

Abstract: We study how income inequality in the composition of peers exerts nonlinear effects across the distribution of students' household income on short- and long-run educational outcomes. We propose a theoretical framework where inequality in peer groups can generate aspiration gaps and draw from this a set of empirical predictions. Guided by these predictions we find that an increase in the share of low income peers within school-cohorts improves the educational outcomes of low income students, has null effects on middle income students, and negative effects on high income students. We further document a range of evidence that corroborates these results before turning to assess factors that moderate the consequences of inequality in peer groups. We find that social cohesion has an important role such that the effects are mitigated for students who have better connections in the school network. Our results provide evidence on how inequality in peer groups can have long-run affects on education, while also demonstrating that there is potential to avoid these consequences.