Introduction and summary

We take pleasure in presenting the final report of the Income Tax and Benefits Committee. The committee was formed on 17 February 2012 by the State Secretary of Finance, Mr Weekers, and was asked to work out a limited number of scenarios for a simple, sound and fraud-resistant tax system that would also help improve the competitiveness of the Netherlands. These scenarios were to comprise substantially lower rates for wage tax and income tax, a simplification of income tax and benefits and a more coherent, transparent and effective system of tax credits and benefits. In principle, the proposals had to be budget-neutral. This means that any increase in the tax burden would have to be offset by a decrease. The committee wants to maintain and if possible, improve, tax ethics, which are generally good in the Netherlands.

The committee's work was interfered with by the fall of the Rutte I government and the early elections of 2012. These developments prompted the State Secretary to ask the committee to expedite publication of an interim report. This summary comprises both the contents of the interim report and those of the final report.

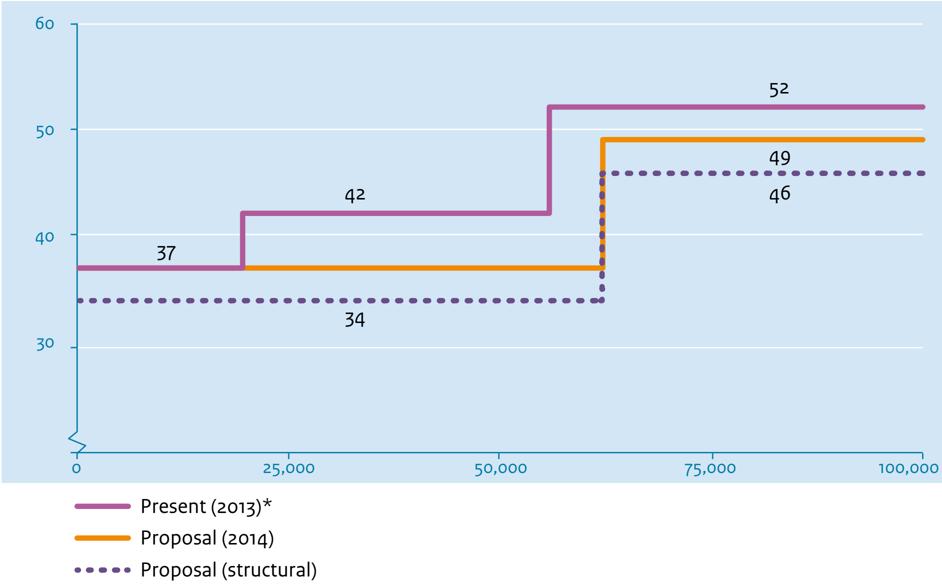
The interim report: making the tax system more motivating by broadening the tax base and lowering the rates in box 1

In the interim report the committee concentrated on the most important element of the wage and income tax in a budgetary sense, which is tax on income from work and home ownership (box 1) and which yields 95 percent of the gross income tax levy.

The committee formulated three priorities:
- encourage labour force participation by making work more profitable
- set the housing market in motion again
- stop just pumping money around and simplify the system.

These priorities were given shape in a system with only two income tax brackets. Under this system, the total income of more than ninety percent of taxpayers will fall in the lower tax bracket with a rate of 37 percent. The rate in the higher bracket will be reduced to 49 percent. The general tax credit will be increased by 300 euro and the earned income tax credit by around 400 euro. In later years the rates can decline even further, to 34 and 46 percent respectively. Labour force participation can be further promoted, among other things by increasing the earned income tax credit and adjusting the child-related budget. The starting point for these proposals is the situation in 2013 as it was set down in October 2012 in the various tax laws. Below the tax bracket system is shown in a diagram.

Figure 1 Present and proposed income tax rates for persons who have not yet reached retirement age



This new rates structure will be financed in the proposal by eliminating a number of tax deductibles, implementing measures to limit the tax subsidies for housing and increasing the VAT rate.

Imbalances in the housing market will be tackled by limiting the deductibility of mortgage interest for both existing and new cases. The rate at which mortgage interest can be deducted will be reduced in one go to 37 percent, the percentage of the new first tax bracket. This is possible thanks to the rate decrease that will take place at the same time. This deduction will also gradually be reduced for both existing and new cases, based on a fixed annuity schedule. This will encourage – but not force – home owners to pay off the total debt they incurred to buy their home. The committee comments that if the debt is paid off up to half the value of the home, this will be sufficient to remove the present financial risks in both a microeconomic and a macroeconomic sense. At the same time the committee chooses to eliminate transfer tax in full.

The committee has also made a provision for the so-called residual debt issue if the value of a home has fallen below the debt attached to it. The interest on the residual debt will continue to be deductible as mortgage interest on an owner-occupied home for twelve years. Furthermore the committee has proposed a temporary (guarantee) fund, financed from a limited surcharge on mortgages, to guarantee or help pay such debts. If this residual debt issue is not resolved, it will become a self-reinforcing mechanism that will continue to put pressure on housing prices.

Parallel to this, rents in the regulated sector will gradually be raised. The proceeds from the rent increase will be creamed off in the form of a landlord levy. The budgetary proceeds from these and other measures will be used to finance the above-described rate structure.

The committee wants to pump around less money and to simplify the system. The present system of income tax and benefits is composed of dozens of schemes that reduce the amount to be paid in income tax. Not only does this mean that money is pumped around unnecessarily, it also means that if a person decides to work more hours, it is less profitable than it could be. This formed a reason for the committee to make a number of proposals. They are based on an envisaged increase in the number of automated returns that are completed in full in advance. These proposals can be found in the summary of the interim report.

Ultimately the committee's proposal will defer 12.6 billion euro in the medium-term future, increasing to 24.2 billion euro in the long term. A calculation of the effect of the proposals in the interim report, made in October 2012 by CPB Netherlands Bureau for Economic Policy Analysis, shows that the number of jobs will increase by 2.1 percent. This corresponds with 142,000 full-time jobs. The proposals generally show a modestly positive effect on purchasing power. Employees stand to gain slightly, people in receipt of a benefit do not gain or lose, and retired persons may lose a bit, while the impact on those at the lower end of the scale will be cushioned.

At the request of the Dutch Lower House, the committee also gave consideration to neutrality with regard to domestic situation. The analysis makes it possible to base schemes aimed at labour force participation on individual income and schemes meant to serve as income support on total household income. The committee observes that there is no clear-cut definition of neutrality with regard to domestic situation.

The final report: changes in box 2 and box 3, streamlining tax allowances and combating fraud

The final report devotes attention to taxation of income from capital in box 2 for shareholders with a substantial interest and in box 3 for investors and holders of savings accounts. The proceeds from these boxes, around 5½ billion euro, are approximately five percent of the gross yield of income tax. Consideration is also given to the interrelationship of the various benefits and the relationship of benefits to the tax system.

Box 2: more balanced treatment of shareholders with a substantial interest, entrepreneurs, investors and employees and other workers

In box 2, the benefits are taxed that a shareholder enjoys from a substantial interest. A shareholder has a substantial interest if he holds at least 5 percent of the share capital. If the substantial interest holder also works in the company, he is referred to as owner-manager. The owner-manager is an specific figure and shares certain characteristics with four types of taxpayers. He is:

- an employee, and so he is taxed in box 1 (for wage tax and income tax)
- comparable to an unincorporated entrepreneur, whose profits are taxed in box 1
- a substantial interest holder, and so he is taxed in box 2
- comparable to a private investor, who is taxed in box 3.

How he is different to the unincorporated entrepreneur and the investor

The substantial interest scheme is aimed at keeping taxation of an entrepreneur who pays income tax and an owner-manager as equal as possible. But there are still differences. For his work in the company, the owner-manager is taxed as if he were an ordinary employee. The company must pay him a salary that is customary for someone who does the same work without being a substantial interest holder. His gross salary must be at least 43,000 euro, unless the owner-manager can make it plausible that a lower salary is customary. If the customary wage is higher, an efficiency margin of 30 percent applies. As a result, his salary is fixed at an amount that is much lower than customary. The profit after deduction of the salary of the owner-manager is taxed at a lower rate than the salary of an employee. Investigations by the committee showed that as profit increases, the salary of a director and major shareholder makes up a smaller and smaller portion of the profit.

Tax arrangements for an unincorporated entrepreneur are different. His total profit, including his remuneration for work, is taxed in box 1. Thanks to the entrepreneur facilities, the rate of this tax is lower than the tax on the salary of an employee.

The second difference between an unincorporated entrepreneur and an owner-manager is the option to defer a portion of the tax. If the profits are retained, only corporation tax is paid and the box 2 levy (intended to make the total amount paid in corporation tax and income tax broadly equal to the tax paid by an unincorporated entrepreneur) is deferred. The period of deferment can be very long, particularly if use is made of business succession schemes. In the event of emigration, the box 2 levy can even be avoided in full.

Deferment is another important difference with a private investor. The latter must calculate a fixed return on his assets and pay tax on this every year. A private investor cannot defer tax payments.

The committee investigated to what extent substantial interest holders actually make use of the possibility to defer taxation. It proved that substantial interest holders do not distribute dividend every year. Moreover, the total amount of dividend reported on the return is significantly lower than the total amount that could be distributed to all substantial interest holders. This shows that the box 2 levy is indeed deferred.

Dual income tax based on the Scandinavian model does not provide a solution to these differences for the Netherlands

Several Scandinavian countries deal differently with the separation between income from capital and income from work for entrepreneurs. They first determine the rate of return on capital on the basis of a ‘normal’ yield on business assets. This yield is taxed only at the corporation tax rate. The profit after deduction of the return on capital is taxed just as heavily as income from labour.

The committee investigated a combination of the Dutch system of the customary wage and the Scandinavian system to split profits of substantial interest holders into a return on capital and a remuneration for work. The profit higher than a normal return on capital was subjected to wage tax. Subjecting a part of the profit to wage tax makes the system complex, particularly in situations in which the actual return is lower than the assumed return on capital. The committee is of the opinion that this increased complexity is undesirable. If an exemption is added in box 2, such problems do not result, but it will ultimately lead to further deferment of taxed distribution of profit. The taxed normal gain from a substantial interest is likely to be lost and the gains from disposal will be deferred even more often than is now the case. Since the committee finds that tax deferment by a substantial interest holder is one of the most significant differences to an entrepreneur who pays income tax, an investor and an employee, it finds this undesirable.

For these reasons the committee came to the conclusion that a dual income tax based on the Scandinavian model would not offer a solution to the observed imbalance.

Making differences smaller: a fixed yield in box 2 and reduction of the efficiency margin in the customary wage scheme to 10 percent

To ensure that substantial interest holders pay income tax on a more regular basis, the committee proposes taxing them in box 2 on the basis of an annual fixed yield. This amount can be linked to the fixed yield for box 3. This fixed yield will then be the minimum basis for box 2. The annual tax to be paid by the substantial interest holder is then at least equal to the box 2 rate applied to the fixed yield. If the actual dividend is lower than the fixed yield, the difference is credited to the acquisition price of the substantial interest. This avoids the holder having to pay tax on that difference again on disposal of the shares.

The committee is of the opinion that an efficiency margin of 30 percent in the customary wage scheme is difficult to justify. It sees no reason to tax the remuneration of an owner-manager at a lower rate than the salary of an employee. On the other hand, the committee realises that the customary wage cannot be determined right down to the final euro. It therefore proposes reducing the efficiency margin to ten percent. The owner-manager may still fix his income at an amount lower than the customary level. This would make the tax paid on the remuneration of the director and major shareholder more equal to the tax paid by an entrepreneur.

Box 3: towards a more realistic fixed yield

In the tax reform of 2001, taxation of income from capital for private individuals was changed. Until 2001, interest, dividend and rent were taxed in the same way as income from work, and capital gains were exempt. There was a wealth tax of 0.7 percent of the total wealth. Starting in 2001, the actual return on capital was no longer taxed, but a yield fixed at four percent. This fixed yield is subject to thirty percent tax. There is a tax-free allowance for capital up to around 21,000 euro. The fixed yield used for tax purposes does not take into account the composition of the assets. The wealth tax was eliminated. The committee observes that the advantage of an approach to income from capital based on a fixed yield is that the amount paid in tax is stable and highly predictable for both the taxpayer and the treasury, and is easy to collect. The committee proposes that the fixed yield approach in box 3 be maintained without a distinction as to the type of assets.

Since the introduction of box 3, the actual yield has been less than the fixed yield

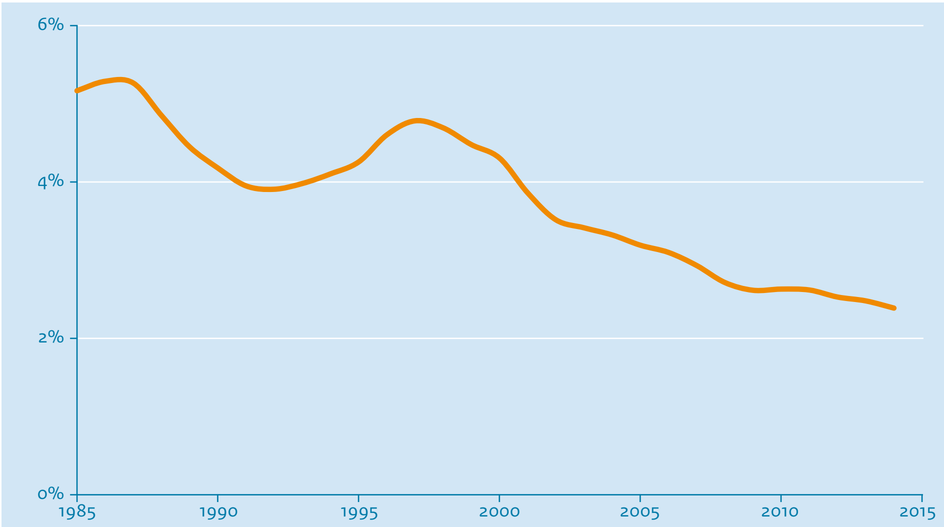
On the introduction of the Income Tax Act 2001, four percent was an estimate of a risk-free realistic yield that a person, on average, could easily earn over a longer period. The percentage was intended to be a bit on the low side because a yield that was lower than average on an incidental basis was deemed to count more heavily than one that was higher. The long-term interest, the yield on ten-year government bonds, was taken as the starting point. In the twenty years before the introduction of box 3 – in the period from 1980-2000 – the average real yield on long-term risk-free government bonds was more than four percent (4.6 percent). The real yield on savings accounts at the time was an average of 1.8 percent. The average annual real yield on shares in that period was over sixteen percent.

Between 2001 and 2012 the long-term interest was around four percent, but the average real yield was considerably lower: 1.6 percent. Savings accounts represent the largest item in box 3 assets. The yield from savings accounts was 2.6 percent and after correction for inflation, 0.5 percent. Since the introduction of box 3, the yield on shares has been negative.

The committee observes that the actual yield since the introduction of box 3 has lagged considerably behind the yield as it was fixed for tax purposes. An automatic mechanism, such as linking the fixed yield to a moving average of the actual yield, would do greater justice to the relationship with the actual yield. The committee is in favour of such a mechanism. It proposes linking the fixed yield to the nominal interest on savings accounts. This nominal interest rate is more in line with the perception of deposit holders than the long-term interest on government bonds. More than forty percent of households with assets in box 3 hold assets only in the form of current accounts and savings accounts. Bank and savings accounts balances represent around half of the total positive wealth in box 3. The committee chooses a link to the nominal interest rate because this is more customary in tax matters than a real yield.

The committee proposes that the fixed yield for each year should be determined automatically as the average interest on savings accounts in the five preceding years. For 2014 the fixed yield would thus automatically be fixed at 2.4 percent.

Figure 2 Five-year average nominal interest on savings accounts, with a two-year time lag, until the end of 2014



In time, owner-occupied homes should move to box 3

For many households, their owner-occupied home is the most important component of their assets. Nearly all recommendations issued in relation to the housing market in recent years have argued in favour of moving owner-occupied homes to box 3. The committee agrees with these recommendations. This year the government has taken a number of measures to decrease tax subsidies to owner-occupied housing and thus to provide enough certainty to the housing market so that it can recover. So far, this has not happened. Only once recovery sets in and proves to be lasting will it be the time to gradually shift owner-occupied housing to box 3 with a tax-free threshold that should be determined later.

Narrowing the base in box 3

In the context of its aim to broaden the base and reduce tax rates, the committee also investigated the main measures that narrow the base in box 3. The most important one is the tax-free allowance of around 21,000 euro per person. The committee stands behind the idea that tax should not be charged on the yield of every single euro in savings. The idea of some progression in the taxation of income from savings and investment appeals to the committee as well: in general, smaller holdings will have a lower yield than larger ones. For this reason the committee is in favour of continuing the tax-free allowance in box 3.

In the opinion of the committee, the allowance for elderly persons in box 3 can be eliminated in the future. This allowance for pensioners has its origins in the difference in tax rates between pension beneficiaries and non-pension beneficiaries. In the interim report the committee proposed a gradual increase in the combined box 1 rate for pension beneficiaries over a period of eighteen years up to the level that applies to younger people. In that case, the reason for this facility in box 3 will no longer exist. The committee recommends eliminating this facility at the same pace as the increase in the box 1 rate for pension beneficiaries. This means that it would also take place in eighteen equal annual steps.

Budgetary effects of the measures in box 2 and box 3

Lowering the efficiency margin used in the customary wage scheme leads to a structural yield of 1.0 billion euro. The committee proposes that this amount basically be used to lower the fixed yield in box 3 from four to three percent, being the first step in the direction of the 2.4 percent that follows from linking the fixed yield in box 3 to the five-year average interest on savings accounts. The costs of the reduction to three percent are 0.9 billion euro. In box 2 the committee proposes introducing a fixed yield of 2.4 percent. This yields 0.2 billion euro. This yield will gradually decrease. Ultimately, the yield will be the part of the box 2 levy that is now finally avoided. The revenue from this fixed yield in box 2, together with the 0.1 billion euro remaining from lowering the efficiency margin, can be used to reduce the box 2 rate from 25 to 22 percent, in line with the reduction of the box 1 top rate proposed by the committee from 52 to 49 percent. This leads to a better global balance between the unincorporated entrepreneur and the substantial interest holder in box 2.

The budgetary effects of gradually transferring owner-occupied housing to box 3 will depend on the shape it ultimately takes. The revenue released by a gradual reduction over a period of eighteen years of the extra allowance for retired persons on their assets will initially be small and will only increase in the longer term. The revenue generated by these measures must also be given back as a reduction of the tax burden in a form yet to be determined.

Benefits: Introduction of a household benefit and countering fraud

In the relatively short period between 2001 and 2005 two system reviews took place that were meant to focus the government's financial toolkit more on low incomes. In 2001 the personal tax allowance and the standard work deduction for income tax were converted into tax credits and in 2005 the system of benefits ('toeslagen') was introduced. These measures meant that the target group was reached better and better, but they also resulted in a patchwork of schemes aimed at income policy. The committee's commission asked for attention to simplification of the benefits and a more coherent, transparent and effective system of tax credits and benefits.

The use made of benefits and some tax facilities expanded greatly in the recent past. Today, nearly every specific target group receives its own tax credit, tax deductible or benefit. At the same time the tax rates in the first two tax brackets have risen by nearly five percent since 2001. The benefits are financially important. They pay for a large part of the specific costs incurred by their recipients. Income support for healthcare, housing and children was not simply introduced all at once when benefits came into use; they often had a longer history (for example, the target group paid lower healthcare contributions, received rent subsidy, etc.). If the benefits are simply eliminated in one fell swoop, it will have huge income effects and strong repercussions in other policy fields, such as the housing market.

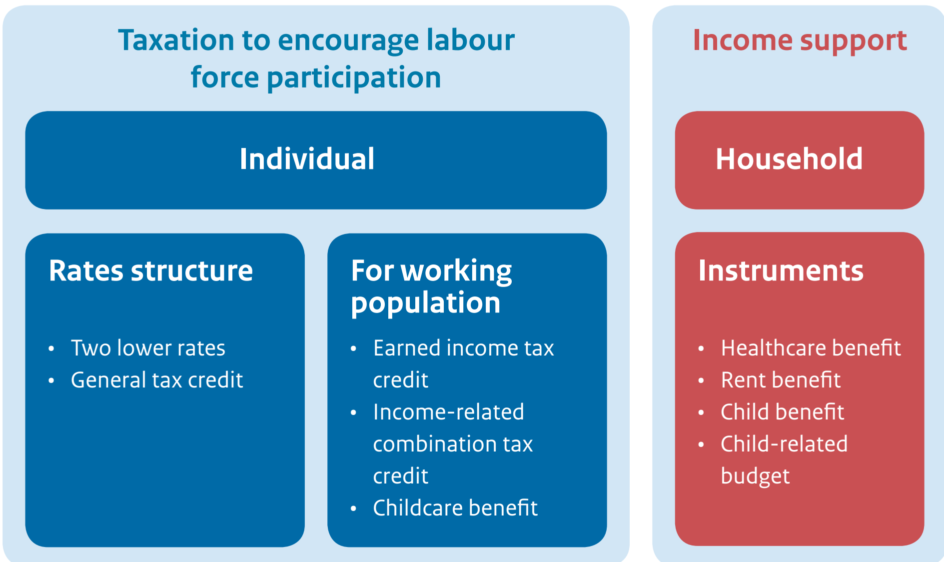
The payment of benefits and tax refunds is based on much faith in the correctness of the details furnished by taxpayers. Whether taxpayers are actually entitled to the advance payment of a benefit is monitored only in retrospect. It has recently become apparent that this system is conducive to fraud. The committee finds it a sensible move to strengthen the monitoring at the gate. The tax ethics of taxpayers – generally speaking, they are good – are impaired by fraud, because citizens lose faith in the system. The majority pay their taxes on time and their requests for benefits are correct, because they are confident that the rules apply equally to everyone. If the impression arises that fraud sometimes goes unpunished, this confidence will evaporate.

The committee sees possible ways to streamline and simplify the system of allowances by introducing a household benefit. In particular, this will reduce the number of persons entitled to a benefit, so that the system (and the monitoring) can be directed at a smaller number of households. The committee also sees a possibility to pay out part of the tax benefit directly to the healthcare insurer. This limits the amount of money that is pumped around between the Tax Administration, citizens and insurers.

Promoting a clear distinction between encouraging participation in the labour force and income support

In its interim report the committee explained how it sees the distinction between benefits and income tax. The committee makes a clear and consistent distinction between tax levy on an individual basis and income support at the level of the household. Taxes are in principle levied at an individual level and the structure of income tax and the instruments for the working population are used in a way that encourages labour force participation, or at least forms as little hindrance as possible. Income support can be most purposely applied by basing it on the financial capacity of a household. Here, the importance of income support must prevail over the disadvantage the gradual reduction of a means-tested payment has for an individual's decision to work or not to work.

Figure 3 Schematic representation of system of income support and tax benefits

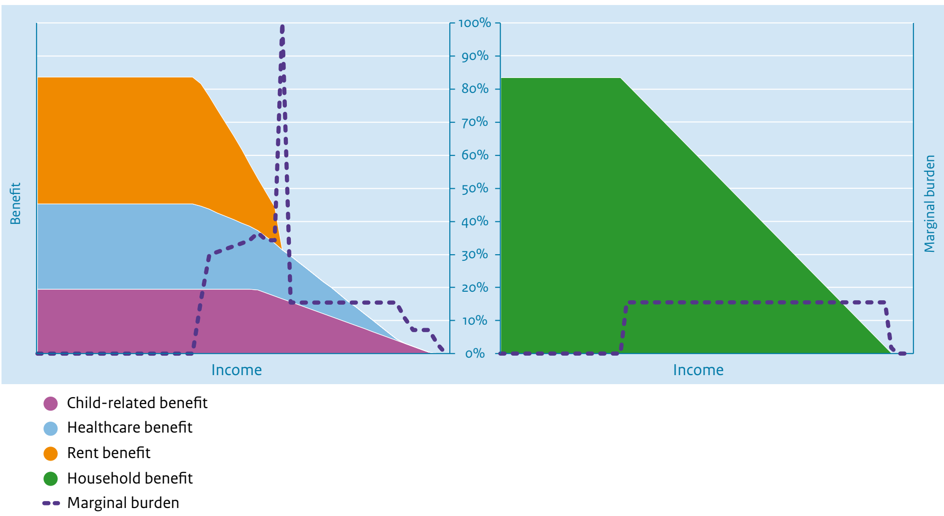


Introduction of a household benefit

The committee recommends streamlining and simplifying benefits presently paid as income support by the introduction of a household benefit which will combine the rent benefit, child-related budget and healthcare benefit. At present, each of these means-tested allowances is phased out at a different rate. For households that receive more than one allowance, they are phased out more quickly than for households entitled to only one allowance. Because of this, the net income of households with more than one benefit grows less rapidly when its earned income rises than does that of households with a single benefit. Because the object of such benefit is to offer income support that is linked to financial capacity, households with less financial capacity are often entitled to more benefits. This also means that they are faced with a higher (cumulative) rate at which payments are phased out. The system of paying out allowances thus works in opposition to income tax, which taxes the income of households with less financial strength at precisely a lower marginal rate. As a result of this system, in the phase when the various allowances are being phased out, the marginal tax rate can accumulate to a very high rate, and it may thus not be very attractive for members of households in receipt of more than one allowance to take a job or work more hours.

The committee is of the opinion that greater justice is done to the principle of financial strength underlying the system of benefit if the healthcare benefit, the child-related budget and the rent benefit are combined into a single household benefit, linked to a percentage for gradually phasing it out that does not depend on the number of allowances received or on income (see figure 4). Because the objective of the child benefit overlaps with the child-related budget, the obvious choice is to include child benefit in the household benefit. To do justice to the differences between different domestic situations, the committee recommends making the rate at which the tax benefit is phased out different for single persons and partners. For single persons the rate of reduction will be higher, because the same gross income for a single person represents a higher welfare level than for partners. The committee recommends removing present differences in the definition of income and the means test by harmonising them.

Figure 4 Streamlining tax benefits by the introduction of a household benefit



The committee developed two variants of this household tax benefit. In the first variant, which is budget-neutral, the tax benefit is paid in full to households earning up to the statutory minimum wage and then gradually reduced for higher incomes. The full payment is the same for single persons and partners. The tax benefit is reduced (phased out) by 15 percent of the income in excess of the statutory minimum wage for partners and by 21½ percent for single persons. The calculations showed that the income effects are relatively limited: the income effect was between 2 percent and +2 percent for 90 percent of the households. The number of households entitled to a tax benefit also decreases by nearly one million, from 4.6 to 3.7 million. These are often households that now receive only a small healthcare benefit payment. The committee calculated the effects of the household benefit and submitted the outcomes to the CPB Netherlands Bureau for Economic Policy Analysis. The CPB concluded that the proposal would have a small positive effect on the level of employment measured in labour-years. The committee also worked out a variant in which the tax benefits would be reduced by 1.3 billion euro (15 percent of the budget), and the funds thus released would be used to reduce the rates in the first and second tax brackets by half a percentage point. The income effects of this variant are larger.

The committee recommends that the difficulty encountered by elderly persons and single parents in claiming their tax credit (their income is so low that they pay too little tax to be able to claim the tax credit) be resolved by integrating their tax credits into the household tax benefit. These tax credits are meant as income support to low incomes and this object can be achieved more effectively by the household benefit.

Entitlement to benefits depends in part on the use of tax deductibles. Deductible items are deducted from the total household income, thus causing the entitlement to benefits to rise. This effect is not transparent. In its interim report, the committee proposed to abolish many deductibles. If deductibles continue to be used, the committee recommends that they be given the form of tax credits wherever possible, and then the expenses will be deducted at a fixed rate. This eliminates their effect on benefits and further simplifies the system of benefits.

Compulsory payment to healthcare insurers

The committee sees a way to further decrease the number of households which receive a benefit by making it compulsory to pay out part of the benefit to their healthcare insurer. The part of the benefit paid to the healthcare insurer can be deducted from the healthcare premium owed by these households. Citizens continue to be responsible for reporting their income details correctly to the Tax Administration/Benefits. Any claims for overpayments will be reclaimed from the taxpayer and not from the healthcare insurer. This proposal limits the pumping around of money. If taxpayers receive a tax benefit, it means they will pay a lower nominal healthcare premium. Because payment to the healthcare insurer is mandatory, it will be impossible to award a tax benefit to people who are not insured, thus limiting the risk of fraud with the benefit. If no benefit is paid, taxpayers will no longer be able to commit fraud in this regard. It also limits the problem insurers have with non-payers: it will no longer be possible to spend the benefit on anything but the nominal premium. Although people on low income will pay a lower healthcare premium each month, the effects of a high nominal premium on the competition between insurers are maintained. Insurers will continue to compete on the basis of a high nominal premium. The proposal has no income effects.

In the proposal the first 1,100 euro per person of the benefit is paid to the insurer. The rest of the household benefit is paid into an account of the person entitled to the benefit. If part of the benefit is paid to the healthcare insurer, the number of households with a benefit can be further reduced from 3.7 million to 1.4 million. After an amount is paid to the healthcare insurer, no further benefit will be paid to 2.3 million households. The number of households with a benefit can thus decline by 70 percent.