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Is the Financial Market driving the Income Distribution? - An Analysis of the Linkage between Income and Wealth in Europe

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Globalisation has a major impact on the levels and distribution of wealth. The financial markets are highly integrated and valuations of financial assets follow international patterns. For instance, in Finland financial wealth has almost doubled in real terms between 1995 and 2016. This has not lead to an equally large increase in property income because the rates of return have almost halved during the same era. During this period the share of capital in the functional income distribution has slightly increased. This has not been reflected fully in the distribution of primary income between households, because other institutional sectors – particularly, the government sector – hold considerable amounts of financial assets.

Even though these results refer to Finland, it is unlikely that the development is completely different in other countries. A key factor in explaining these developments is likely the decreased rates of return, evident in all the Western societies. It is also probable that the largest differences in the developments in different regions are caused by differences in the profitability of companies and in particular, structural elements of the economy such as how large a role the government sector.

At least in the short term, the decrease in rates of return seem to contradict Thomas Piketty’s theory which claims that due to increase of financial as well as inherited property, we are entering into an era of increasing income inequality.

In this paper, the link between financial wealth and pre-tax income distribution is scrutinised in a conceptually fully consistent macro framework for selected European countries. First, the national balance sheets are combined with the related income flows. After this, the income flows which are not property income but belong to the national income concepts (e.g. wages and salaries) are added. Finally, the national income flows are broken down by the institutional sectors and the household sector income flows separated. The income flows are then linked with income distribution (micro) data and these income flows are broken down by income deciles. By using this framework, this paper analyses how the property income flows created by the financial wealth have affected the income distribution between the households.