Perceptions of Inequality

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Abstract

Although people’s perception of (income or wealth) inequality has important effects on their decisions as economic agents or voters, little is known about how perceptions relate to objective inequality. We present a novel formal framework that is based on the assumption that people typically do not observe the entire income (wealth) distribution but that their guesses about the extent of inequality are based on heterogeneous reference groups. This framework implies that the perception of inequality will be different for different positions in the income distribution but that for a specific position various dimensions of the inequality perception should be related to each other. The framework delivers four testable predictions that correspond to popular survey questions: First, low (high) income individuals overestimate (underestimate) their own position. Second, subjective estimates of average earnings increase with the own income position. Third, high or low income people have different perceptions about the "distributional shape" of society (e.g. pyramid or diamond). Fourth, the subjective perception of inequality is lower for high-income individuals. Survey data from 40 countries provide strong support for the framework.

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