Abstract

The widespread concern that the gap between the rich and the poor is continuously expanding prompts the stimulus for further examination. Standard theory suggests that the level of income inequality has a significant effect on policies with redistributive elements. However, empirical studies propose that rather than the actual shape of income distribution, individual perceptions of income distribution define the public finance models. Individuals tend to misperceive income inequality, yet there is little evidence regarding the origins of these perception biases. The bachelor thesis examines one of the possible theories that attempt to explain roots of misperceptions. The geographic reference group theory suggests that people project their local findings onto their estimates of overall income inequality. To test this hypothesis, we used the Gini coefficient with respect to country's districts as an explanatory variable and the subjective inequality index (Perceived inequality index) as a dependent variable. The empirical findings, nevertheless, provide little support for the geographic reference group theory as all regressions showed a highly insignificant relationship between district inequality and perceived inequality. The evidence suggests that respondents, who live in districts with high levels of income inequality relative to other districts do not necessarily perceive income inequality more critically.