



Tackle inequality by transforming the tax system

by Karl Happe | 08/01/2019   



Summary

There is no easy solution to the problem of rising economic inequality, but we may be able to address it with a more enlightened tax system – one that maintains incentives for work and investment while improving economic efficiency.

Key takeaways

- Making tax systems more progressive could create positive incentives for work, which could help reduce the wealth and income gap
- Fairer tax systems could combat rising inequality by incentivising companies to invest more in their businesses – including in their employees – rather than encouraging automation
- To help boost productivity and investment, we could reform the tax code to reward companies for generating operating earnings – not for financially engineering their results
- A more equitable tax system could help the wealthy – not just low- and middle-income earners – by potentially reducing political turmoil and increasing economic growth

Rising economic inequality is a pressing problem that drags down growth and destabilises societies, putting low- to middle-income earners in increasingly precarious economic situations as fewer people control a growing share of income and wealth.

While the biggest impact is on those on the lower end of the economic spectrum, economic inequality has ramifications for everyone. Government revenue streams are growing more stretched as tax coffers shrink and welfare expenses rise; this can reduce the level and quality of government services across the board. And as the divide between the haves and have-nots expands, resurgent populism is threatening to create headwinds for economies and markets.

Given these tensions, couldn't we construct an economic model that maintains the benefits of capitalist production while limiting its tendency to create extreme inequality? One answer could be through a more enlightened tax system that incentivises investment while sharing the benefits of economic efficiency. Here are six ideas to help us get there.

1 Build better incentives for work over welfare

Governments have long searched for ways to encourage lower-income workers to work and reduce their dependency on state support. Universal income is a popular proposal among academics, but a negative income tax for low-income employees may be a better solution. Similar to how the US earned-income credit functions, a negative income tax would "pay" workers whose incomes are under a certain level. It could effectively target subsidies at people who don't earn much but are economically active, and it could limit the negative incentives created by welfare systems that provide basic support in exchange for not working. For this idea to be effective and sustainable, however, careful thought must be given to the transition between negative tax rates and positive ones.

2 Balance the taxation of labour and capital

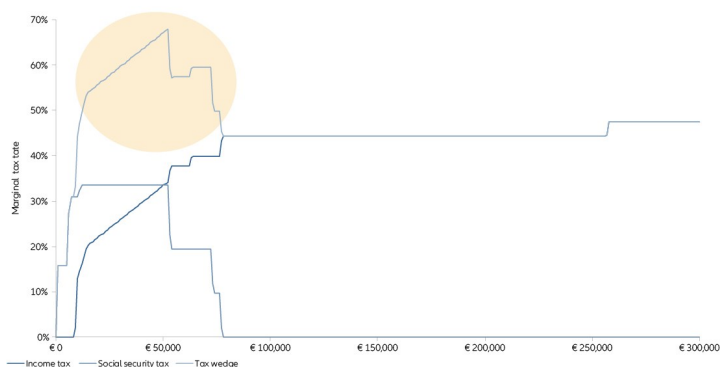
Automation and artificial intelligence have already displaced or eliminated millions of jobs around the world, and tax codes can make matters worse by taxing corporate earnings from automated processes at a lower rate than earnings from employing humans. This could be addressed by levelling out tax rates on employment income with tax rates on investment income and gains. Moreover, adjusting capital gains for inflation so only real gains are taxed would provide a greater incentive to invest for the longer term. These ideas might reduce efforts to reclassify employment income as investment income – a technique that many hedge funds use to lower tax bills for their employees, but that also reduces revenue streams for governments.

3 Design more progressive tax wedges

In many countries, social security (or payroll) taxes are taken out of earnings only up to a certain level. This can create unfair “tax wedges” – an example of which can be seen on the accompanying chart, which shows a higher sum of income and social security taxes for low- and middle-income earners than for higher-income earners. By making tax wedges more progressive – or at least not regressive – governments could reduce incentives for individuals to either not work, or to limit how much they work.

Germany has extreme marginal tax wedges

These marginal tax wedges are higher for low- and medium-income earners than they are for high-wage earners, and they peak at about the average wage.



Source: OECD. Data as at 2018. Chart shows data for German single earners with no children.

4 Reduce the use of debt as financing

High levels of debt are a drag on economic growth. Yet in much of the developed world, corporate remuneration is linked to earnings per share, which can make it more profitable to use increased leverage to buy back shares. Tax codes also make it more attractive for companies to secure financing by taking on debt rather than using equity. A more fair system would tax corporations on their operating earnings – earnings before interest and taxes.

5 Impose a universal tax on land

One goal of tax reform should be to tax wealth rather than income in way that is both fair and hard to circumnavigate. Land taxes could be one such solution. A 1% annual tax on the market value of land – but perhaps not on improvements that enhance the value of the land – could make it more rewarding to develop land to its optimal economic use before selling it, and make it more expensive for speculators to hold on to undeveloped land while speculating on increasing prices. A tax like this could secure much-needed revenue that helps close the inequality gap while encouraging economic growth.

6 Close tax loopholes

Implementing a land tax is one way to reduce the amount of income that some wealthy citizens shield from taxes while also ensuring they still contribute their fair share to good government. Many similar loopholes exist, created by lobbyists and exploited by accountants to lower the tax bills of high earners. Real tax reform would close as many loopholes as possible and re-invest the proceeds in lower overall taxation rates.

These six steps won't be easy to implement, and they may not solve the economic inequality problem. Yet they could help make economies more robust, more equitable and more politically stable – and even help those paying higher taxes by potentially increasing economic growth rates.

Further reading

Learn about [the toll that economic inequality takes](#) on society, the [role that central banks play](#) in making inequality worse, and [specific strategies](#) for addressing this pressing global problem.

707584

About the author



Karl Happe
CIO Insurance-related Strategies

Karl Happe is Chief Investment Officer (CIO) Insurance Related Strategies with Allianz Global Investors, which he joined in 2013. He leads a team that manages equity and fixed-income portfolios for insurers. Karl was previously the head of the global fixed-income strategy team, responsible for managing global fixed-income portfolios for Allianz. Before joining Allianz in 2004, he worked at McKinsey & Co. in Munich; at BankBoston as the head of non-USD fixed income derivatives trading; and at Morgan Stanley in private equity and fixed income derivatives structuring and trading in New York, Frankfurt and London. Karl has a B.S.E in civil engineering and operations research, summa cum laude, from Princeton University and studied at the University of Stuttgart on a Fulbright scholarship. He also has an M.B.A. with distinction from INSEAD.

[→ VIEW DETAILS](#)

Want to view more?



Investment themes & strategy

A shared vision is vital for a sustainable recovery

[→ DISCOVER MORE](#)

by [Deborah Zurkow](#) | 27/08/2020



Investment themes & strategy

How will private debt be changed by Covid-19?

[→ DISCOVER MORE](#)

by [Deborah Zurkow](#) | 11/08/2020



Investment themes & strategy

ESG: What's really in the portfolio?

[→ DISCOVER MORE](#)



Active is: Finding value in Europe

For European equities, winter won't last forever

by [Stefan Hofrichter](#) | 08/01/2019 [📄](#) [↓](#) [↻](#)



Summary

While Europe faces its own share of political uncertainty, many of its headwinds are similar to those faced by capital markets around the world – not specific to Europe. In fact, with trade wars hurting the US and China, and with the Fed in danger of overreaching, European equities may be in a strong relative position.

Key takeaways

- Thanks to Brexit, Italian politics and EU Parliamentary elections, political uncertainty is on the cards for Europe in 2019 – and the markets don't like uncertainty
- If European equities can weather the region's political storms – which won't be without challenge – they could emerge in a strong position, particularly compared with US stocks
- Some of the biggest market headwinds aren't Europe-specific, including trade wars (which could hurt the US more than Europe) and monetary policy (the Fed may be at bigger risk of overplaying its hand than the ECB)
- Valuations are attractive for European equities, both compared with their long-term average and compared with US stocks: CAPE is around 18 in Europe vs about 30 in the US

↓ [LOAD MORE](#)

Disclaimer

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. [*] Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

This material has not been reviewed by any regulatory authorities. In mainland China, it is used only as supporting material to the offshore investment products offered by commercial banks under the Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations. This document does not constitute a public offer by virtue of Act Number 26.831 of the Argentine Republic and General Resolution No. 622/2013 of the NSC. This communication's sole purpose is to inform and does not under any circumstance constitute promotion or publicity of Allianz Global Investors products and/or services in Colombia or to Colombian residents pursuant to part 4 of Decree 2555 of 2010. This communication does not in any way aim to directly or indirectly initiate the purchase of a product or the provision of a service offered by Allianz Global Investors. Via reception of his document, each resident in Colombia acknowledges and accepts to have contacted Allianz Global Investors via their own initiative and that the communication under no circumstances does not arise from any promotional or marketing activities carried out by Allianz Global Investors. Colombian residents accept that accessing any type of social network page of Allianz Global Investors is done under their own responsibility and initiative and are aware that they may access specific information on the products and services of Allianz Global Investors. This communication is strictly private and confidential and may not be reproduced. This communication does not constitute a public offer of securities in Colombia pursuant to the public offer regulation set forth in Decree 2555 of 2010. This communication and the information provided herein should not be considered a solicitation or an offer by Allianz Global Investors or its affiliates to provide any financial products in Brazil, Panama, Peru, and Uruguay. In Australia, this material is presented by Allianz Global Investors Asia Pacific Limited ("AllianzGI AP") and is intended for the use of investment consultants and other institutional/professional investors only, and is not directed to the public or individual retail investors. AllianzGI AP is not licensed to provide financial services to retail clients in Australia. AllianzGI AP (Australian Registered Body Number 160 464 200) is exempt from the requirement to hold an Australian Foreign Financial Service License under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order (CO 03/1103) with respect to the provision of financial services to wholesale clients only. AllianzGI AP is licensed and regulated by Hong Kong Securities and Futures Commission under Hong Kong laws, which differ from Australian laws.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors U.S. LLC, an investment adviser registered with the U.S. Securities and Exchange Commission; Allianz Global Investors Distributors LLC, distributor registered with FINRA, is affiliated with Allianz Global Investors U.S. LLC; Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors (Schweiz) AG; Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 1999071692]; Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424, Member of Japan Investment Advisers Association and Investment Trust Association, Japan]; and Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan.

[*Subject to change – depends on the content of the material which may mention certain investment instruments that involve particular risk]

Our firm

[Why partner with us](#)

[A brief history](#)

[Inclusion & diversity](#)

[Sustainability](#)

[The SeaCleaners](#)

[Our leadership team](#)

[Our experts](#)

[Careers](#)

[Contact us](#)

Insights

[Outlook & commentary](#)

[Investment themes & strategy](#)

[Why active?](#)

[2020 Outlook](#)

[Coronavirus](#)

[Update Magazine](#)

[The Investment Intelligence](#)

[Podcast](#)

[Staying active](#)

Capabilities

[Alternatives](#)

[Equity](#)

[Fixed income](#)

[Multi asset](#)

[China A-shares](#)

[Research](#)

[risklab](#)

Press centre