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Fear is the Major Cost of Recessions

Andrew Oswald, Professor of Economics, Warwick University

Fear will be the worst consequence of the recession to come. Understanding the psychological damage from an economic downturn, and facing up to it in the way we design our economic policy, is Britain's best response to the tough times around the corner.

As many undergraduate students will begin to be taught this week, the textbooks tell us that recessions are costly for two reasons. First, recessions lead to unemployment. This wastes scarce resources – people's talents. Second, recessions lead to lower output and incomes. That is a loss of potential riches for our citizens.

Yet this view of recessions, we know now from the latest statistical research, is only half the story. Fear is the missing half. In an economic downturn, even those who do not lose their jobs or take a pay cut end up suffering a lot. Although routinely neglected by economic analysts, this generalised fear, because it is multiplied by everyone in the population, is the single biggest loss from a downturn in the economy.

The latest research has studied the mental wellbeing and life satisfaction levels of hundreds of thousands of randomly sampled Europeans through the last 3 great recessions. From the 1970s to the 1990s, this statistical work finds that there are clear patterns in mental wellbeing caused by the ups and downs of the economy. In a boom, everyone in a country is happier. In an economic slowdown, and this is the less predictable discovery, even those who keep their jobs and suffer no income loss show markedly lower levels of psychological wellbeing. In other words, it is not just those directly affected by a recession who are hurt.

This is important evidence, because it proves that the damage produced by a recessionary slide is more widespread than thought. We knew, of course, that the downside of business cycles was bad. We did not know how bad. In retrospect, it is probably obvious from everyday life that recessions make everyone fearful, but until economists began using psychological data there was no way to pin down the size of these effects.

So what is the right policy response to our new knowledge about the psychological damage that stems from recession? Strikingly, the case for generous unemployment benefits is strengthened. Benefits are more important than has been appreciated: those who have designed benefits systems in recent years have forgotten that a key rationale is to reduce the fear in a society. *As a nation, we pay unemployment benefits just as much for the good of our employed citizens as for the good of our unemployed citizens*. That is not properly understood.

In nations with advanced and generous welfare states, the new research finds, citizens are markedly happier than those in nations with stingy benefits. That is a problem for modern Britain: our country now has one of the least-generous benefit systems in the Western world. The ‘replacement rate’ -- the amount of income made up by the state when someone becomes jobless -- for a normal British family is only about 18%. Compare that to Denmark, where it is over 60%.

There is one good side to having weak unemployment benefits. It gets people motivated. Such a philosophy worked well in the prosperous 1990s, because weak benefits gave Britons sharp incentives. But a world recession now may bring a frightening reminder of what happens to human beings when you cut holes in their safety nets.

In the latest research, the happiest European countries from the 1970s to the 1990s were the small generous welfare-state nations of the Netherlands, Denmark and Belgium. The least happy were Italy and Greece, which have the weakest benefit systems in Europe (with Britain now next).

One old idea is that Europe's welfare state has led to the high unemployment that we continue to see in nearly all European nations (averaging today more than 9%, compared to 5% in the United States). Some say that Europe became too kind, in its setting of unemployment benefits, through the 1980s, and that millions of workers gratefully then accepted the dole as an easier option than taking a job. The evidence from happiness statistical research, however, does not support such a view. In most countries, the gap between the wellbeing of employed and unemployed people did not shrink over the last few decades. In the year 2001, being jobless in Europe remains as bad as ever.

The broader lesson from this way of thinking is that economists have too often forgotten the mind. Real economics is about human psychology.

The paper, The Macroeconomics of Happiness, written jointly with Rafael Di Tella of Harvard Business School and Robert MacCulloch of the London School of Economics is available as a downloadable October 2001 working paper on Andrew Oswald's website, www.oswald.co.uk.