary Policy Committee. Andrew Oswald is Professor of Economics at the University of Warwick. Bert Van Landeghem is at the LICOS Centre for Institutions and Economic Performance and the Department of Economics of the University of Leuven.

#### Further reading

Blanchflower, David, and Andrew Oswald. 2004. "Well-being over Time in Britain and the USA." *Journal of Public Economics* 88: 1359-86.

Blanchflower, David, and Andrew Oswald. 2008. "Hypertension and Happiness across Nations." *Journal of Health Economics* 27: 218-33.

Blanchflower, David, and Andrew Oswald. 2008. "Is Well-being U-shaped over the Life Cycle?" *Social Science and Medicine* 66: 1733-49.

Oswald, Andrew. 1983 "Altruism, Jealousy and the Theory of Optimal Non-linear Taxation." *Journal of Public Economics* 20: 77-87.

Oswald, Andrew. 1997. "Happiness and Economic Performance." *Economic Journal* 107: 1815-31.

Oswald, Andrew, and Nattavudh Powdthavee. 2007. "Obesity, Unhappiness, and the Challenge of Affluence: Theory and Evidence." *Economic Journal* 117: F441- 54.

Oswald, Andrew, and Nattavudh Powdthavee. 2008. "Does Happiness Adapt? Longitudinal Evidence on Disability with Implications for Economists and Judges." *Journal of Public Economics* 92: 1061-77.

---

## The University of Warwick Economics Research Institute

The ERI is an integral part of the Department of Economics at the University of Warwick. Its members include the academic and research staff and research students of the Department of Economics; visitors attached to the Department of Economics; and scholars from other institutions who are associated with programmes of research administered within the Institute.

The Director of ERI is Professor Abhinay Muthoo. You can contact Abhinay at [a.muthoo@warwick.ac.uk](mailto:a.muthoo@warwick.ac.uk).

The aims of ERI are to promote directly and indirectly research in economics and interdisciplinary research that has an economic aspect; to facilitate the funding and organisation of collaborative research projects involving the participation of members of the Department of Economics; and to support scholarly activities such as

conferences and research networks that extend beyond the routine scholarly life of the Department of Economics.

The Bulletin of the ERI appears once a term. Each issue features summaries of published or forthcoming research by ERI members. The Bulletin's editor is Romesh Vaitilingam. You can contact Romesh at [romesh@vaitilingam.com](mailto:romesh@vaitilingam.com).

The Bulletin is freely available in electronic format from <http://www.warwick.ac.uk/go/eri/bulletin/>. It is not copyrighted and may be reproduced freely with appropriate attribution of source. Please provide us with a copy of any material that you reproduce.

The mail address of the ERI is: Department of Economics, University of Warwick, Coventry CV4 7AL, United Kingdom.