

DOES THE RISK OF POVERTY REDUCE HAPPINESS?*

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Abstract

We investigate the unexplored link between the risk of poverty and happiness in the context of a developing country. Using unique longitudinal data, we estimate workers' vulnerability to income poverty and find a strong negative relationship between vulnerability and life-satisfaction, over and above a positive income effect. The result is robust and cannot be reduced to the effect of two-sided uncertainty. A matched behavioural experiment shows that respondents are significantly loss-averse. We conclude that downside risk is an important determinant of happiness and of economic decisions under uncertainty. Policies that mitigate downward risk may thus have direct impacts on both well-being and efficiency.

JEL codes: D60, I31, I32, D81, O12.

Keywords: poverty, low pay, vulnerability, risk, subjective well-being, happiness, loss-aversion.

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1 Introduction

Economic outcomes are often characterised by pervasive uncertainty. This is particularly true when insurance markets and safety nets are incomplete, saving opportunities limited, and many individuals rely on risky entrepreneurial activities to generate their incomes (Banerjee and Duflo, 2007). Poverty, which constitutes a possible outcome for many, has in turn profound impacts on the quality of the lives people live. Recent studies have shown that low income correlates with lower life satisfaction and with a larger loss in well-being following shocks in other domains of life (Clark et al., 2008; Kahneman and Deaton, 2010). In developing countries, where poverty is widespread, the correlation between economic outcomes and life satisfaction is even stronger (Howell and Howell, 2008).

In this study we investigate the relationship between the risk of income poverty and life satisfaction (interpreted henceforth as "happiness"¹), and the link between sensitivity to downward risks and decision-making. In particular, we tackle the following two questions. Is there a connection between happiness and the risk of poverty? And how are people's decisions affected by exposure to such risk?² While the connection between life satisfaction and low income has been heavily researched, the one between life satisfaction and the risk of income poverty is still unexplored. This is partly due to the challenges of estimating the probability distribution of income convincingly. At the same time, it appears to be a very important area of research, especially in developing countries, where widespread exposure to uninsured shocks makes the risk of future income poverty pervasive for both poor and

¹ Researchers distinguish two components of happiness (Kahneman and Deaton (2010)). The first component is life satisfaction: the evaluation we make of our own life. The second component is emotional well-being, or the tendency to experience positive or negative affect. In this paper we analyse responses from a survey question on life satisfaction and hence we focus the analysis on the first component. Throughout the text, we will use the terms "happiness" and "life satisfaction" interchangeably.

² We choose to focus on income, rather than consumption for two main reasons. First, we aim to link directly to the existing literature on subjective well-being, which has widely explored the relationship between happiness and income. Second, in urban contexts like the one we are studying, labour earnings are typically the main source of income and earning shocks are directly transmitted to consumption. Changes in income and consumption are hence likely to be tightly correlated. We fully acknowledge the difficulties that arise from attempting to measure income precisely in a low-income setting with widespread informality, such as Ghana, especially when self-employment is prominent. Section 2 provides a detailed discussion of the methodological challenges involved.

non poor households.³ Evidence is also missing on the connection between the determinants of happiness and those of decision making: are the same individuals whose happiness is sensitive to downside risk loss-averse in economic decisions? Vulnerability may affect individual behavior in ways that are detrimental to economic efficiency.⁴ Such evidence is thus a necessary first step towards a full assessment of the welfare effects of economic vulnerability.

The context of our analysis is the urban labour market in Ghana, a fast-growing African country. Ghana is an interesting setting for our analysis as the country experienced substantial poverty reduction in recent years (Nsowah-Nuamah et al., 2010) while, as our results will suggest, large numbers are still exposed to a significant risk of poverty. Given the novelty of the question and of the testing strategy, our results provide leads that may prove relevant in other contexts as well.

Our estimate of the risk of poverty builds upon the work by Chaudhuri (2003) and Chaudhuri et al. (2002), who propose two indices of vulnerability to poverty that are amenable to empirical estimation based on panel and cross-sectional variation respectively.⁵ Using data from the Ghana Urban Household Panel Survey (GUHPS), a long panel dataset gathered by the Centre for the Study of African Economies in urban Ghana, we obtain estimates of the two indices for a representative sample of working age Ghanaian earners. We focus more extensively on the panel measure, since it enables us to estimate individual-specific vulnerability. We further rely on the longitudinal nature of the data to investigate the relationships of interest, between the risk of income poverty and life-satisfaction. Improving upon most of the existing literature on happiness in developing countries, we are able to control for *individual fixed effects in the happiness model*, ruling out potential biases from unobserved personality traits. Previous studies have indeed highlighted the importance of unobserved heterogeneity in happiness regressions (Ferrer-i

³ For example, in a recent study of seven west-African capitals, Bocquier et al. (2010) construct a multi-dimensional index of employment vulnerability and find that 85% of private sector workers are vulnerable on the basis of at least one criterion in 2002-2003.

⁴ Throughout the analysis the term 'vulnerability' will be used to refer to 'the risk of falling below the income poverty line'.

⁵ The two indices are reviewed in a survey article by Ligon and Schechter (2004), who compare the performance of different vulnerability measures through Monte Carlo simulations.

Carbonell and Frijters, 2004; Graham et al., 2004; Powdthavee, 2010).

Our main result is *a strong negative relationship between vulnerability to income poverty and workers' happiness*, over and above the positive income effect commonly documented in the literature. It is both statistically significant and economically meaningful. Reducing the risk of poverty by 20 percentage points (which amounts to entirely offsetting the risk of poverty for the median worker in our sample) has the same effect on well-being as increasing earnings by 50%. When we bootstrap the estimation sequence to account for imprecision in the measure of vulnerability, the results do not change. Upon testing for the role of two-sided uncertainty as opposed to downward income losses, we find that the effect of downward vulnerability on happiness is more evident. These findings become more compelling when we consider the extent of the vulnerability to poverty we uncover. About 35 percent of all workers, and 15 percent of currently non-poor workers, face a risk of poverty of at least 50 percent. Vulnerability decreases the life satisfaction of a large pool of individuals.

In addition, we analyze the choices of a sub-sample of respondents in a set of behavioral games designed to elicit attitudes towards risky prospects. Our maximum likelihood estimates reveal that subjects are characterised on average by a substantial degree of loss aversion. We are careful not to collapse the distinct notions of experienced utility and decision utility (Kahneman et al., 1997).⁶ Our findings from the behavioral experiment show that, besides influencing subjective well-being, downside risk also has an appreciable impact on economic decisions.

Our work relates to two different strands of the literature. First, we contribute to the study of downside risk in developing countries. This literature has focused on measurement (Chaudhuri, 2003; Ligon and Schechter, 2004), on the persistence of downside shocks (Dercon, 2004; Dercon et al., 2005), and on the strategies employed to minimize and cope with shocks (Rosenzweig and Binswanger, 2003; Dercon, 1996; Fafchamps, 2003; Dercon

⁶ Decision utility refers to the weights that people assign to outcomes when making choices. Experienced utility refers to the quality of an experience. The life satisfaction question we employ in this analysis asks respondents to make an evaluation of the latter. The behavioral experiments allow us to make inferences about the former.

and Christiaensen, 2007; Fafchamps, 2009). Most importantly, our analysis contributes to the growing literature on the determinants of happiness. A number of empirical papers have documented a cross-sectional correlation between income and happiness (Kahneman and Deaton, 2010), which does not disappear once individual fixed effects are accounted for (Ferrer-i Carbonell and Frijters, 2004; Powdthavee, 2010). A separate concern has been that of adaptation: the happiness effects of income gains seem transitory and tend to disappear once income reference points have adjusted (Easterlin, 2001; Frey and Stutzer, 2002; Di Tella et al., 2007; Knight and Gunatilaka, 2008). The literature has also explored the effect of social comparisons on well-being (Blanchflower and Oswald, 2002; Kingdon and Knight, 2004; Luttmer, 2005). Our contribution is to highlight the fact that risk and, in particular, the risk of poverty is a major negative determinant of life satisfaction. Moreover, we show that the same people who manifest loss-sensitivity in life evaluation make economic decisions consistent with loss aversion.

The results of this analysis bear important policy implications that may generalise well-beyond the African context. Our findings provide clear motivation for policy interventions to reduce people's exposure to (downside) risk. They also suggest that non-Rawlsian models of growth, whereby "someone may be left behind", may fail to enhance general welfare despite rising average incomes, if the risk of falling behind is sufficiently widespread. Lastly, loss aversion motivates individuals to forgo economic opportunities that are profitable in expectation but may involve outcomes below the reference point. A reduction in vulnerability may result in efficiency gains too.

The article is structured as follows. Section 2 introduces the data we use in the analysis. Section 3 outlines the empirical strategy. First, it explains the methodology to estimate income vulnerability; second, it outlines the happiness model. Section 4 presents and discusses the results. Section 5 concludes.

2 Data

Our analysis is based on data from the Ghana Urban Household Panel Survey (GUHPS), which was conducted by the Centre for the Study of African Economies (CSAE) in the

cities of Accra, Kumasi, Takoradi and Cape-Coast starting in 2004.⁷ Respondents were drawn by stratified random sampling of urban households from the Population and Housing Census of 2000. The survey was designed to cover all household members of working age at the time of the interview. This paper focuses on the period between 2004 and 2009, when the survey was repeated every year with the sole exception of 2007.⁸ Panel datasets of this length are unusual in developing countries, and are particularly uncommon in Africa.⁹

A module on subjective well-being – designed in accordance with the existing literature – was added to the survey in 2005. Our analysis will focus on the answers to the following two questions: (a) *"All things considered, how satisfied are you with your life as a whole these days?"* (b) *"All things considered, how satisfied are you with your current work?"*. In both cases, the options given to respondents were: *"1. Very Dissatisfied, 2. Dissatisfied, 3. Neither Satisfied Nor Dissatisfied, 4. Satisfied, 5. Very Satisfied"*. Figure 1 depicts the distribution of answers. Responses appear to be skewed towards positive values. For our quantitative analysis, we attribute numerical values on a scale from 1 to 5 to these answers, where 1 corresponds to "Very Dissatisfied" and 5 to "Very Satisfied". Despite early criticism of their ability to accurately capture well-being (e.g. [Mullainathan and Bertrand \(2001\)](#)), these measures have been consistently used throughout the literature. Moreover, psychologists have recently been able to validate the use of these questions, by showing their correlation with other measures of well-being, such as smiling more frequently ([Graham et al., 2004](#); [Layard, 2005](#); [Oswald and Wu, 2010](#)).

⁷ The first wave was collected between the end of 2003 and the beginning of 2004, but for simplicity we will refer to it as 2004.

⁸ Subsequent survey waves were unavailable to us at the time of writing. Moreover, extending the analysis beyond 2009 would pose severe challenges due to a change in the survey question on life satisfaction introduced in 2010.

⁹ The panel is unbalanced, but attrition is not an absorbing state, in the sense that respondents who are not interviewed in a given wave are kept in the sample and re-interviewed in subsequent years. Out of the initial sample of respondents interviewed in 2004, over 92% were re-interviewed at least once more in the following years and about 65% are observed in at least 3 waves. Random attrition would decrease precision and pose a classical problem of attenuation bias in the happiness model. In this case, the large effects we estimate would be a lower bound of the true impacts. On the other hand, if the people whose happiness is least affected by the risk of poverty are most likely to drop out, our estimates may be biased upwards. Reassuringly, previous studies on this data have similarly found no evidence of selective attrition (see [Falco et al. \(2011\)](#) and [Falco et al. \(2015\)](#)). As a robustness check, the analysis presented below has been repeated on the strictly balanced sample of individuals who are interviewed in all waves and we find that this does not affect the results. The point-estimates of the coefficients discussed below do not change substantially, despite a drop in precision due to the fall in sample-size.

< Figure 1 here >

A selection of key summary statistics for our sample of interest is presented in Table 1. The average worker is 35.3 years old and has 8 years of formal education. Most of them are self-employed (largely in the informal sector), as it is typical in the labour markets of many developing countries.¹⁰ For the self-employed income is calculated as revenue minus cost (i.e. profit).¹¹ In low-income settings, such as urban Ghana, it is difficult to obtain precise estimates of such profit and we are aware of the challenge. A number of published studies, however, have successfully relied on profit information from GUHPS (see [Falco and Haywood \(2016\)](#) and [Falco et al. \(2015\)](#) for the most recent examples).

3 Empirical methodology

3.1 Constructing an indicator of vulnerability to income poverty

This section outlines the methodology to construct the vulnerability indicators used in the remainder of the analysis. For a detailed discussion of the relative merits of different vulnerability indices, the reader is referred to the survey paper by [Ligon and Schechter \(2004\)](#). The analysis in this article will mainly draw on the two measures proposed by [Chaudhuri \(2003\)](#) and [Chaudhuri et al. \(2002\)](#). The former relies on time-series variation in individual earnings and suits particularly well the characteristics of our dataset, where subjective well-being is recorded for the same individuals over a number of consecutive years, in addition to income and other worker characteristics from which we can model vulnerability. The latter method will produce a benchmark index that attempts to model cross-sectional variation and infer from it the degree of individual vulnerability. [Ligon and Schechter \(2004\)](#)

¹⁰ The sample described in Table 1 is confined to workers for whom self-reported subjective well-being data is available. Furthermore, it only includes paid workers, for whom income is observed and we are therefore able to construct a measure of income vulnerability.

¹¹ The resulting profits are attributed to the owner of the business. The remaining household members who work in the business are categorized as paid or unpaid family labour, depending on whether they receive an income. This may lead to some imprecision as it may be difficult to clearly identify business ownership in some cases. However, the fact that the large majority of the self-employed in our sample (about 80%) does not employ any other person (including household members, either paid or unpaid) makes the potential magnitude of the problem relatively small. When a self-employed works by himself/herself (i.e. hires no other workers), the value of the variable "employees" is set to 1. Consequently, its log in the regressions below equals 0. The same approach was followed by [Falco et al. \(2011\)](#).

compare the performance of these two (and several other) vulnerability indices via Monte Carlo simulations and their conclusion is in favour of the panel approach as the best performing indicator of actual vulnerability.¹²

In what follows we will discuss how we obtain estimates of income vulnerability using the panel method. A section in the appendix presents alternative estimates based on the cross-sectional method.

Following [Chaudhuri \(2003\)](#), the income vulnerability of a worker at time t is defined as the probability that the worker's income will fall below a certain threshold (z) next period. This differs from a simple measure of volatility. The distribution from which a given worker's income is drawn can have very large volatility, but if most of the variation occurs above the threshold z , this worker has a low probability of earning less than z and hence has low vulnerability.

Let ν_{it} be the inverse of vulnerability, that is, i 's probability at t of earning an income above z at $t + 1$:

$$\nu_{i,t} = Pr(y_{i,t+1} > z) \quad (1)$$

When z is the poverty line, ν_{it} is the probability at t that household i will not be income poor at $t + 1$. Following standard Mincerian earnings analysis, we assume that income is generated by the following process:

$$\ln(y_{i,t}) = \delta X_{i,t} + \eta_i + \tau_t + e_{i,t} \quad (2)$$

where X_{it} is a bundle of observable characteristics, η_i is an individual unobservable fixed effect, τ_t captures time-effects that are common across workers (e.g. aggregate income growth factors and common shocks) and e_{it} is a stochastic component.

¹² This is a sensible conclusion, considering the likely presence of unobserved individual fixed effects that cannot be controlled for in a cross sectional model of earnings and could therefore mislead the analysis of vulnerability. As part of our future research we intend to explore how the results of this analysis will change upon using new vulnerability measures, including Ligon and Shechter's own index of vulnerability (see [Ligon and Schechter \(2003\)](#)).

Second, we assume the variance of e_{it} to be a function of worker and household characteristics.

$$\ln(\sigma_{\ln y_{i,t}}^2) = \theta K_{i,t} + \xi_i \quad (3)$$

where ξ_i is an individual fixed-effect in the model of income variance and $K_{i,t}$ may or may not contain additional workers' characteristics, outside the set $X_{i,t}$. In Chaudhuri (2003) $K_{i,t}$ and $X_{i,t}$ coincide.

The variance of the stochastic component can be modeled empirically using the log of first-stage residuals from the earnings model:

$$\ln(\hat{e}_{i,t}^2) = \theta K_{i,t} + \xi_i + \omega_{i,t} \quad (4)$$

given that:

$$\frac{1}{T} \sum_{t=1}^T \hat{e}_{i,t}^2 \rightarrow_p \sigma_{\ln y_{i,t}}^2 \quad (5)$$

Assuming income to be (log)normally distributed and Φ to be the cumulative distribution function of the log normal distribution, we can now compute the probability of not earning less than z at $t + 1$ for every worker i using the following expression.¹³

$$\hat{\nu}_{it} = \hat{Pr}(\ln(y_{it}) > \ln(z) | X_{it}, K_{it}, \hat{\delta}, \hat{\theta}) = 1 - \Phi \left[\frac{\ln(z) - \hat{\mu}_{it}}{\hat{\sigma}_{it}} \right] \quad (6)$$

Where $\hat{\mu}_{it}$ denotes the predicted value of (log) income, and $\hat{\sigma}_{it}$ the predicted variance.

This measure does not differentiate transitory from permanent shocks. When saving, credit and insurance options are limited, both transitory and permanent shocks can have a significant impact on consumption. However, in the presence of an effective saving technology, the two may have different impacts on welfare since transitory fluctuations can be smoothed out through precautionary savings. We acknowledge that separating transitory and permanent shocks would be useful, especially in the largest urban areas where financial

¹³ The reader should note that, differently from the definition in 1, our estimates of vulnerability will be obtained as the probability of falling below the poverty line given worker characteristics at t , rather than $t + 1$. This choice was made based on the idea that workers are most likely to assess their future prospects on the basis of their current characteristics, some of which might themselves be stochastic and subject to unpredictability.

markets are likely to be more accessible. Unfortunately, attempting to explicitly separate the permanent from the transitory component of income variation (e.g. following the approach by Meghir and Pistaferri (2004)) would pose major challenges given the length of the panel at our disposal. This remains an open alley for future research.

3.2 Empirical model of happiness

Having constructed a measure of income vulnerability, we can now explore its relationship with subjective well-being. The following equation describes our workhorse model of happiness:

$$h_{i,t} = \beta y_{i,t} + \gamma \nu_{i,t} + \delta Z_{i,t} + \kappa_i + \epsilon_{i,t} \quad (7)$$

where h_{it} is worker i 's level of life satisfaction in period t , y_{it} is income at time t and ν_{it} is the inverse of vulnerability in the same period; Z_{it} is a vector of worker characteristics that are expected to be correlated with life-satisfaction. κ_i is an unobserved happiness fixed-effect that accounts for unobserved traits that make an individual naturally more (or less) prone to be satisfied with his/her life (e.g. optimism). Our main hypothesis is that β and γ are positive (once again, note that $\nu_{i,t}$ is the inverse of vulnerability and, hence a 'good' in this specification): *increasing income and decreasing vulnerability enhances life satisfaction*. In order to test it, we will attempt to overcome several identification challenges.

First, a number of time-varying and time-invariant determinants of happiness may be correlated with income and vulnerability. If omitted from the analysis, those variables may bias the results. Among the time-invariant factors, one can think of *personality traits* and endowments of *social and human capital* (which may have direct impacts on both job prospects and life-satisfaction). More extroverted and optimistic individuals, for instance, may be both 'naturally' satisfied with their life and more likely to find good, secure employment, or, equally plausibly, more willing to face the risks and uncertainty of entrepreneurship. The same may hold for educated or well-connected people. Among the time varying unobservables, *working conditions* are a first, obvious source of bias. Powdthavee (2010) argues that income gains are often correlated with deterioration in the conditions of work and the latter may have an important influence on life satisfaction. Vulnerability might also

be correlated with working conditions, though we have no strong a-priori evidence of the sign of such correlation. *Relative income* is a third potentially confounding factor. Extensive empirical evidence has been generated showing that relative income is correlated with the life-satisfaction of individuals in both developed and developing countries (Blanchflower and Oswald, 2002; Luttmer, 2005; Kingdon and Knight, 2004) and it is natural to assume that relative income will be correlated with absolute income and vulnerability. We will attempt to account for these potential sources of bias by including in the model controls for working-conditions (proxied by a measure of satisfaction with work) and for a worker's position in the income distribution. Most importantly, thanks to our panel dataset we will be able to *control for all time-invariant individual characteristics correlated with happiness (e.g. personality traits)*.

The second challenge is methodological: life-satisfaction is generally recorded in datasets like GUHPS as a categorical variable. Modeling it as a discrete (ordered) outcome would, therefore, appear to be the most appropriate approach. However, such approach would not easily lend itself to controlling for those time invariant unobservables that we have argued are of great relevance in the determination of life satisfaction. To address this issue Ferrer-i Carbonell and Frijters (2004) develop a conditional estimator for the fixed effects logit model. Their findings show that *"it makes virtually no difference whether one assumes ordinality or cardinality of happiness answers, whilst allowing for fixed effects does change results substantially"* (Ferrer-i Carbonell and Frijters, 2004).¹⁴ It therefore seems justifiable to assume cardinality of the life satisfaction indicator and use the corresponding estimators.

Third, issues of reverse causality may arise in the analysis. High levels of life satisfaction may help individuals earn higher incomes or reduce their income vulnerability (Graham et al. (2004), De Neve and Oswald (2012)). Such effects may again bias the estimated coefficients β and γ . In order to fully address this problem, we would be required to specify an FE-IV regression approach. However, doubts are often raised about the validity

¹⁴ Ferrer-i Carbonell and Frijters (2004) base their analysis on data from the German Socio-Economic Panel. The life satisfaction question in their data uses the same phrasing as GUHPS. The only difference is that it is posed on a 1-10 scale, while in Ghana the scale is from 1 to 5. This should not pose a challenge for comparability. The results reported in our paper confirm the main conclusion of Ferrer-i Carbonell and Frijters (2004) on the importance of controlling for individual fixed effects in empirical models of life satisfaction.

of the instruments proposed by the authors who have attempted the IV or FE-IV approach for income, such as [Knight and Gunatilaka \(2008\)](#) and [Powdthavee \(2010\)](#).¹⁵ Hence, we do not attempt to instrument vulnerability, while fully acknowledging the possibility that these concerns might be important.

Finally, the vulnerability index is a non-linear function of the first two moments of the earnings distribution, which are both modeled as functions of household and individual characteristics in the first stage of the estimation. It follows that the happiness model (where we include both income and vulnerability on the right-hand side) contains *two* functions of those characteristics among the regressors. Separate identification of these two functions implicitly relies on assumptions regarding the relationship between income and well-being. Existing studies have often imposed *linearity* on the relationship and, for comparability, we choose the same approach.¹⁶

4 Results

We present here three sets of results. First, we discuss our estimates of income vulnerability. Second, we present a number of regressions of happiness on vulnerability, which constitute the central results of our analysis. This section also offers a test to distinguish between the effect of vulnerability and that of two-sided uncertainty. Third, we show an additional set of results obtained using experimental measures of attitudes to gains and losses.

4.1 Vulnerability Estimates

Table 2 shows the results from estimating the earnings and variance models used to predict vulnerability later in the analysis.¹⁷ The first feature of the results is that while the earnings

¹⁵ Furthermore, the vulnerability variable has been constructed as a deterministic function of the predicted values of an earnings model, which would complicate an IV strategy.

¹⁶ [Fafchamps and Shilpi \(2008, 2009\)](#) report non-parametric results that show a linear relationship between consumption expenditures and subjective satisfaction with consumption levels, lending empirical support to this modelling choice.

¹⁷ We document the results from the income model in col 1 and from several specifications of the variance model in col 2 - 5.

model (col 1) shows a relatively high predictive power, trying to predict the variance of earnings proves to be a much more challenging exercise (col 2 - 5).¹⁸

Upon experimenting with different earnings specifications, we concluded that the best model is one that controls for individual fixed effects and for a set of key time-varying covariates (col 1), the choice of which is grounded in a long-established literature on Mincerian earnings regressions (see Rankin et al. (2010) for an application on Ghana using the GUHPS dataset). The results confirm a number of standard patterns observed in related studies of earnings in Sub-Saharan Africa. First, we find a statistically significant effect of firm-size on earnings (captured by positive coefficients on the log of firm-size for wage-employees and on the log of the number of hired employees for the self-employed). Second, we detect a sizable civil service premium and a positive premium for longer tenure in the job. Third, while the linear effect of age cannot be estimated when time-trends are also controlled for, we are able to capture the typical concavity of the age-earnings profile (although the coefficient on age squared appears to be insignificant). Since the estimation in col 1 is carried out with controls for individual fixed effects, it is not possible to separately identify the coefficients on time-invariant characteristics such as education and gender.

We estimate several variance models. We first estimate a model with the same covariates used in the earnings regression and no fixed effects. This model is only able to explain a small portion of the variation in the data. We then estimate a model that includes additional covariates that were not part of the earnings model. Motivated by the observation that social networks can provide an important buffer against negative income shocks, such additional variables include the respondent's ethnic background and marital status. This strategy allows us to marginally increase the fit of the model, but requires us to make the assumption that ethnicity and marital status only determine the variance of income and not its mean. Our preferred model is thus the model reported in column 5, where we include the same covariates used in the earnings regression as well as allow for individual fixed effects to determine the variance of income.¹⁹ This strategy is close to the one employed in

¹⁸ This is to be expected, partly because a fraction of what appears to be true variation in earnings may in fact be random measurement error.

¹⁹ Ethnicity does not vary across time and we also have very little variation in marriage status. This gives us a second reason to omit ethnicity and marital status in the variance model with fixed effects.

Chaudhuri (2003) and the measure of vulnerability employed in the rest of the paper will be based on this method.

< Table 2 here >

Given our estimates of the earnings model, before we can calculate vulnerability we need to define a low-earnings threshold (alternatively referred to as 'poverty line'), z . Figure 2 shows the percentage of people who are below different income thresholds, while figure 3 shows the resulting cumulative distribution of the vulnerability index. Our choice for the remainder of the paper will be to set $z = 10$ GHC per month, which approximately translates into 40 USD.²⁰ When we experimented with alternative lines in the vicinity of this value, the main patterns in our results did not change.²¹ For $z = 40$ USD the risk of poverty we estimate is substantial for large portions of our sample. The central line in Figure 3 shows that, on average, 35 percent of workers in a given year have a chance of 50 percent or more of being poor in the next period. When we disaggregate the estimation between currently poor and non-poor workers (Figure 4), we find that even among the latter a sizable group faces a large probability of becoming poor.

< Figure 2 here >

< Figure 3 here >

²⁰ All income figures have been deflated and the entire analysis will be conducted at constant prices with 1997 as the base year. The reader should be alert to the fact that in 2007 the Ghana Cedi was converted into the New Ghana Cedi at a rate of 10,000 Ghana Cedis to 1 New Ghana Cedi. For simplicity, all the income figures used in the analysis have been converted into New Ghana Cedis. The exchange rate with the USD is not adjusted for PPP.

²¹ The poverty line we have chosen (10 Ghana Cedis per month) translates into nearly 170 PPP-adjusted USD. Assuming the typical earner in our sample sustains a family of 5 people with one additional adult (older than 14) and three children (or alternatively a family of 4 with 2 additional adults and one child, based on a standard equivalence scale), this translates into about 1.7 dollars per capita a day, which is close to standard definitions of poverty. This figure is also consistent with the responses to a question added to GUHPS in 2009, which asked respondents to report the income level they deemed sufficient to cater for (i) basic needs and (ii) a comfortable life. We interpret the answers as a direct, albeit crude, measure of workers' reference points and variation below the reference point can be considered as downside risk. Upon plotting those answers (available upon request), we found that for the vast majority of the sample (more than 90%), our chosen poverty threshold lies below both measures of minimum desirable income. This lends strong support to the assertion that our low-income range is within the domain of poverty as perceived by urban Ghanaians. We are aware that, while we have good reasons to set the poverty line at 10 Ghana Cedis per month, other thresholds could be used. We thus experimented with poverty lines that range from about one third to about three times our preferred value and found no major changes in our main results.

< Figure 4 here >

4.2 Happiness

This section will present the results from estimating our happiness model. Figure 1(b), in the previous section, plots the histogram of happiness responses after splitting the sample by low/high income relative to the poverty line. The histogram shows prima-facie evidence for the link between income and happiness that we are attempting to formally test, with people who are above the low-income threshold more likely to report to be "satisfied" with their life.

Table 3 reports the results from estimating the workhorse model of happiness (equation 7) using first OLS (col 1 - 2) and then controlling for fixed effects (col 3 - 4).

Our first result is a positive and significant effect of absolute income on life-satisfaction, in line with the existing literature (e.g. [De Neve and Cooper \(1998\)](#)). This relationship is evident in OLS and, rather strikingly, it does not change significantly once we control for fixed effects. It appears, therefore, that time-invariant unobservables correlated with earnings are not biasing the estimated effect of income on happiness. Interestingly, the size of the estimated coefficient on the log of income in col 3, 0.017, is remarkably close to that estimated by [Powdthavee \(2010\)](#) using data from the British Households Panel Survey and a fixed-effect estimator, 0.019.

On the other hand Table 3 shows that individual fixed effects play an important role in the relationship between vulnerability and life-satisfaction. Once we control for them, we find *a strong negative relationship between vulnerability and happiness, over and above the income effect* just described (recall that in the regression tables this is reported as a *positive* relationship between the *inverse of vulnerability* and happiness). This is the key result in the paper. It is both statistically significant and economically meaningful. Reducing the risk of poverty by 20 percentage points (which amounts to entirely offsetting the risk of poverty for the median worker in our sample) has the same effect on well-being as increasing earnings by 50%.

The change in the coefficient on the inverse of vulnerability, which we obtain upon controlling for fixed effects, is an indication that individuals who tend to be more satisfied with their lives (high κ_i) face more downside risk.²² This could be the case if a common personality trait determines life satisfaction as well as occupational choice. For example, individuals who value autonomy may be happier as well as more likely to work in sectors such as self-employment, where autonomy comes at the cost of a higher risk of low earnings (Benz and Frey, 2008; Falco et al., 2015). We provide suggestive evidence for this possibility by computing the correlation between the estimated fixed effects from the happiness model in (7) and the probability of being self-employed (which in Ghana, as shown by Falco (2014), is associated with higher earnings risk than salaried work). Consistently with our hypothesis, we find a positive and highly significant correlation (not shown for conciseness).

Our estimation also includes controls for work satisfaction (proxying changes in working conditions), income quartile, age and its square and marital status. Work satisfaction is closely correlated with life satisfaction and shows by far the biggest positive coefficient in the life satisfaction regression.²³ The income quartile dummies allow us to control for the position of respondents in the income distribution, which has been shown to be a significant predictor of well-being (Clark et al., 2008). Their inclusion in the regression model does not affect our main results (if anything, the coefficient on vulnerability increases slightly). This should reassure the reader that changes in relative income are not confounding our estimates of the relationship between income vulnerability and happiness.²⁴

Finally, the vulnerability index has been constructed using estimates from a first-stage model of earnings. Hence, it carries a degree of statistical imprecision that could pose a challenge to the significance of our estimates in the second-stage model of happiness. In

²² The fixed effects appear to correlate negatively with the 'inverse' of vulnerability. Hence, they correlate positively with downside risk.

²³ As a robustness check, we tried to exclude work-satisfaction from the estimation and the results did not change significantly (we only detected a slight increase in the effect of vulnerability).

²⁴ In addition to what is reported in the table, we experimented with finer quantile disaggregation (quintiles and deciles) and the main results did not change.

order to check the robustness of our results to such concern, we bootstrap the entire estimation sequence (including the first stage to construct the vulnerability index), sampling with replacement to obtain 200 replications of the original sample. The results are summarised in Figure 5 and 6, where we plot the distribution of the bootstrapped coefficients on earnings and on the inverse of vulnerability, and they are consistent with the discussion so far. The effect of earnings on happiness remains statistically different from zero in every specification. The effect of vulnerability is significant once the fixed effects in the happiness model are controlled for.

< Table 3 here >

< Figure 5 here >

< Figure 6 here >

4.3 Alternative explanations

The measure of vulnerability employed in this paper focuses on the notion of *exposure to downside risk* and we interpret our findings as showing that the risk of income poverty has a significant impact on well-being. An alternative explanation could be that individuals dislike income volatility per se (rather than exposure to downside risk). In this section we attempt to disentangle the two hypotheses by replacing the vulnerability measure used so far with *two-sided measures* of earnings volatility.

First, we use the raw squared residual \hat{e}_{it}^2 from a first stage earnings regression with fixed effects as a proxy for income volatility and find no significant relationship with happiness (table 4), despite the sign of the estimated effect is always negative (as we would expect if workers are risk-averse).²⁵ The lack of statistical significance might be due to the fact that ex-post realizations of the shock are a noisy proxy of the expected degree of vulnerability workers perceive (and are affected by). A way to circumvent the problem is to model the variance of these residuals, as we already did in section 3.1, and use the predicted value as a measure of expected variance. Upon doing that, we document once again a negative

²⁵ Using experimental data, Falco (2014) shows that the majority of GUHPS respondents are indeed risk-averse.

effect of volatility on life satisfaction that is not statistically significant (the results are not reported for conciseness, but available upon request). Overall, this evidence points to the conclusion that vulnerability to downside income risk, as analysed in the previous section, plays a more prominent role in the determination of well-being than two-sided volatility.

< Table 4 here >

4.4 Choice among risky prospects

Our final piece of evidence comes from a behavioural experiment that studies individual choices between risky prospects when downside risk is present and when it is absent. Our objective is to investigate whether downside risk impacts the economic decisions of the respondents in our sample. We do so by estimating the level of loss-aversion implied by the respondents' choices in a series of lottery games. This complements our analysis of life satisfaction and highlights the role of downside risk in the domain of decision-making (Kahneman et al., 1997).

The experiment, extensively described in Falco (2014), was run in 2007, with a random sub-sample of 307 GUHPS respondents. It consisted of 21 choices between pairs of monetary lotteries. Each 'game' was framed as a choice between two opaque urns containing marbles of different colours and, correspondingly, different monetary values.²⁶ After being shown the composition of each urn, respondents were asked to choose the one from which they would prefer to draw a marble. Prior to making their choices, they were informed that at the end of the game one of their 21 preferred lotteries would be randomly selected and played out. The winnings of that game would then be paid to the respondent. Monetary incentives of this kind are used to induce truthful revelation of preferences.

Choices were framed in terms of losses and gains with respect to the reference point of no gain over the initial endowment. This standard manipulation is ubiquitous in the experimental literature on loss aversion.

²⁶ A detailed description of the experimental setup is contained in (Barr, 2007).

Using data from the experiment, we perform a maximum likelihood estimation of the following utility function, which incorporates a loss aversion parameter, λ .²⁷

$$u(x) = \begin{cases} x^\alpha & \text{if } x \geq 0 \\ -\lambda(-x^\beta) & \text{if } x < 0 \end{cases} \quad (8)$$

This is a standard parametrization of utility functions in the prospect theory literature (Wakker, 2010). An estimate of λ greater than one is evidence of loss aversion: losses are felt more than gains. In line with prospect theory, we further assume that prospects are evaluated as a weighted sum of the utilities of the various outcomes, where the weights are transformations of the actual probabilities given by the following probability weighting function:

$$\omega(p) = \frac{p^\gamma}{(p^\gamma + (1-p)^\gamma)^{\frac{1}{\gamma}}} \quad \text{if } p \geq 0$$

$$\omega(p) = \frac{p^\phi}{(p^\phi + (1-p)^\phi)^{\frac{1}{\phi}}} \quad \text{if } p < 0 \quad (9)$$

Given these assumptions about the form of the utility function and the weighting of probabilities, we can calculate the difference in utility between the two lotteries in each pair. For each two lotteries R and L we obtain:

$$\nabla PU = \frac{\sum_R \omega(p_R)u(x_R) - \sum_L \omega(p_L)u(x_L)}{\mu} \quad (10)$$

∇PU includes an error term, capturing the possibility that individuals make mistakes when assessing the utility they would derive from a lottery. We model this error term following the recommendations of the recent literature (Hey and Orme, 1994; Andersen et al., 2010). The choice of a lottery is then modelled as a stochastic function of ∇PU . The log-likelihood is hence given by:

$$\ln L(\alpha, \beta, \lambda, \gamma, \phi, \mu; y, X) = \sum_i [\ln \Phi(\nabla PU)|y_i = R) + (\ln \Phi(1 - \nabla PU)|y_i = L)] \quad (11)$$

²⁷ Following prospect theory, this utility function has separate parameters to define the curvature in the loss and in the gain domain. We assume the reference point is 0 and define x as the gain over the initial endowment. This is consistent with the framing of the lotteries.

Details on the estimation procedure are further outlined in [Harrison \(2008\)](#) and [Falco \(2014\)](#).

We first estimate the parameters of utility function (8) pooling the choices of all respondents. We cluster standard errors at the individual level, as recommended by [Andersen et al. \(2010\)](#). The estimate of loss aversion we obtain is 1.77, which is in line with previous experimental findings ([Booij et al., 2010](#); [Wakker, 2010](#)). Using a standard test, we can reject the null of $\lambda = 1$ at a 1-percent significance level.

< Table 5 here >

Furthermore, we attempt to estimate a coefficient of loss-aversion for each individual in the sample. Our maximum likelihood routine converges for 266 respondents. However, for 45 of them we obtain estimates of λ above 10, which are inconsistent with the upper bounds reported in other studies ([Booij et al., 2010](#); [Wakker, 2010](#)). We exclude these from the analysis. Out of the remaining observations, we estimate λ above 1, indicating loss aversion, for 55 percent of individuals. The precision of these individual estimates is however low, so we are able to reject the null hypothesis of $\lambda = 1$ for only 22 percent of the respondents. Figure 7 shows the distribution of estimated loss-aversion coefficients.

Loss aversion describes the weight that people give to outcomes below a reference point when making decisions. This ‘decision utility’ may not correlate perfectly with ‘experienced utility’ ([Kahneman et al., 1997](#)). However, as the individual estimates of loss aversion are rather noisy, we are not in a position to convincingly investigate in our data whether income vulnerability causes larger well-being costs for loss-averse individuals.²⁸

Overall, the results we present in this section suggest that the workers in our sample are characterised by significant loss aversion, highlighting how downside risk will affect *both*

²⁸ There is a second reason not to attempt this analysis. In the experiment we measure loss-aversion with respect to a reference point created by a fixed endowment, which represents the ‘status quo’ before the decision. This is standard practice in the literature that studies loss aversion. In the previous sections, on the other hand, we have studied the risk of falling below a poverty line. The poverty line will differ from the status quo for many individuals. Thus, while we study attitudes towards downside risk in both cases, the two measures we use define ‘downside risk’ differently. In general, the literature on loss aversion has not yet fully understood how individuals choose reference points and we flag this as an area for future research ([Kőszegi and Rabin, 2006](#)). We thank an anonymous referee for raising this point.

well-being and decisions. Thus, labour markets that expose workers to large downside risks not only harm workers' welfare, but may also lead people to forgo profitable (but risky) investment opportunities (Blumberg and Kremer, 2014).

< Figure 7 here >

5 Conclusions

This article investigates the relationship between income and well-being in a fast-growing developing country, with a focus on the previously unexplored link between *the risk of income poverty and happiness*. Using unique longitudinal data from a representative household survey from urban Ghana, we are able to measure the probability of income poverty at the individual level and explore its relationship with life-satisfaction. Our results are compelling.

First, our analysis reveals a substantial risk of poverty for a large share of the population. Second, we find *a strong negative relationship between vulnerability to poverty and life-satisfaction*, over and above the positive income effect commonly documented in the literature. It is both statistically significant and economically meaningful. Reducing vulnerability by 20 percentage points has the same effect on well-being as increasing income by 50%. Interestingly, we find that failing to control for individual fixed effects leads to significant bias and misleading conclusions. Further, we attempt to disentangle the effect of *downside risk* on happiness from the effect of *two-sided uncertainty*. We find that the former has the clearest impact on subjective well-being. Finally, in a matched behavioural experiment which elicits respondents' attitudes towards risky prospects we find evidence of significant levels of loss aversion among our respondents. This suggests that the effect of downside risk is not limited to life evaluation, but extends to decision making.

Our results highlight the importance of social protection as an instrument to shield workers from the risk of falling into poverty. Loss-averse agents will be more willing to undertake productive investments when safety nets and insurance minimize this risk. Importantly, our evidence suggests that these policies will also improve life satisfaction,

and should be considered alongside interventions that target other determinants of well-being, such as working conditions and work-life balance. More broadly, our results suggest that the well-being gains that developing countries can obtain by raising mean incomes may be dampened if the risk of poverty remains significant for a large part of the population.

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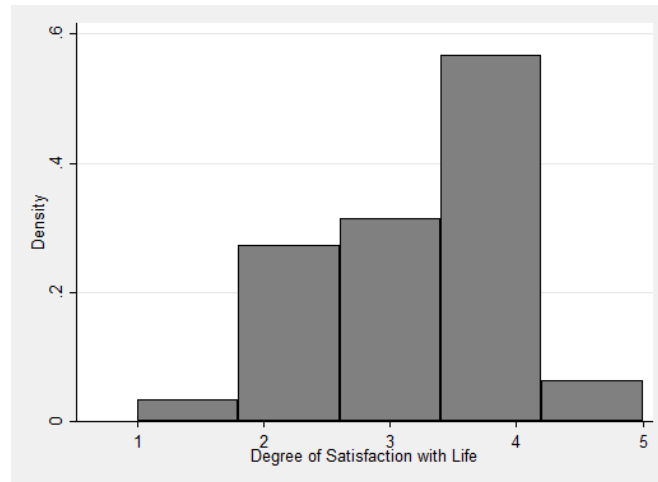
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6 Figures

Figure 1: Distribution of Life-Satisfaction

(a) Across the population



(b) By level of income (employed people only)

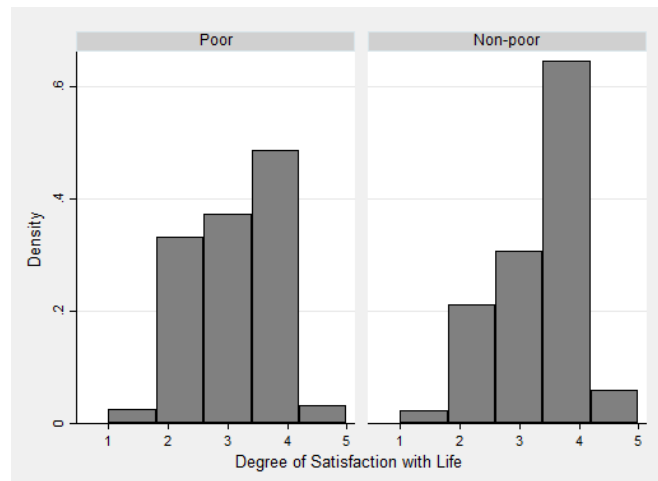


Figure 2: Percentage of employed with $y < z$

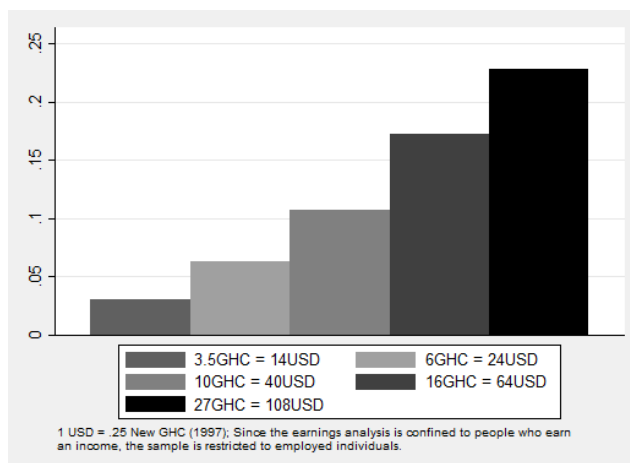


Figure 3: Cumul. Dist. of Vulnerability for different poverty lines (z_t)

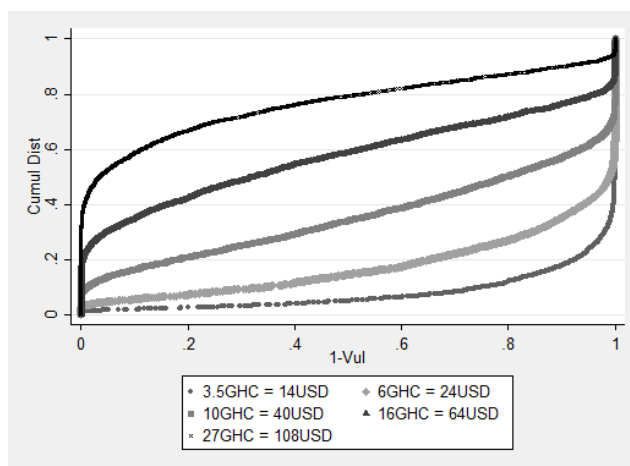


Figure 4: Cumul. Dist. of Vulnerability by current poverty status

$z_t = 10$ (1997) GhCedis

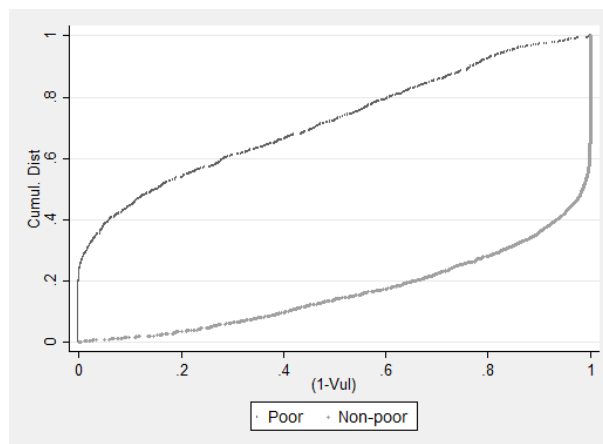


Figure 5: Bootstrapped distribution of the coeff on *LnRealEarn*

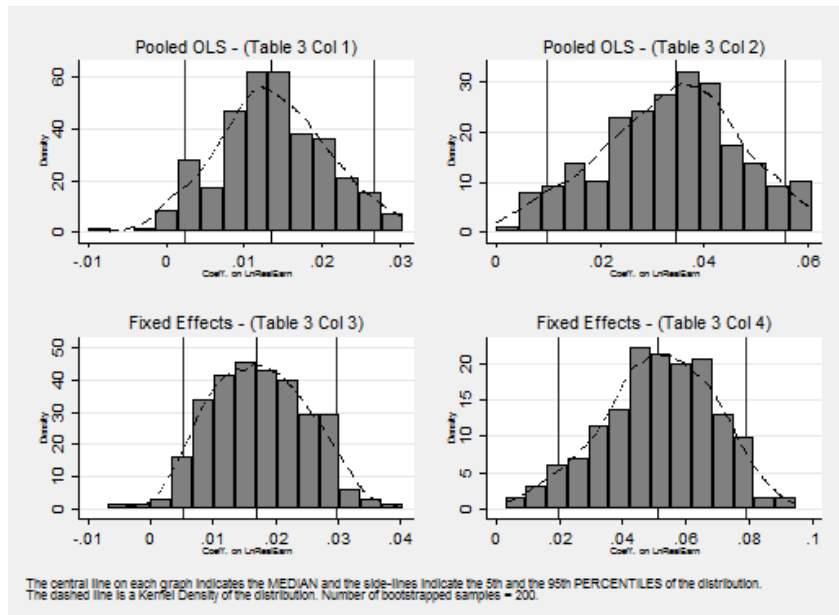


Figure 6: Bootstrapped distribution of the coeff. on $(1-Vul)$

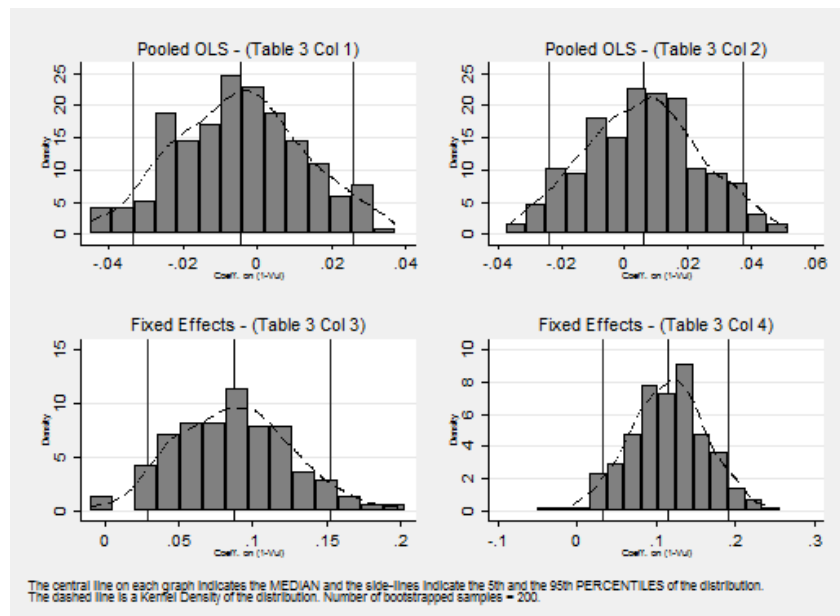
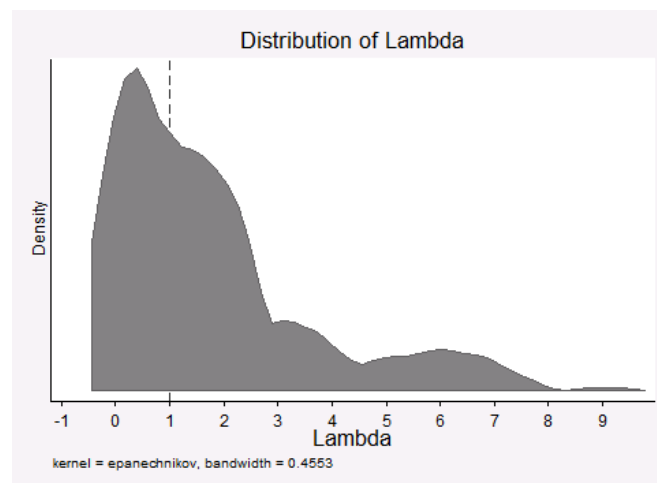


Figure 7: Distribution of λ



7 Tables

Table 1: Summary Statistics, 2005[†]

Variable	Mean	Std. Dev.
Age	35.27	10.73
Educ (ys)	8.038	4.032
Male	0.446	0.497
Private Sect. Wage	0.265	0.442
Public Sect. Wage	0.074	0.262
Ln(employees)	0.133	0.418
Ln(firmsize)	0.842	1.551
Years since started current job	10.625	9.888
Married	0.53	0.499
Ga-Dangme	0.145	0.352
Ewe	0.06	0.237
Mole-Dagbani and Hausa	0.096	0.295
Other ethnicity	0.112	0.316
Obs. ^{††}		740

[†]Restricted to observations in the happiness model, pooling survey waves.

^{††}Only 738 observations include ethnic origin.

Table 2: Estimation of Vulnerability - *Panel Approach*

<i>Dep. Var.</i>	y	$\sigma^2(K)$	$\sigma^2(X)$	$\sigma^2(X^2)$	$\sigma^2(X, FE)$
	(1)	(2)	(3)	(4)	(5)
Age		.035 (.028)	.019 (.026)		-.0005 (.001)
Age2	-.0003 (.0004)	-.0004 (.0003)	-.0002 (.0003)	-5.49e-08 (4.76e-08)	-.0005 (.001)
Educ		-.028 (.034)	-.055 (.032)*		
Educ2		.003 (.002)	.004 (.002)*	7.17e-06 (8.15e-06)	
Male		.134 (.095)	.133 (.092)	.127 (.092)	
Private Sect. Wage	-.147 (.074)**	-.991 (.149)***	-.944 (.145)***	-.967 (.121)***	-.234 (.177)
Public Sect. Wage	.196 (.112)*	-1.342 (.184)***	-1.319 (.180)***	-1.313 (.177)***	-.120 (.269)
Ln(employees)	.187 (.051)***	.008 (.115)	.040 (.113)	.044 (.057)	-.030 (.121)
Ln(firmsize)	.055 (.021)**	.005 (.042)	-.013 (.042)	-.0003 (.008)	.062 (.051)
Yrs since curr. job start	.005 (.003)*	.003 (.006)	.004 (.006)	.0002 (.0002)	.005 (.007)
Married		-.052 (.095)			
Eth.: Ga-Dangme		-.037 (.119)			
Eth.: Ewe		.392 (.171)**			
Eth.: Mole Dag. - Hausa		.578 (.155)***			
Other ethnicity		-.181 (.162)			
Const.	2.588 (1.346)*	-3.041 (.519)***	-2.642 (.491)***	-2.514 (.190)***	-3.293 (1.294)**
Indiv. Fixed Effects	Yes				Yes
Time Dum.	Yes	Yes	Yes	Yes	Yes
Obs. [†]	3659	3014	3110	3110	3110
R^2	.685	.073	.065	.064	.627

Notes: y : (log) real monthly earnings; $\sigma^2(K)$: (log) variance of y modelled as a function of K ; $\sigma^2(X)$: (log) variance of y modelled as a function of X ; $\sigma^2(X^2)$: (log) variance of y modelled as a function of X^2 ; $\sigma^2(X, FE)$: (log) variance of y modelled as a function of X incl. indiv. fixed effects (this specification is used to compute vulnerability subsequently in the paper); X is the set of key regressors in the income model, K is an augmented set of regressors to include potential determinants of the variance; omitted occupational category = self-employed; omitted ethnicity = Akan; *Public Sect. Wage* includes all salaried workers in the public sector, including civil servants and workers in public enterprises. [†]NxT; Col (2) to (5) have fewer observations than (1) since the variance analysis must be confined to respondents who appear multiple times in the panel. Col (2) has fewer observations than (3) to (5) due to missing values in the marriage and ethnicity variables. Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%; Robust standard errors in parentheses.

Table 3: Happiness and vulnerability - *Panel Approach*

	<i>Pooled OLS</i>		<i>Fixed Effects</i>	
	(1)	(2)	(3)	(4)
(1-Vul)	-.006 (.017)	.005 (.018)	.087 (.036)**	.117 (.044)***
LnRealEarn	.013 (.006)**	.033 (.012)***	.017 (.008)**	.051 (.017)***
LnWorkSatis	.618 (.014)***	.615 (.014)***	.588 (.025)***	.587 (.025)***
Married		.027 (.010)**		.023 (.020)
Age		-.006 (.003)*		-.019 (.014)
Age2		.00007 (.00004)*		.0002 (.0002)
EarnQuart=2		-.0009 (.018)		-.026 (.025)
EarnQuart=3		-.048 (.023)**		-.069 (.034)**
EarnQuart=4		-.060 (.032)*		-.099 (.048)**
Const.	.426 (.019)***	.489 (.059)***	.388 (.036)***	.784 (.273)***
Obs. [†]	2507	2507	2507	2507
R^2	.45	.454	.422	.425

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%; Robust standard errors in parentheses; [†]NxT; The number of observations is lower than in the earnings model in table 2 due to missing values in the life-satisfaction variable (most notably due to the fact that there was no question on life satisfaction in the very first wave of GUHPS (2004)). We keep 2004 data in the earnings regressions to ensure we model the earnings process as precisely as possible.

Table 4: Vulnerable to Downside Risk or Averse to Uncertainty? (*Residual*)

	OLS1	OLS2	FE1	FE2
	(1)	(2)	(3)	(4)
\hat{e}_{lny}^2	-.003 (.007)	-.004 (.007)	-.009 (.010)	-.011 (.010)
LnRealEarn	.012 (.005)**	.034 (.011)***	.021 (.008)***	.051 (.017)***
LnWorkSatis	.618 (.014)***	.615 (.014)***	.588 (.025)***	.588 (.025)***
Married		.027 (.010)**		.018 (.020)
Age		-.006 (.003)*		-.007 (.013)
Age2		.00007 (.00004)*		.0001 (.0002)
EarnQuart=2		-.003 (.018)		-.027 (.026)
EarnQuart=3		-.050 (.023)**		-.068 (.035)*
EarnQuart=4		-.061 (.032)*		-.096 (.049)**
Const.	.428 (.019)***	.487 (.059)***	.438 (.031)***	.524 (.247)**
Obs.	2507	2507	2507	2507
R^2	.45	.454	.42	.423

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%; Robust standard errors in parentheses; \dagger NxT.

Table 5: Maximum likelihood estimates of utility function (8)

Parameter	Estimate	Robust standard error	z	$P > z $
α	0.42	0.017	24.24	0.00
β	1.90	0.074	25.77	0.00
λ	1.77	0.169	10.45	0.00

APPENDIX

A Cross-Sectional (CS) Approach to the Estimation of Vulnerability

A.1 The CS Method

This section outlines an alternative cross-sectional approach to estimating vulnerability, based on [Chaudhuri et al. \(2002\)](#), which will serve as a useful benchmark for the results discussed in the paper. The method is very similar to the panel approach outlined in the article, except for the fact that it relies on cross-sectional variation in earnings to obtain measures of income vulnerability. It may therefore suffer from inconsistency due to confounding individual fixed effects in the earnings model. Comparing the results with the ones we obtained from the panel-approach, our aim is precisely to assess the strength of such concerns.

The main advantage of this methodology is that it allows us to gain precision, using a three-step feasible generalised least squares estimator (FGLS). The definition of income vulnerability and the structure of the income and variance models remain the same as in the panel estimation. Differently from above, though, we now take each of the available cross sections in isolation. For each one of them, consistent estimates of δ and θ can be obtained with a three-step feasible generalised least squares estimator (FGLS) ([Chaudhuri et al. \(2002\)](#)). First, we estimate equation (2) using Ordinary Least Squares (on each cross-section separately). Next, we obtain the squared residuals from the first stage (which now contain both the idiosyncratic component and the fixed effect, i.e. $u_{it}^2 = (\hat{\eta}_i + \hat{\epsilon}_{it})^2$), and use them as the dependent variable in a second stage model of the variance:

$$\hat{u}_{it}^2 = \theta K_{it} + \omega_{it} \quad (12)$$

At this point we can obtain predicted values for the variance of income - $\hat{\theta}K_{it}$ and use them to adjust equation (12) as follows:

$$\frac{\hat{u}_{it}^2}{\hat{\theta}K_{it}} = \frac{\theta K_{it}}{\hat{\theta}K_{it}} + \frac{\omega_{it}}{\hat{\theta}K_{it}} \quad (13)$$

From this adjusted equation, [Chaudhuri et al. \(2002\)](#) show that one can estimate the asymptotically efficient FGLS estimator - $\hat{\theta}_{FGLS}$. The next step is to obtain a consistent

prediction for the variance of income, $\hat{\sigma}^2 = (\hat{\theta}_{FGLS} K_{it})$ and use it to adjust equation (2):

$$\frac{\ln(y_{it})}{\hat{\sigma}^2} = \frac{\delta X_{it}}{\hat{\sigma}^2} + \frac{e_{it}}{\hat{\sigma}^2} \quad (14)$$

which delivers $\hat{\delta}_{FGLS}$.

As in the panel analysis, having obtained asymptotically efficient estimates of δ and θ , we can now obtain consistent predictions for the first two moments of the income distribution:

$$E(\ln(y_{it})|X_{it}) = \hat{\delta}_{FGLS} X_{it} \quad (15)$$

$$V(\ln(y_{it})|K_{it}) = \hat{\theta}_{FGLS} K_{it} \quad (16)$$

and given the same assumption of (log)normally distributed earnings, we can obtain estimates of vulnerability as in (6).

A.2 Results: Vulnerability Estimates

The results of the first stage estimations are reported in Table 6 to 9, but in the interest of conciseness we will not discuss them in detail. It will suffice to note that our choice of regressors for the earnings and the variance model follows the same principles as in the panel approach and, as in the previous section, we find that while the earnings regressions (Step 1 and 3) show a relatively high predictive power, trying to predict the variance of earnings (Step 2 and 4) is considerably more difficult.

More interestingly, when we plot the cumulative distribution of the estimated levels of vulnerability for $z = 10$ (1997) Cedis per month (Figure 8) and we compare it to the same distribution in the results section (Figure 4), we find that vulnerability to being poor next period is now much more widespread, both among the current poor and the current non-poor²⁹) than it was according to the estimates in the paper (where a sizable proportion of respondents was clustered at $\nu_{it} = 0$ and $\nu_{i,t} = 1$, as shown by the lower and upper tails of the lines in Figure 3). This is in itself an interesting result, drawing a clear distinction between the two methodologies, though one that might be expected, considering that vulnerability estimated through a cross-section compounds true idiosyncratic variation and unobserved heterogeneity across individuals that cannot be controlled by means of fixed-effects estimators. As mentioned above, one of the goals of this appendix is to assess

²⁹ Vulnerability is obviously lower among the currently high-earners, but still considerable, indicating that the risk of falling into poverty between periods is widespread across the labour market (50% of the currently poor face a likelihood of 50% or higher to be poor next period; the same level of risk is faced by approximately 20% of the currently non-poor).

whether failing to control for such potentially confounding effects will make a significant difference in the results of our happiness model.

< Figure 8 here >

< Table 6 to 9 here >

A.3 Results: Happiness

We can now employ the measure of vulnerability obtained with the CS method to re-estimate the happiness model (equation 7). Our main interest is to explore the role of (time-invariant) unobserved heterogeneity *in the vulnerability specification* (which we cannot control for in the cross section) in potentially confounding the results of the happiness regressions. The reader should pay attention not to confuse such fixed effects in the vulnerability model (which are the ones the CS approach cannot control for, η_i and ξ_i) with the fixed effects in the happiness model mentioned hereafter (κ_i).

Table 10 reports the estimates from our happiness model with income vulnerability obtained through the CS methodology. The results are very similar to the ones in the previous section. We estimate a positive and significant effect of absolute income on life-satisfaction and a strong negative impact of vulnerability, *over and above* the income effect. Interestingly, therefore, we conclude that estimating vulnerability via a cross-sectional approach does not bias the results of the happiness analysis. This may partly be expected, since, by definition, the individual fixed effects in the earnings model (η_i) are constant over time and do cannot form part of the idiosyncratic variation that constitutes ex-ante vulnerability. Hence, we may not expect them to have an impact on our analysis of how ex-ante vulnerability impacts happiness. This finding contributes to the methodological debate led by [Ligon and Schechter \(2003, 2004\)](#) on the relative merits of different approaches to compute vulnerability.

< Table 10 here >

Figure 8: Vulnerability by current poverty status - CS Approach

($z_t = 10$ (1997) GhCedis)

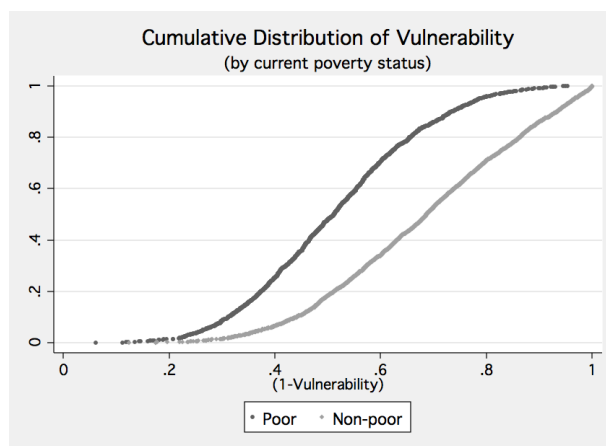


Table 6: Earnings Regression by year (STEP1 - CS Approach)

	Y2004	Y2005	Y2006	Y2008	Y2009
	(1)	(2)	(3)	(4)	(5)
Age	.064 (.022)***	.079 (.016)***	.100 (.015)***	.107 (.024)***	.097 (.023)***
Age2	-.0008 (.0003)***	-.0008 (.0002)***	-.001 (.0002)***	-.001 (.0003)***	-.001 (.0003)***
Educ	-.058 (.025)**	-.026 (.020)	-.052 (.020)**	-.021 (.031)	-.031 (.030)
Educ2	.005 (.002)***	.005 (.001)***	.006 (.002)***	.005 (.002)**	.005 (.002)**
Male	.223 (.069)***	.281 (.061)***	.264 (.059)***	.373 (.091)***	.442 (.089)***
Priv Wage	-.157 (.109)	-.258 (.098)***	-.186 (.092)**	-.164 (.144)	-.161 (.154)
Civil or Pubent	.304 (.138)**	.242 (.134)*	.446 (.117)***	.310 (.174)*	.338 (.156)**
Ln(employees)	.441 (.113)***	.180 (.072)**	.271 (.096)***	.262 (.104)**	.280 (.088)***
Ln(firmsize)	.154 (.030)***	.134 (.028)***	.122 (.030)***	.146 (.041)***	.111 (.045)**
Years since started current job	.011 (.005)**	.008 (.004)**	.023 (.004)***	.015 (.006)**	.018 (.006)***
Const.	.898 (.388)**	.331 (.299)	.291 (.280)	.147 (.462)	.389 (.444)
Obs.	619	826	1007	593	614
R^2	.212	.261	.243	.208	.188

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%

Table 7: Residual Regression by year (STEP2 - CS Approach)

	Y2004	Y2005	Y2006	Y2008	Y2009
	(1)	(2)	(3)	(4)	(5)
Age	-.049 (.028)*	-.030 (.019)	-.056 (.023)**	.008 (.037)	.020 (.038)
Age2	.0007 (.0004)*	.0003 (.0002)	.0007 (.0003)**	.0001 (.0005)	-.0003 (.0005)
Educ	.071 (.030)**	-.012 (.023)	-.030 (.030)	-.126 (.046)***	-.060 (.050)
Educ2	-.004 (.002)*	.001 (.002)	.002 (.002)	.010 (.003)***	.004 (.004)
Male	.087 (.083)	.024 (.068)	-.049 (.083)	-.030 (.134)	.151 (.146)
Priv Wage	-.324 (.131)**	-.110 (.108)	-.474 (.129)***	-.820 (.213)***	-.788 (.249)***
Civil or Pubent	-.347 (.165)**	-.387 (.146)***	-.317 (.167)*	-.611 (.255)**	-.546 (.255)**
Ln(employees)	-.070 (.135)	-.138 (.080)*	-.098 (.133)	-.043 (.152)	.218 (.141)
Ln(firmsize)	-.028 (.036)	.002 (.030)	.002 (.043)	-.019 (.061)	.029 (.073)
Years since started current job	.003 (.006)	.004 (.004)	-.006 (.006)	-.017 (.009)*	-.005 (.009)
Married	-.180 (.088)**	.033 (.069)	.126 (.084)	-.127 (.136)	-.126 (.145)
Ga-Dangme	.232 (.110)**	-.084 (.089)	.060 (.106)	-.243 (.168)	-.143 (.165)
Ewe	.408 (.151)***	.245 (.133)*	.170 (.155)	.097 (.209)	.098 (.245)
Mole-Dagbani and Hausa	-.006 (.150)	-.048 (.111)	.358 (.130)***	-.168 (.201)	-.550 (.268)**
Other ethnicity	.255 (.138)*	-.048 (.104)	.160 (.132)	-.088 (.286)	-.029 (.286)
Const.	1.279 (.478)***	1.300 (.346)***	1.993 (.420)***	1.282 (.716)*	1.079 (.738)
Obs.	617	813	852	591	595
R^2	.069	.028	.07	.106	.059

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%

Table 8: Weighted Residual Regressions by year (STEP3 - CS Approach)

	Y2004	Y2005	Y2006	Y2008	Y2009
	(1)	(2)	(3)	(4)	(5)
Age	-.056 (.026)**	-.024 (.019)	-.047 (.021)**	.005 (.026)	-.010 (.032)
Age2	.0007 (.0003)**	.0002 (.0002)	.0006 (.0003)**	.0001 (.0003)	.0001 (.0004)
Educ	.067 (.022)***	-.016 (.022)	-.035 (.029)	-.137 (.040)***	-.024 (.047)
Educ2	-.003 (.002)*	.001 (.002)	.002 (.002)	.010 (.003)***	.003 (.003)
Male	.080 (.067)	.026 (.064)	-.022 (.070)	.022 (.099)	.098 (.127)
Priv Wage	-.199 (.098)**	-.132 (.098)	-.448 (.088)***	-.819 (.146)***	-.687 (.183)***
Civil or Pubent	-.273 (.127)**	-.342 (.111)***	-.239 (.102)**	-.643 (.206)***	-.549 (.209)***
Ln(employees)	-.023 (.117)	-.124 (.068)*	-.117 (.128)	.027 (.153)	.123 (.168)
Ln(firmsize)	-.047 (.024)*	.004 (.025)	-.0002 (.029)	.021 (.034)	.046 (.052)
Years since started current job	-.0001 (.005)	.001 (.004)	-.004 (.005)	-.012 (.007)*	.004 (.008)
Married	-.127 (.076)*	.018 (.064)	.061 (.071)	-.054 (.103)	.003 (.129)
Ga-Dangme	.195 (.105)*	-.089 (.078)	.067 (.088)	-.209 (.100)**	-.064 (.139)
Ewe	.287 (.162)*	.201 (.148)	.127 (.148)	.103 (.172)	.160 (.253)
Mole-Dagbani and Hausa	.073 (.108)	-.013 (.107)	.324 (.137)**	-.056 (.109)	-.213 (.179)
Other ethnicity	.186 (.133)	-.060 (.099)	.188 (.125)	-.172 (.204)	-.068 (.265)
-con	1.406 (.441)***	1.216 (.345)***	1.861 (.381)***	1.386 (.487)***	1.308 (.624)**
Obs.	614	813	851	588	591
R^2	.114	.03	.101	.173	.051

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%

Table 9: Weighted Earnings Regression by year (STEP4 - CS Approach)

	Y2004	Y2005	Y2006	Y2008	Y2009
	(1)	(2)	(3)	(4)	(5)
Age	.068 (.022)***	.079 (.017)***	.099 (.017)***	.099 (.022)***	.095 (.022)***
Age2	-.0009 (.0003)***	-.0008 (.0002)***	-.001 (.0002)***	-.001 (.0003)***	-.001 (.0003)***
Educ	-.050 (.024)**	-.024 (.020)	-.055 (.024)**	-.037 (.032)	-.034 (.030)
Educ2	.005 (.002)***	.005 (.001)***	.007 (.002)***	.006 (.002)***	.005 (.002)**
Male	.233 (.067)***	.290 (.061)***	.233 (.063)***	.351 (.084)***	.427 (.089)***
Priv Wage	-.138 (.104)	-.214 (.095)**	-.155 (.092)*	-.178 (.124)	-.139 (.142)
Civil or Pubent	.311 (.130)**	.265 (.121)**	.435 (.121)***	.310 (.160)*	.317 (.149)**
Ln(employees)	.437 (.110)***	.147 (.068)**	.277 (.105)***	.254 (.108)**	.297 (.096)***
Ln(firmsize)	.149 (.027)***	.116 (.026)***	.112 (.030)***	.143 (.035)***	.105 (.042)**
Years since started current job	.011 (.005)**	.007 (.004)**	.022 (.004)***	.014 (.006)**	.018 (.006)***
Const.	.805 (.392)**	.324 (.304)	.271 (.318)	.341 (.427)	.413 (.440)
Obs.	614	813	851	588	591
R^2	.254	.271	.242	.229	.193

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%

Table 10: Happiness and vulnerability - CS Approach

	<i>Pooled OLS</i>		<i>Fixed Effects</i>	
	(1)	(2)	(3)	(4)
(1-Vul)	-.024 (.027)	-.006 (.032)	.141 (.055)**	.237 (.080)***
LnRealEarn	.019 (.005)***	.037 (.011)***	.016 (.008)*	.048 (.017)***
LnWorkSatis	.601 (.013)***	.599 (.013)***	.590 (.026)***	.589 (.026)***
Married		.031 (.010)***		.025 (.020)
Age		-.007 (.003)**		-.035 (.016)**
Age2		.00008 (.00004)**		.0003 (.0002)*
EarnQuart=2		.002 (.017)		-.021 (.026)
EarnQuart=3		-.040 (.021)*		-.066 (.035)*
EarnQuart=4		-.052 (.030)*		-.094 (.049)*
Const.	.440 (.021)***	.516 (.054)***	.354 (.041)***	1.019 (.313)***
Obs. [†]	2814	2814	2814	2814
R ²	.441	.445	.424	.429

Confidence: *** \leftrightarrow 99%, ** \leftrightarrow 95%, * \leftrightarrow 90%; Robust standard errors in parentheses; [†]NxT