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INEQUALITY AND WELL-BEING IN OECD COUNTRIES: WHAT DO WE KNOW?

SIMON CHAPPLE, MICHAEL FÖRSTER AND JOHN P. MARTIN*

* John Martin is Director and Simon Chapple and Michael Förster are Senior Economists at the Directorate for Employment, Labour and Social Affairs, Organisation for Economic Co-operation and Development (OECD), Paris. They are very grateful to Monika Queisser for helpful comments.

1. Income inequality has widened in more than three-quarters of OECD countries over the past two decades (OECD 2008). This widening of the income distribution happened over a period of sustained economic growth, the indicator by which progress is commonly measured. Can real progress be achieved when inequality is increasing? Should we thus revise our concept of progress to take account of the fact that the benefits of economic growth were not distributed evenly? One could argue that a revision is not necessary, as long as the citizen of the countries concerned do not see increased inequality as a problem. If, however, growing inequality affects people's happiness and we accept that happiness should be an important component of any concept of progress, inequality must be taken into account.

2. This paper considers in more detail the relationship between actual inequality, desired inequality and overall social well-being, focussing on the evidence from OECD countries over the past two decades. It first summarises the overall results from the OECD's recent publication *Growing Unequal?* in terms of recent levels and changes of inequality. It considers the relationships between actual income inequality and perceptions about whether it is too high or too low. Finally, it examines the literature on the implications of income inequality for a global measure of well-being, represented by self-assessed life satisfaction or happiness.

3. The paper shows that income inequality seems to be considered differently in each country and thus has varying impacts on well-being. The impact not only depends on country contexts but also on the actual roots and perceived beliefs about what causes inequality[1].

Have inequalities increased?

4. There is a general feeling that inequalities have been on the rise in recent times, both in OECD and non-OECD countries. However, in discussing generalised trends of inequality, one needs to have clearly in mind the inequality of "what". There are many different aspects of inequalities which can often evolve in different and sometimes contradicting ways: inequality of opportunities; inequalities of conditions (e.g. health); or inequality of resources (e.g. wealth or income).

5. It is equally important to specify inequalities "among whom". For instance, while there is some evidence that the relative income gap *between* countries has narrowed over the past two decades, it may be that income inequality *within* countries has increased at the same time. A further question – to which no conclusive answers have yet been found – refers to the development of "global" inequality, i.e. inequality among world citizens.

6. Over the 20 years to the mid-2000s, the distribution of <u>market incomes</u> (i.e. the sum of labour earnings, self-employed income, dividends, capital gains etc.) has become significantly more unequal in all but three OECD countries (Figure 1). The main driver behind this increase was market earnings, as these make up more than 70% of household income. On average, across OECD countries, market income inequality increased by one fifth (or 4 percentage points) from the mid-1980s to the mid-2000s.

7. People's living standards are determined by the <u>final income</u> they have at their disposal (i.e. including public cash benefits and deducting household taxes) rather than by market income. The

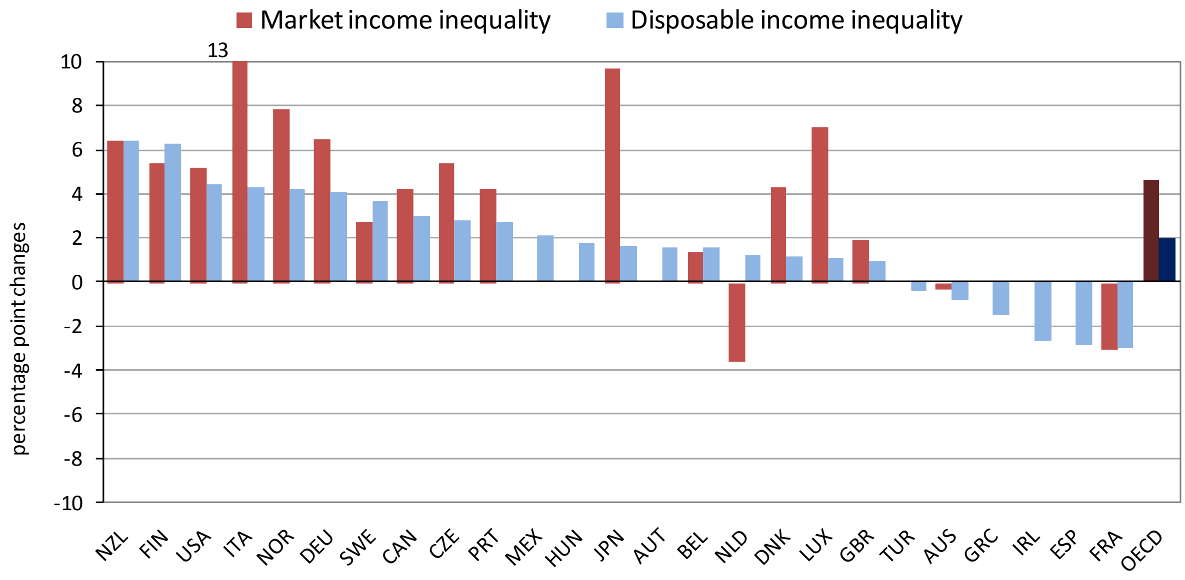
[1] The OECD is currently engaged in a project examining the reasons behind the trends in income distribution and poverty highlighted by *Growing Unequal*?

distribution of disposable incomes has become more unequal, too, but at a more moderate pace: on average across OECD countries, inequality increased by 7% (or 2 percentage points).

8. The increase concerned three quarters of OECD countries. But a handful of countries, including France, Spain, Ireland and Greece, bucked this trend, meaning there is nothing inevitable about increasing income inequality.

Figure 1. Generalised increase in household income inequality in the OECD area

Trends in inequality of market and disposable household income, percentage point changes of Gini coefficients, mid-1980s to mid-2000s



Note: Countries are ranked in decreasing order of changes in inequality of disposable income. OECD refers to the unweighted average of countries for which information is available.

Source: OECD (2008).

9. How large are income inequalities in OECD countries? In a typical OECD country, the average income of the richest 10% of people was nearly nine times that of the poorest 10%, and around one person in 10 had an income below half of the national median in 2005. But country variations are large, with the lowest inequality indicators found in the Nordic countries, higher ones in the United States and the highest ones in Mexico and Turkey.

10. In sum, the evidence for the OECD countries confirms that there has been a significant and widespread increase in income inequality during the past 20 years. The rise was more modest when measured in terms of final disposable incomes than for market incomes, indicating that the tax and social transfer systems do serve to redistribute income towards the poor. But it is also the case that the redistributive power of the tax/transfer system declined over the past two decades in many OECD countries.

Do people care about inequality?

11. Why should we care about rising inequality? Some degree of inequality may yield economic gains via beneficial effects on incentives to work, innovate or to invest in human capital. However, excessive levels of inequality may have an economic price: greater income inequality can imply a waste of human resources if it reflects high unemployment/inactivity rates and/or a significant proportion of the population trapped in low-paid, low-skilled jobs. Second, they may have a political price: greater inequality can fuel populist and protectionist sentiments which are inimical to growth policies. Finally, an excessively unequal distribution of resources seems a concern *per se* to both citizens and governments.

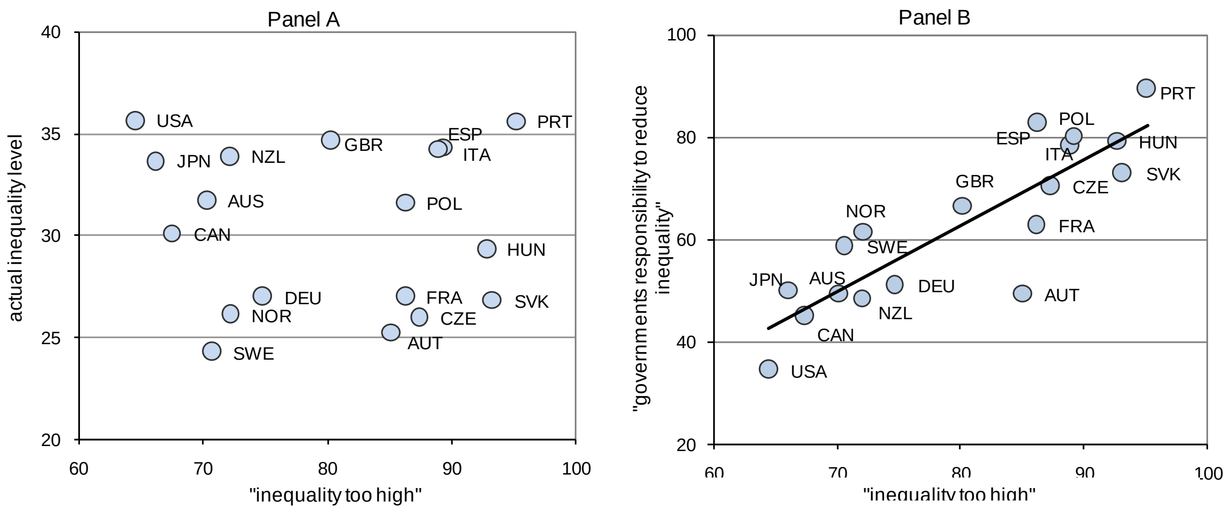
12. According to various alternative opinion polls and surveys, a large majority of people – between two thirds and 90% according to the International Social Science Programme (ISSP) survey – perceive differences in income as "too large" in the country in which they live. There are, however, considerable variations across countries. More than 85% of citizens in the former centrally planned economies in Central and Eastern Europe and in Southern Europe perceive income inequality as "too high", while only 65% of US citizens hold this view.

13. Furthermore, in many countries, people's perceptions of inequality do not match measures of actual income inequality. Four country groupings can be distinguished with respect to the differences between actual and perceived inequality (see Figure 2, Panel A). High-inequality countries with lower inequality perceptions include the English-speaking countries and Japan. High-inequality countries with high perceptions of inequality include the Southern European countries and Poland. Low-inequality countries with higher inequality perceptions include the other Central European countries, as well as France and Austria. Low-inequality countries with low perceptions of inequality include Germany and some Nordic countries. A weak association between real and perceived inequalities also holds when using other common inequality indicators. This means that, beyond actual levels of inequality, other factors play a significant role in shaping these perceptions.

14. On the other hand, there is a relatively strong positive association between the degree of perceived inequality and the degree to which citizens agree that it is government's responsibility to reduce inequalities (see Figure 2, Panel B). As the latter can be taken as a crude proxy for redistribution preferences, it follows that voters' pressures for redistributive policies are stronger in countries where income inequality is perceived as high but not necessarily where income inequality actually is high.

Figure 2. Actual and perceived levels of income inequality do not go hand-in-hand

Actual and perceived inequalities in the distribution of income (Panel A) and the relation between perceived inequalities and views about government's role in reducing them (Panel B), around 2000



Note: Perceived inequalities are measured by the share of respondents who agree or strongly agree with the statement "differences in income are too large". Actual inequalities are measured by the Gini coefficient of disposable income inequality. Data on government's role in reducing inequalities refer to the share of respondents who agree or strongly agree with the statement "it is the responsibility of governments to reduce inequalities".

Source: OECD (2008) and International Social Science Programme.

15. These country differences change remarkably little over time, as evidenced by estimates for a more recent year (2007) and using a different survey (European Social Survey, Lelkes 2009). While jobless people and people in low-income households are more likely to support redistribution, more affluent people still demand a positive redistribution on average (Kuhn 2009). Interestingly, women are more likely to support a reduction in inequality than men, even if income differences, marital status and employment status are accounted for (Lelkes 2009).

16. Furthermore, the perceptions of poverty and reasons for poverty also suggest similar country patterns. The burden of poverty on individuals and families depends not just on its size but also on how others in society view its nature, in particular whether poverty is perceived as the result of individual attitudes or of the way society is organised. Data from the *World Values Survey* distinguish respondents who believe that people are poor because of laziness or lack of will, on one side, from those who believe that people are poor because society is unfair, on the other. In general, the share of respondents who believe that poverty reflects laziness is greater in the Asian and English-speaking countries than in the Nordic and Continental European countries.

17. Beyond these cross-country differences in levels, attitudes towards poverty also change over time within individual countries, often related to the state of the business cycle. For example Paugman and Selz (2005) note that fewer people believe that poverty is based on laziness in times when unemployment rises, as more people are exposed to risks of job losses. Thus, it is very likely that the "laziness" explanation of poverty is less prevalent since the onset of the global recession and the steep rise in unemployment in most OECD countries over the past 18 months.

Does inequality make people unhappy?

18. There is a rapidly growing literature which uses self-assessed measures of happiness or life satisfaction as proxies for final utility. This literature has also turned to examining the impact of income inequality on this utility proxy. Consequently, it may offer some new and interesting insights to a consideration of the age-old question of defining an axiomatically fair income distribution which would optimise utility.

19. Discussions about the links between inequality, however defined and well-being can be traced to the philosopher John Rawls notion of justice as fairness which he began to develop in the 1950s as a critique of the then dominant theory of utilitarianism, i.e. that collective welfare can be regarded as a sum of individual well-beings. In opposition to utilitarianism, Rawls propose a theory of social justice, built upon a social contract between individuals who choose on the basis of a so-called "veil of ignorance". The key principle which governs their view of justice is the so-called "maximim principle"[2]. In this view, inequalities in the distribution of primary goods and services are regarded as unjust except to the extent that they serve to increase the well-being of the worst-off in society. Primary goods are "things that citizens need as free and equal persons" and include income and wealth. Sen's work extended the focus from equalising goods to what goods *do* for people, in his framework of justice as equalising capabilities across persons (Sen 1980)[3].

What is subjective well-being?

20. In the broadest sense, these measures aim to capture people's well-being, a proxy for their utility, by actually asking them about it. Using such indicators, policies, including redistributive policies, can be considered in terms of whether they improve people's perceptions of the quality of their own lives.

21. The two most commonly used measures of subjective well-being refer to life satisfaction ("Overall, how satisfied are you with your life these days?") or to happiness ("How happy are you with your life?"). The answers to these questions are ranked on an ordered scale, ranging from least to most happy or satisfied.[4] The scale of responses differs between questions and between surveys.[5]

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2 See Rawls (1971). See Little (2002) for an excellent, non-technical discussion of Rawls theory of justice and its contrasts with utilitarianism.

3 Note that the vector of functionings underlying Sen's notion of capabilities was initially limited to "objective" aspects of behaviour such as health, literacy etc. However, at a later stage, Sen (1992) also added "happiness" to the list.

4 Studies have shown that answers to such questions are reliable, both with regard to test-re-test correlations and with regard to third-partiy judgements (e.g. friends and family, interviewer). Further, many panel data studies have found that subjective well-being at time t predicts future behaviour, e.g. in terms of job quits or future marital break-up.

5 One popular life satisfaction question is Cantril's ladder of life, recently applied by the Gallup organization. The Cantril ladder requires respondents to rate their satisfaction with their lives relative to self-defined minima and maxima (the concepts of the "worst and best possible life for you") and are then asked "on which step of the ladder do you feel you personally stand at the present time?").

What does the subjective well-being literature say regarding inequality?

22. What insights can this new literature shed on the issue of income inequality, income comparisons and the potential for public interventions to improve subjective well-being by re-distributing income?

23. First, that there is very strong evidence that poor people gain more in subjective well-being from a dollar of extra income than richer people. One way of interpreting this evidence is that the marginal utility of income is declining. Thus, optimising overall subjective well-being may involve prioritising lower over high-income people to obtain the maximum gain in societal well-being, with the consequence of a compression in the income distribution and a reduction in inequality.

24. However, there is also evidence of loss aversion – subjective well- being is more affected by a fall in income than a rise of a similar amount, which may impose a substantial constraint on redistributional policies of the "Robin Hood" variety.

"Keeping up with the Jones" matters

25. Second, the evidence suggests that comparisons with others matter for subjective well-being. Differences in income are an important source of such comparisons.

26. Theoretically and empirically, income comparisons can be good or bad for "happiness". If an individual's income falls short of others, this comparison can be positive – a signal that one's income is soon likely to increase. Or it may be negative – people feel bad because they are worse off than their peers.

27. Empirically, positive "signal" effects of inequality seem to dominate in many former state socialist countries and the United States. On the other hand, negative comparison effects tend to dominate in Western Europe. These geographic differences have been related to perceptions of income mobility in former socialist states and the United States being higher (though these perceptions may be at odds with objective reality), and perceptions that the reasons people move up are socially fair (*i.e.* due to people working hard and not on account of corruption, social connections, and nepotism).

28. Most studies find a negative welfare impact of income of a reference group on a person's happiness or life satisfaction. In many cases, the effects of reference income and own income were found to be of the same magnitude but with opposite signs, suggesting that the net benefit of higher income for all in the group is zero (Clark and Oswald, 1996; Ferrer-i-Carbonnell, 2005; Helliwell and Huang, 2009).

29. What are people's reference groups? Some studies consider the relationship between income gaps in the professional sphere and various notions of satisfaction, ranging from job to life satisfaction. The hypothetical reference group is then defined as being composed of colleagues or workers with the same productive characteristics. Beyond the impact of relative income, a few studies have shown evidence that self-reported well-being depends upon the ordinal rank of an individual's wage within a comparison group, such as his/her firm, industry or society as a whole.

30. There is also direct evidence on reference groups from people's own responses. In a recent paper, Senik (2009) exploited a survey of 25 post-Transition countries (Life in Transition Survey, 2006), where people were explicitly asked to compare their current living standard with those of groups including former colleagues, former school-mates, parents, and one's own past standard of living that they used to know before the transition started. She finds that the most important negative welfare impact comes from the deterioration of one's own living standard and from under-performing relative to one's former schoolmates or colleagues, rather than from more general comparisons. Additionally, comparisons which reduce satisfaction increase the demand for income redistribution. A possible interpretation is that comparison benchmarks are all the more significant when they are interpreted in terms of seized or lost opportunities.

31. New survey information from 22 European countries with direct measures of the intensity and the direction of income comparisons allowed Clark and Senik (2009) to address the following questions: (i) Do people compare their incomes? (ii) If so, to whom do people compare their incomes? and (iii) Do income comparisons affect subjective well-being and a demand for income redistribution?

32. It turns out that income comparisons are acknowledged as important by the majority of Europeans. They are associated with lower levels of self-declared happiness, and this negative impact increases with the age of the respondent but falls with their income. Colleagues are the most frequently-cited reference group. Interestingly, they are also the most innocuous as their income situation produces the smallest reduction in the subjects' well-being. It is comparisons with family members and "others", much more than comparisons with colleagues, that hurt more and prompt a demand for income redistribution. (Clark and Senik 2009)

33. A general lesson of this literature is the following: income comparisons can have a negative impact on well-being, but they may also increase life satisfaction when they create prospects for mobility. This literature strengthens the case for labour market inclusion of the disadvantaged. Integration into the labour market makes it more likely that relative deprivation can be partly compensated by prospects for improvement.

34. However, results are also country-specific and are strongly conditional on beliefs about the justice or otherwise of the existing income distribution. This raises the interesting policy question of whether the focus might be on changing the distribution or changing the beliefs about what gives rise to the distribution. Of course, much political discourse in many countries is about a struggle to influence beliefs about the justice or otherwise of current levels of inequality.

Income distribution as a whole

35. Beyond the gap between individual income and some relevant other's income, how does income distribution *overall* affect subjective well-being? The relationship is generally hypothesized to be negative, with higher societal inequality being associated with lower average subjective well-being. There are many possible pathways which may lie behind such an empirical finding. The first and probably most commonly postulated relationship is the concavity of utility, as proxied by subjective well-being measures, with respect to income. If the marginal utility of income is decreasing, then the more unequal the distribution of income is, the lower the average well-being. This pathway has been discussed above and there is good evidence for it. Additionally, income inequality – and extreme poverty – can also reduce well-being if it generates negative social externalities in the form of crime and violence or simply via observation of disadvantaged people in public spaces.

36. Furthermore, people may have a preference for more or less equal distributions because of the consequences for their own situation and prospects. Among these channels, the most common motives considered are risk-aversion and prospects for upward mobility. These relationships derive from a view of the income distribution as a ladder that one can either descend or ascend. Attitudes to inequality can also be based on other-regarding preferences such as fairness and reciprocity. Essentially, the idea is that people are unhappy when faced with income inequality when they judge that it is not grounded in a fair process regardless of their income position.

37. In summary, attitudes to income inequality and a demand for income redistribution can stem from self- or other-regarding motives. Beyond this distinction, an important point is that these attitudes are the joint output of preferences and beliefs concerning income distribution in society. The demand for redistribution is expected to be strong whenever people have strong preferences for equal outcomes or opportunities but believe that in the society in which they live, outcomes or opportunities are unequal.

Possible explanations for different societal preferences for equality

38. Most studies on these issues have hypothesized that preferences for equality are universal, while there is an important degree of heterogeneity in beliefs about the sources of income inequality or the return to individual efforts.

39. The most obvious basis of inequality aversion and an ensuing desire for redistribution is self-interest. All studies based on survey data show that certain socio-demographic variables are correlated with less tolerance for income inequality (Alesina and Giuliano 2009). These include:

- age (being older)
- gender (women)
- ethnicity (poorer minorities)
- income levels (poor), and:
- marital status (singles).

40. These findings may arise because those with these characteristics are more likely to be in the lower part of the income distribution or more exposed to the higher risk implied by higher inequality.

41. Support for income redistribution can be viewed as a demand for social insurance against income-risk. This risk-aversion motive is largely confirmed by empirical evidence. In 1996, in Russia, for example, 63% of the individuals who belonged to the richest consumption decile were in favour of "restricting the income of the rich": those were essentially individuals who expected their personal material situation to deteriorate in the coming year. (Ravallion and Lokshin 2000)

42. Risk aversion can differ across people depending on their experiences. Negative experiences can change the beliefs of people, making them more risk-averse or less optimistic about upward mobility. Having experienced personal trauma (death of a relative, divorce, unemployment or hospitalization) positively affects the desire for income redistribution by the state. By way of contrast, self-employed people, less risk-averse than the average, are much less in favour of redistribution, even after controlling for income and other individual characteristics (Alesina and Giuliano 2009; Alesina and La Ferrara 2005).

43. Finally, risk aversion is a strong argument for reducing poverty, both absolute and relative. Indeed, reducing the share of the population in the extreme ends of the income distribution is a means to reduce the expected variance of individual income.

44. People may desire more redistribution because they fear falling down the income scale, but they may also desire less redistribution when they expect to climb the same social ladder. Alesina *et al*. (2009) stressed the importance of perceived – instead of actual – mobility: " *... in the U.S., the poor see inequality as a ladder that, although steep, may be climbed, while in Europe the poor see that ladder as more difficult to ascend*." This difference could explain why Europeans are more averse to income inequality than Americans.

45. Risk-aversion and prospects for upward mobility are self-centered motives. But what about pure preferences for equality? The unstable relationship between inequality and happiness has led some to hypothesize that attitudes to inequality could be cultural, in the sense that they are persistent in time and transmitted from generation to generation. If preferences for inequality are part of national culture, they should naturally differ across countries.

46. There is indeed evidence of international differences in attitudes towards inequality. Declared satisfaction in the *Eurobarometer* survey (1975-1991) and the *General Social Survey* (1972-1994) shows that inequality measures like Gini coefficients calculated at the State level do not affect the well-being of Americans, no matter whether they are right or left-wing in politics, or poorer or richer than the median person. In contrast, Europeans' satisfaction decreases with the degree of inequality in their country, most strongly for both poor and left-wing people. Europeans thus seem to have a pure preference for income equality compared with their US counterparts[6]. (Alesina *et al*. 2004)

47. A person's attitude towards redistribution depends on his/her opinion concerning the determinants of income (Alesina and La Ferrara 2005). Those who think that income is determined by luck, social acquaintances, and family history rather than individual effort, education, ability, are more favourable to government redistribution, even after controlling for all their personal circumstances. The demand for redistribution may be a demand for social insurance aimed at reducing the role of luck, a view which resonates with Rawls theory of social justice (see above). In this sense, a fair income distribution would be one in which the role of accidents is reduced. But beyond this opposition between individual (endogenous) effort and (exogenous) luck, individual outcomes can also be the fruit of corruption, social connections, fraud, etc. The demand for redistribution is then based on beliefs about the procedures which create income inequality.

48. Social attitudes to inequality may change. An analysis of repeated cross-section surveys of the Polish population shows a structural break in the relationship between income inequality and subjective well-being. Inequality, initially perceived as a positive signal of increased opportunities, starts to undermine satisfaction after a couple of years when individuals become sceptical about the legitimacy of the enrichment of reform winners. Various public opinion surveys confirm the changing popular opinions about the degree of corruption in the country and the desirability of high pay-offs in certain professions. (Grosfeld and Senik 2009)

49. At this early stage of its development, the literature on inequality and subjective well-being has not had a strong connection to policies to redistribute income. A notable exception is the proposal for a re-distributory progressive tax policy in recent books on subjective well-being by Robert Frank (1985, 1999) and Richard Layard (2005). However, in a recent review article on the tax implications of the happiness literature, Weisbach (2008) concludes that "we do not yet know enough to make recommendations to change the tax system on the basis of the happiness literature". The reason is that the research on redistribution in the subjective well-being models has not yet been done in a manner that allows identification of the key parameters from the point of view of inclusion into optimal tax models.

6 Exploring the same cultural hypothesis further, Alesina and Fuchs-Schündeln (2007) exploited the "experiment" of German reunification in order to establish a causal link running from the prevalent ideology to individual preferences. At the outset of reunification, East Germans were more in favour of redistribution and state intervention than West Germans, even after controlling for economic incentives. This effect was especially strong for older cohorts, who lived under Communism for a longer time period. However, with time, East Germans' preferences have partially and slowly converged towards those of West Germans. The authors interpret this as evidence of the impact of ideology or habit, as Easterners may have "become used to an intrusive public sector".

Conclusion

50. The empirical literature about inequality and subjective well-being shows that the impact of income inequality depends on the vision that citizens have of their society, their preferences concerning this society and their beliefs about the way it functions and the groups that compose it.

51. What are the possible policy implications that can be derived from these findings? The literature is in its unruly teenage years, and strong policy conclusions are not yet available. However, some things can be said. Beliefs about the causes of high and low incomes matter. People consider it unfair to free ride on the contribution and efforts of others. In this view, a pro-poor policy should try to design a system of income security and economic opportunity that would tap these motivations.

52. One of the strongest research focuses in the literature on subjective well-being has been the causal impact of changes in income on subjective well-being, finding a positive but diminishing relationship between income and subjective well-being. This non-linearity immediately suggests the policy possibility of raising average subjective well-being by redistribution of income from high to low-income people. The strong evidence of loss-aversion (a given rise in income has a lesser effect than a given fall on subjective well-being) suggests that it may only be marginal additional income which can be redistributed in such a fashion. This also has implications for policies addressing inter-generational inequality. If gains are more rapidly and thoroughly adapted to than losses (loss aversion), it becomes important to avoid downward mobility and there is less to be gained by upward mobility.

53. This paper has shown that people's happiness is affected in different ways by income inequality in different countries, and that the impact also depends on which groups each person compares himself or herself to. While in some cases inequality can have an incentive effect, it is also often perceived as a threat, a possibility of sliding down the ladder rather than moving up. Thus, from the subjective well-being perspective alone, economic growth with increasing inequality would not deserve to be classified as pure progress. When the economic costs and political costs of increasing income inequality are added, there appears to be a good case for modifying the concept of progress to take inequality into account.

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