English summary

Income distribution, taxation and equality have been hotly debated in Iceland in recent years and indeed for decades. In this collection of papers, six Icelandic scholars discuss some of the issues arising from an analysis of these topics. The authors do not agree on everything, but they seem nevertheless to have made some common conclusions:

- It is hard properly to measure distribution of income. One-dimensional indices like the Gini coefficient can produce quite misleading results.
- Income varies with age. Therefore measurements of income distribution in one year or over a period of years, for example by the Gini coefficient, will always show an unequal distribution, even in cases where incomes over lifetime would be exactly equal. Thus, the measurement of income distribution is already distorted.
- For the same reason, some social changes, usually regarded as positive, such as longer life expectancy, lower retirement age, more education and longer school attendance will bring about a measured increase in inequality by for example a Gini coefficient, even in cases where incomes over lifetime would be exactly equal.
- Poverty, both relative (which is really a measurement of distribution of income) and absolute, tends to be less significant, the more economic freedom the countries of the world enjoy. In Iceland, relative poverty is on the same level as in the other Nordic countries, and this has been so for a long time.
- The income tax, both the tax rate and the tax burden, was lowered in 1995–2008, but it has been raised significantly since, except for the lowest-income group.
- High marginal taxes lead to so-called tax wedges: incomes at a level where the gain from the supply of additional labour is negligible. Tax wedges reduce the supply of labour so they are socially damaging. They should be regarded as a defect in the design of a tax system.
- Tax wedges are higher in Iceland than in the other Nordic countries. The reasons are (i) a high level of tax-free income, and (ii) a high tax rate in the first taxed level.
- Tax payments less benefits and other gains to taxpayers from the tax collected, may be called a net income tax. When the income tax burden is analysed, it is necessary to look at the net income tax.
- It is highly likely that the net income tax is much more progressive in Iceland than the gross income tax.

- The Icelandic system of taxes and benefits is characterised by a progressive income tax and means-tested benefits. This system leads to strange and abrupt changes in the real marginal tax, especially in the low and middle income groups. At some levels it is not financially advantageous for people to try to increase their income. Thus the system creates so-called poverty traps.

The book is divided into three parts. The first is devoted to Income Distribution. In the first paper in this part, Professor Ragnar Arnason discusses income distribution and lifetime incomes. He points out that an individual's income varies over his or her lifetime. It is usually low in the beginning, relatively high in mid-age and again relatively low in old age. This fact will be reflected in all measurements of income distribution over all age groups. Such measurements will always show inequality, even if there would be perfect equality in the sense that everybody would enjoy equal lifetime income. Arnason uses numerical examples to demonstrate that the Gini coefficient would always be between 0.2 and 0.3 (0 being equivalent to total equality and 1 to total inequality), even if all would enjoy equal lifetime income. Arnason uses the same method to demonstrate that the Gini coefficient would show more inequality if people go longer to school or if life expectancy would increase, even if all would, in his hypothetical example, continue to enjoy equal lifetime income. Arnason concludes that the use of Gini coefficients in discussions on changes in income distribution can be very misleading. To get an adequate idea about income distribution, lifetime incomes have to be measured.

In the second paper, Dr. Birgir Thor Runolfsson discusses poverty in an international perspective. He refers to much evidence that the strong connection between economic freedom on the one hand and high living standards and little poverty on the other hand is a causal one, not only a correlation. In particular, Dr. Runolfsson discusses the "economic freedom index" which has been developed by an international network of scholars. The latest available result is from 2012 and refers to the year 2010 and to 144 economies. It shows a strong connection between economic freedom and high living standards and also between economic freedom and little absolute poverty. No strong connection can however be identified between economic freedom and relative poverty, or income distribution. In free economies income distribution can be rather even, but it can also be rather uneven. Dr. Runolfsson emphasises that good institutions are crucial if people are to escape poverty. They have to have well-defined and well-protected private property rights to the means of production and to be able to utilise the advantages of the division of labour and of free trade, as Adam Smith had argued long ago.

In the third paper, Professor Hannes H. Gissurarson discusses income distribution and welfare benefits in Iceland in comparison to the other Nordic countries. He quotes several works by Professor Stefan Olafsson and others where they argue that during the comprehensive liberal economic reforms in Iceland in 1991–2004 inequality had increased more and the living standards of single parents and of pensioneers had become worse than in the other Nordic countries. He points out that according to surveys by Eurostat and Statistics Iceland, income distribution in Iceland in 2003–4 was similar to that in the other Nordic countries, the Gini coefficient showing more equality in Sweden and Denmark and less equality in Norway and Finland. What had happened was that Olafsson had compared incomparable data, namely income with all capital gains included in Iceland and income without some parts of capital gains (profits from selling stocks) in the other Nordic countries; this had made quite a difference. Moreover, official statistics do not show, according to Professor Gissurarson, more relative poverty in Iceland in 2003–4 than in the other Nordic countries, as Olafsson had also asserted. Iceland was, with Sweden, one of the European countries where poverty was at the lowest level. Welfare benefits were not, either, less generous than in the other Nordic countries. The difference was that they were means-tested so that for example a single, low-income parent received a much more generous benefit for each child than a wealthy couple would do. The Icelanders used less money per capita for children's benefits, but those who received them received more. The case of the pension system was similar, although for a different reason. Icelanders were typically not compelled to retire at 65 or 67, as in many other countries. Many of them chose to work longer. While total pension payments to people of pension age were therefore on average lower per capita in Iceland than in the other Nordic countries, the real pensions paid to the pensioneers themselves were however on average higher.

In the fourth paper in this first part of the book, Dr. Helgi Tomasson discusses income distributions. He points out that all models or measurements of income distribution require simplifications which may affect the results. The Gini coefficient is one of the attempts to model income distribution and to come up with relevant figures for inequality. It has its limitations, however. The Atkinson, Kolm and Theil indices of inequality are more complicated, but more adequate from a theoretical point of view. It is therefore worth considering why the Gini coefficient is so widely used in official statistics on income distributions. Probably the main reason is how simple it is and easy to use. Dr. Tomasson then illustrates many of the pitfalls of using the Gini coefficient when significant demographic changes are taking place, such as aging populations, growing or shrinking populations, vast differences in the size of age groups, and increases in the divorce rate or other factors determining how many live in families and how many single. The Gini coefficient is affected by all these factors, even if the real income distribution would remain the same. Scholars should therefore be more cautious, Dr. Tomasson concludes, in using this particular measurement of inequality, especially in recommendations of certain policies.

The second part of the book is about Taxes and Tax Burdens. In the first paper, Professor Ragnar Arnason discusses the real tax burden on various income groups. He points out that government is supposed to use tax revenue to provide three kinds of services to taxpayers. First, it produces private or quasi-private goods such as professional education, health care and transport facilities. These goods could be produced and priced in the market. In the second place, government produces public goods such as defence, policing, basic education and setting safety standards. All citizens benefit from the production of these goods. Thirdly, government transfers various kinds of benefits to groups on grounds of need or obligation; mostly these are welfare benefits. Professor Arnason then discusses to what extent different income groups benefit from these three kinds of services, arguing that low-income groups probably benefit more from transfer payments, or welfare benefits, and from the public provision of some private or quasi-private goods, such as health care, whereas high-income groups possibly benefit more from the public production of some private goods, such as professional education, and most public goods, such as policing and transport facilities. On the whole, according to Arnason, income and government benefits do not seem to be closely correlated. But if taxpayers receive roughly equal benefits from government, irrespective of their income, it is clear that low-income groups gain from the income tax structure, whereas high-income groups lose. The net tax burden of low-income groups—their tax burden less their benefits—is negative, whereas the net tax burden of high-income groups is positive. Consequently, the net income tax is really much more progressive than figures about the gross income tax would suggest. Professor Arnason illustrates with examples that the difference can be quite significant. Thus, the income tax system may reduce the willingness to work even more than it appears to do when figures about the gross income tax burden are discussed.

The second paper in this part is by economist Axel Hall on the tax system in Iceland until 2007. Under this system, according to Hall, an attempt was made to strike a precarious balance between efficiency and equality. Public expenditure was increasing in Iceland from 1980 to 2007, with direct taxes gradually becoming a larger part of the total tax revenue and indirect taxes a lesser part. However, the income tax rate fell, especially in the period from 1995 to 2007. The main reason for increased tax revenue, Hall says, was that income grew faster than the income tax rate fell; the tax-free income limit was not adjusted to the general growth of income; consequently a higher proportion of people paid income tax than before. Hall adds that a similar development took place in many other OECD countries in this period. Disposable income, i.e. income after tax, grew in all income groups in Iceland from 1995 to 2007, but fastest in the highest income groups. Despite higher income tax payments in this period, therefore, living standards of all groups improved. However, the redistributive or equalizing impact of the tax system was reduced during this period, so in that sense it became more efficient. Hall quotes studies by Edward Prescott and other economists showing that in the United States people work harder (longer hours) than in Europe because they pay lower tax on their additional work hours. Therefore, it is plausible to conclude that raising taxes for redistributive purposes will reduce the willingness to work. This will in turn slow down economic growth, and in the long run reduce the income of low-income groups.

In the third paper in this part of the book, Axel Hall compares the Icelandic tax system to that of the other Nordic countries. He describes briefly the changes in the tax system after 2008 when a progressive income tax was adopted, essentially in two steps after the tax-free income limit. Taxes on middle and high-income groups were raised, while lowered slightly on low-income groups. Hall points out that in the other Nordic countries the tax-free income limit remains much lower than in Iceland. If the Icelandic tax authorities had aimed at a more Nordic tax system, then they should have lowered the tax-free income limit much more. The lower step in the income tax—after the 0 per cent tax below the tax free limit—is relatively high in Iceland, creating a tax wedge. This reduces the incentives for low-income earners to seek work. A lower tax rate at this level combined with a much lower tax-free limit would work against this. Hall adds that in Iceland, unlike the other Nordic countries, children's benefits are means-tested which also creates a tax wedge. By raising their income people may lose a part of their children's benefits.

The third part of the book is about Taxes and Redistribution. The first paper in this part is by economist Arnaldur Solvi Kristjansson. He analyses the real marginal taxes paid by Icelandic citizens, taxes less benefits, a concept akin to the net income tax discussed by Professor Ragnar Arnason. Solvason points out that the stated goal of a progressive income tax and of means-tested benefits is to make disposable incomes more equal and to alleviate poverty. However, under the Icelandic tax system low-income groups face high marginal taxes at certain levels. They are sometimes caught in poverty traps which Kristjansson defines as situations where the reduction in benefits exceeds the additional increase in income from working longer hours, in other words when the real marginal tax is over 100 per cent. It has also a significant impact, according to Kristjansson, when real marginal taxes become more than 50 per cent at a broad low-income level. Kristjansson provides a comprehensive overview of the Icelandic tax system as it was in 2008. He discusses the interplay of the income tax with children's benefits, mortgage interest credits, house rent subsidies, direct relief from municipalities, unemployment benefits, pensions and repayments of students' loans. Kristjansson's calculations demonstrate that there are many poverty traps embedded in the system, because of high marginal taxes at a broad income level.

The second paper in this third part of the book is by Professor Ragnar Arnason. He investigates to what extent the income tax system redistributes income from high-income groups to low-income groups. Taxes reduce disposable income, but much more that of the high-income groups than of others. This means that income distribution is more equal after than before tax. But, in addition, tax revenue is used to provide services to taxpayers and to transfer other kinds of benefits to them. These benefits can be regarded as income, the cost of producing these services, and they are comparable to transfer payments. Therefore, it makes sense to speak of net disposable income, which would be disposable income with the addition of transfer payments and cost of goods produced by government. Most transfer payments go to the low-income groups. This is also the case, Professor Arnason argues, with most public services where health care and education are the most widely used. The groups using these services, patients and students, are mostly in low-income groups. Therefore, the net disposable income distribution—income after income tax, benefits and public services—must be more equal than the income distribution after tax. Professor Arnason illustrates this with a few examples: they show that even under the assumption that public services financed by the income tax are distributed equally among all income groups, a Gini coefficient derived from the net disposable tax would show much more equality than a Gini coefficient derived from income before and after tax. Professor Arnason concludes that in discussing equality and income distribution it may be highly misleading to overlook the distribution of that which matters most to people which is their access to goods, or in other words their net disposable income.