

## **Project: Public Economics, Economic Power and Distribution**

### **Research topics**

**(i) Long run trends in top incomes (wealth):** In empirical Public Economics, there has been a recent upsurge of interest in advanced countries at the top of the income and wealth distribution. The studies, starting with Piketty (2001) for France, have used income tax statistics to examine long-run trends in top incomes in various countries – notably Atkinson (2002) for the UK. The evolution of top incomes in Finland has been dramatic and the period of major income equalization from the mid 1960s to the mid 1990s has been reversed. The shares of top income groups are now higher than found 40 years ago. The main factor that has driven up the top income shares in Finland since the mid 1990s is in an unprecedented increase in the fraction of capital income. Top incomes are composed more and more of dividend income (Riihelä et al. 2005, 2007). Our results suggest that the decline in income progressivity since the mid 1990s is a central factor explaining the increase of top income shares in Finland (see also Suoniemi, 2004). Our earlier studies suggest that even in the contemporary welfare state economic elites not only exist but dispose an enormous economic power, measured in terms of income relative to ordinary people's income. It is also often blamed income and wealth concentration for tilting the political process in favour of the wealthy. In this view progressive taxation is an appropriate counter-force against wealth and income concentration. Thus, elites constitute an important ingredient of our economic system, one that deserves more economic research. Specifically, exploring the income shares and composition of top income group may contribute to a better understanding of the determinants of economic success or failure. These considerations are closely related to the debate on the relationship between inequality and growth. Therefore it is of great importance to understand the forces driving income and wealth concentration over time and understand how effective taxation and public expenditures are as government interventions. To make progress on those questions, the availability of long and homogeneous series of income and wealth concentrations is very important.

We aim to extend our previous studies to include top wealth shares. The concepts of wealth and power relate in various ways. First, certain kinds of wealth, such as stock ownership, can be used to control corporations, which have a major impact on how society functions. Second, just as wealth can lead to power, so too can power lead to wealth. Those who control a government can use their position to promote their own interests. Finally, both wealth and income distribution can be also used as power indicators. We also aim to extend our previous empirical studies to which extent change in social norms and public policy, in particular our income tax system has been responsible for changes in top income shares over the last ten years. We also plan theoretical work on social norms and redistribution within optimal tax framework.

**(ii) Top incomes (wealth) and taxes:** We will use the Wealth and Housing Surveys collected by the Statistics of Finland (1994, 1998 and the most recent data from 2005, available in 2007), and a new very large set of panel data of individual incomes compiled by Statistics Finland using register data starting from 1995. Due to these new data sets we can deliver a very precise description of top incomes and wealth, in terms of shares (or distribution) and composition by source. We can also produce effective average tax rates for various groups, and especially for top income groups. Additionally we plan to examine top incomes (and poverty) and their persistence, i.e. income mobility among the high (and low) incomes using these new data sources.

**(iii) Taxing the wealthy:** The critical question is whether differences in income come mostly from luck or from ability. If luck plays a substantial role in the determination of income it makes sense to have a progressive tax, creating a form of social insurance in which the lucky subsidize the unlucky. None of these considerations bear directly on the question whether there should be a tax on the returns from capital. There are considerable variations in the rate of return people receive on their capital. It is quite possible that some of variations in the return on capital are the result of the

application of skill and effort; but most is clearly the result of risky outcomes (luck). These considerations may suggest, even in the world of mobile individuals and capital, there is a case for rather progressive tax on income from capital. This would provide people with insurance against investment risk. It is our aim to extend optimal tax framework with these considerations. These questions are particularly important in the context of the Finnish dual income tax model.

**(vi) Voting, polarization of income distribution and provision of local public goods:**

Voting activity varies with education and income. Relative income differentials among the voting districts may play a substantial role in explaining voting participation. Therefore, political processes that aim to either widening or dampening of income differentials by public policy may be self-enforcing. We plan to study this hypothesis by examining voting participation and voting behaviour in Finnish parliamentary and municipal elections using a new data set where local aggregates of wage and capital income, taxes and social transfers, and some social-economic variables by *voting districts* are calculated by the Statistics of Finland using their extensive panel data on all individual incomes in Finland from 1995. Using data from individual voting districts we expect to get more precise empirical results from our analysis than studies that use more aggregated, say municipal, data.

**(v) Inequality and growth:** Some economists argue that unequal income distribution is a necessary but regrettable consequence of economic policy that enhances growth. For them, unequal wealth and income distribution is seen as a necessary outcome of an economic environment that provides incentives for work, entrepreneurship, capital accumulation that in turn are key elements of macro-economic success. Many economists in turn have challenged the growth-inequality syllogism on the grounds that in some circumstances, inequality can serve as an obstacle to growth. Several macro theories predict that inequality might have negative impact on economic growth. There are also several attempts that have tried to test this relationship. The key weakness of the previous studies is that they have used low-quality international databases on inequality. The current consensus on this relationship seems to be that there is no systematic empirical relationship between inequality and growth. Using new international database on top income shares we are going to test the impact of inequality on growth.

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**Publications**

Marja Riihelä - Risto Sullström - Matti Tuomala and Markus Jäntti (2008), Long term trends in top income shares in Finland, eds. Tony Atkinson-Thomas Piketty, forthcoming **Oxford University Press**.

Marja Riihelä-Risto Sullström - Matti Tuomala (2007), Varallisuuserot kasvussa, kirjassa Kasvun hedelmät toim. Heikki Taimio, **TSL Helsinki**

Hannu Tanninen - Matti Tuomala, (2007), Talouden kasvu ja tulonjako, Jukka Pekkarisen juhla-kirja toim. M.Jäntti et al. **PT Helsinki**.

Marja Riihelä-Risto Sullström – Ilpo Suoniemi (2007), Tuloerojen kehitys ja verotus, kirjassa Kasvun hedelmät toim. Heikki Taimio, **TSL Helsinki**