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Inequality and happiness: When perceived social mobility and economic reality do not match

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ABSTRACT

We argue that perceived fairness of the income generation process affects the association between income inequality and subjective well-being, and that there are systematic differences in this regard between countries that are characterized by a high or, respectively, low level of actual fairness. Using a simple model of individual labor market participation under uncertainty, we predict that high levels of perceived fairness cause higher levels of individual welfare, and lower support for income redistribution. Income inequality is predicted to have a more favorable impact on subjective well-being for individuals with high fairness perceptions. This relationship is predicted to be stronger in societies that are characterized by low actual fairness. Using data on subjective well-being and a broad set of fairness measures from a pseudo micro-panel from the WVS over the 1990–2008 period, we find strong support for the negative (positive) association between fairness perceptions and the demand for more equal incomes (subjective well-being). We also find strong empirical support for the predicted differences in individual tolerance for income inequality, and the predicted influence of actual fairness.

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> Inequality is undoubtedly more readily borne, and affects the dignity of the person much less, if it is determined by impersonal forces than when it is due to design.
>
> Friedrich Hayek (1944: 117)

1. Introduction

Since Abba Lerner's classic contributions from the 1930s, welfare economics has argued that income redistribution can increase overall welfare in a society with an unequal distribution of incomes, due to the decreasing returns to income caused by an assumed strict concavity of individual utility functions (Lerner, 1944). This view implies that most people in societies characterized by a highly skewed income distribution should, all other things being equal, experience lower levels of utility than those living in more equal societies. With the advent of the economics of happiness, it has become possible – and fashionable – to test this implication on individuals' self-reported life satisfaction, which arguably proxies for the economic concept of 'utility'.[1] If Lerner's implication – and indeed standard economic theory – holds, we would expect to see a clear negative association between income inequality and life satisfaction of the average person. Such empirical results would also be in line with the more recent theoretical model by Fehr and Schmidt (1999), that takes account of social (other-regarding) preferences in individuals' utility functions, equally predicting a negative relationship between inequality and happiness.

Even though this straightforward microeconomic approach predicts that overall and average welfare in an economy decrease with income inequality, the empirical literature on the association between income inequality and happiness[2] has yielded ambiguous findings.[3] One of the first empirical contributions, Alesina et al. (2004), identify a negative association between income inequality and happiness for 12 European countries that remains statistically insignificant for most U.S. states, however. The authors hypothesize that differences in perceived and actual social mobility exist between these two subsamples. Extending the sample to 30 OECD countries, Fischer (2009b) reports a negative association between individual life satisfaction and inequality in final income, but not for market-generated income inequality – potentially indicating that it is actual consumption on which social comparisons are based.[4] In a world sample, however, the large-scale robustness analysis in Bjørnskov et al. (2008) suggests that the skewedness of the income distribution does not, in general, directly affect individual happiness.

In this paper, we investigate the relationship between inequality and happiness, extending previous research in two dimensions: First, we allow individuals' subjective perceptions of 'fairness' attributed to the income-generating process to affect the association between life satisfaction and income inequality. Second, we allow for differences in the actual fairness of the income generation process across countries, expecting that these affect how fairness perceptions influence the inequality-happiness-relation. Indeed, Grosfeld and Senik (2009) show that in the transition country Poland, income inequality at first contributed positively to people's happiness from 1992 to 1996, possibly because it was associated with given and perceived good economic opportunities (see also Hirschman and Rothschild, 1973). In contrast, in the later period from 1997 onwards, it affected people's happiness negatively, possibly because lower actual social mobility mismatched with the high perceptions people still had. Alesina et al. (2004) already conjectured that inequality might affect people's happiness with specific values and specific views on social mobility within the same societies differently, even if inequality *in general* is not associated with happiness.

We present a stylized theoretical model, which serves to illustrate our main arguments and allows us to derive testable hypotheses. The model analyzes individual labor-market participation on the extensive and the intensive margin, depending on expected (i.e., perceived) fairness of the income-generating process. In the model, a society is considered the fairer the closer the relationship between individual effort and market outcome is. Actual fairness can therefore also be interpreted as a measure of social mobility, because with increasing objective fairness, inherited social status loses relevance. Our model allows systematic and persisting incongruences between actual and perceived fairness. The model predicts that persons with higher *perceived fairness* will, on average, experience higher levels of utility and be less in favor of income redistribution.

We argue that in a society where the distribution of individuals' inherited starting positions is sufficiently skewed to the right (i.e., where relatively few individuals "are born with a silver spoon"), subjective fairness perceptions are the main driver of investments into effort on the labor market. Using a standard notion of status utility, we then show that individuals with high subjective fairness perceptions react more favorably to income inequality than those with low fairness perceptions. Finally, we demonstrate that the composition of the pool of individuals with high subjective fairness perceptions systematically differs between countries with high and low actual social mobility. In countries with high actual mobility, more individuals with low *ex ante* fairness perceptions who invest little into effort are surprised by higher than expected

[1] For an overview of the economic, sociological and psychological concepts of subjective well-being and validity studies on its alternative measures, see Diener et al. (2008), Fischer (2009a), and Veenhoven (2000).

[2] In this paper, we use the terms 'happiness', 'subjective well-being', and 'well-being' interchangeably.

[3] In a related field of research Clark et al. (2008), Layard et al. (2010), and Fischer and Torgler (2013) among others, use micro data to analyze income inequality effects through social comparisons where persons compare their income with a reference level. In our study, inequality rather refers to differences in absolute income across persons and the presence of redistributive government activities.

[4] This is in line with Hopkins' (2008) 'rivalry model in conspicuous consumption' according to which income inequality increases individual utility under certain conditions (high income and consumption levels, and a dense income distribution), as greater incentives to compete in consumption are generated.