Towards a more motivating tax system

Summary of the interim report of the Income Tax and Benefits Committee

Tax systems are always in motion. Every year a large number of more or less drastic amendments of tax legislature are implemented by way of the Tax Plan. These amendments can result from government agreements of coalitions with varying colours and are sometimes reactions to current situations. In addition all kinds of social developments exist that make it advisable to regularly hold the tax system up to the light. So as to periodically look whether the tax system still complies with the requirements of the moment, with larger intervals more fundamental analyses are carried out. In their turn these analyses can lead to structural amendments of the system. Milestones were the review at the proposal of the Oort Committee in 1990 and the tax review of 2001. The operation *Werken aan winst* (Working on Profit) of 2007 is the most recent large corporate tax review.

The most recent income tax review lies more than ten years behind us and the preparation of a new review passes off in stages. First the Cabinet Balkenende IV appointed the Tax System Study Committee in 2009. This committee reported early in 2010. This report has been used by the Cabinet Rutte I for drawing up the Fiscal Agenda. The parliamentary hearing of this Fiscal Agenda led to the Dijkgraaf motion which was accepted by said Cabinet in February 2012 by the appointment of the Income Tax and Benefits Committee. This Committee directed by C. Van Dijkhuizen herewith issues an interim advice.

The Committee's commission

The State Secretary of Finance has provided the Committee with the commission to draw up a limited number of scenarios for a simple, sound and fraud-proof tax system that will contribute to the competitiveness of the Netherlands. Three elements have to be part of the drafting of these scenarios in any case: a substantial decrease of the rates of wage tax and income tax, a simplification of income tax and benefits, and a more coherent system of tax credits and benefits. In order to come to these scenarios the Committee has to analyse the consequences of the abolition of the various facilities, as well as the introduction of a flat (flatter) rate structure and the shift of the tax burden from wage tax and income tax to indirect taxes. In principle the scenarios have to be designed burden-neutral. The Committee has a year to carry out these activities.

Interim report as a consequence of the fall of the Cabinet

The time schedule has been thwarted by the fall of the Cabinet Rutte I and by advancing the elections to September 2012. Therefore the Committee's advice was to be issued at a moment that the new Cabinet had probably started its activities already. As a result the concrete application of the Committee's advice would become improbable. For this reason the State Secretary has asked the Chairman to issue an advice at an earlier moment, so that it could be included in the formation of the new Cabinet. The Committee agreed. However, this has had consequences for the Committee's modus operandi. For instance, the remaining time turned out to be too short to come to a well-considered advice on the structural development of the entire system of income tax and benefits. However, the Committee has identified a number of measures that will help to make the tax system more activating and of which it is desirable, in view of the current social and economic developments, that these measures are taken into account by the new Cabinet. These measures have been included in the present interim report. The Committee has focussed on box 1 of the income tax. It advises the future Cabinet to adopt these measures. Next year the Committee will provide some other proposals.

The main objectives of the Committee
The Committee has started its activities by making an inventory of the major bottlenecks of the economy, to the solution of which a review of the system of income tax and benefits can contribute. To this end the Committee has come to the following main objectives:

- The stimulation of the labour force participation rate by making working more profitable,
- Setting the housing market in motion again,
- Less pumping-around of money and simplification of the system.

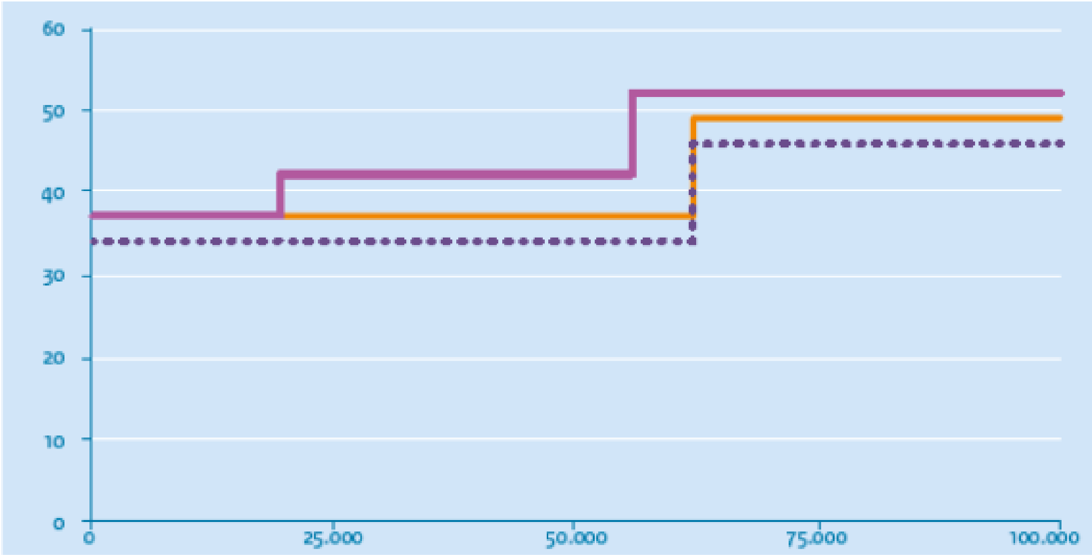
On the basis of these three main objectives the Committee has identified a number of measures forming together a burden-neutral package. In the short term, this will look as follows:

Stimulation of the labour force participation rate by making working more profitable
The primary starting point of the Committee's advice is that the labour force participation rate is stimulated by making work more profitable than it currently is. In the next few years the population of the Netherlands will age. This will result in a considerable increase of public expenditure, whereas the labour force who has to pay for this expenditure is decreasing. If the Netherlands wishes to maintain and even improve its competitive position, wealth and benefit schemes, it is necessary that the labour supply is used as much as possible. The Committee wishes to stimulate this by taking a number of measures:

- Lowering the rates of wage tax and income tax: during the next government's term of office the number of tax brackets will be decreased to two. The second and third brackets will be included in the first bracket. The rate of this first bracket will remain at the level of 2013: 37 percent.[1] The rate of the second bracket will be 49 percent. More than 90 percent of the tax payers will then come under the first bracket. Currently 45 percent of the tax payers do so. After the following government's term of office the yield of a number of measures will increase. This will offer room for a further rate decrease by three percentage points. The new bracket structure is rendered in figure 2.1.
- By amending the fiscal treatment of the owner-occupied houses and the abolition of deductible items the taxable income of a number of tax payers will increase. As a result they will move to the highest bracket sooner. In order to prevent that the number of tax payers in the new second bracket will be larger than the number of tax payers in the current fourth bracket, the limit of the new second bracket will be EUR 5,500 higher than the current limit of the highest bracket. Thus the number of households under the top rate will be the same as the current number.
- An increase of the earned income tax credit by EUR 70 in 2014 increasing to EUR 410 in 2017. For the highest incomes the earned income tax credit will be gradually reduced to nil.
- An easier shift to work for unemployed single parents. The increased social assistance benefit for single parents and the single parent's tax credit will be replaced by a top on the income-related child benefit.
- The abolition of schemes that stimulate taking leave, such as the parental leave benefit.
- These measures will be financed by abolishing various tax deductibles, by limiting measures to subsidise housing and by increasing the VAT rate. The latter will also improve the economic structure.

[1] Wherever no year is mentioned, the figures refer to 2014.

Figure 2.1 Current and future rates income tax, persons under 65 years of age



Current (2013)*
Proposal (2014)
……. Proposal (structural)

* In 2012 the rate of the first bracket is 33.1 percent. The Committee has taken 37 percent as a basis for 2013 in accordance with the Tax Plan 2013.

Setting the housing market in motion again

The housing market in the Netherlands has de facto come to a halt. Due to the economic crisis slumbering instabilities have come to light. As a result of the crisis the construction of new houses has decreased considerably, whereas the number of transactions on the market for existing owner-occupied homes have drastically decreased and the prices also have been decreasing for four years now.

The instabilities on the housing market have a fiscal component as well. The interest paid for one's own house is deductible from the taxable income in box 1, whereas this is not the case for other interest types paid by private persons. Financing one's own house by borrowed money therefore is too attractive. In addition capital can be built up by way of savings-based mortgages and similar products, the growth of which is not taxable. By contrast the growth of other capital is taxable by way of the fixed capital yield tax in box 3. All this leads to a household being incited to take a large debt on its own home and to redeem as little as possible thereof. Apart from that the fixed addition for an owner-occupied house is lower than the fixed yield of other capital components.

In the event of a low sensitivity of house building for prices this will lead to upward price pressure on the owner-occupied homes market. For the banks this will lead to an increasingly larger difficulty to finance mortgage debts, so that the banks will be less prepared to offer mortgages. The large size of the mortgage debt of approximately EUR 650 billion not only leads to a loss of tax income of more than EUR 10 billion, but also to an independent impairment of the financial stability of the Netherlands.

Opposed to the upward price pressure of the tax treatment of owner-occupied houses there is a downward price pressure of the government with regard to rents. For a large part of the market for rented housing these are limited by rent regulation. As a result tenants are incited to continue to rent a house and for commercial offerers it is not profitable to offer rented housing.

Due to the decrease of the prices on the housing market during these past few years for a substantial group of households the value of their houses is lower than their mortgage debts. If these owners decide to sell their houses now, they will be confronted by residual debts. These possible residual debts hinder the flow on the housing market even further.

The Committee is of the opinion that owner-occupied houses should be facilitated less strongly as to taxes and that the redeeming of mortgage debts should be stimulated. Only then there will be more confidence in the housing market and buyers and sellers will dare to take risks again. For that reason the Committee advises the following measures for the next government's term of office:

- New and existing home owners will be stimulated to redeem their mortgages. The mortgage interest relief will remain as a principle. However, during the mortgage term the deductibility of the interest will be gradually decreased by way of a thirty-year fixed annuity scheme. This scheme will be fixed during the mortgage term and is based on the house debt at the moment the debt is concluded.[2] There is no obligation to actually redeem.
- The tax exemption for payments from an mortgage-linked endowment insurance and similar schemes will be abolished for new mortgages. Therefore it will no longer be possible to keep a high housing debt on the one hand and build up a tax-free capital on the other hand.
- The notional rental value and the mortgage interest relief will be included in the collection for the rate of the new first bracket, 37 percent.
- The transfer tax for houses will be abolished.
- The interest of the residual debt created after a house has been sold will become tax deductible during a period of twelve years. In addition a guarantee scheme for these residual debts will be created (comparable to the National Mortgage Guarantee Scheme), so that banks will more easily grant mortgages or loans to buyers with residual debts. This guarantee scheme will be financed by a limited increase of the mortgage loan interest.
- These measures have the largest impact on people with incomes in the current fourth bracket. Therefore the yield, after deduction of the costs of the abolition of the transfer tax, will also be used to decrease the rate of the new second bracket from 52 to 49 percent.

So in order to restore the balance between renting and buying a house and to prevent that an increase in the tax and premium burden for buyers drains away to tenants via lower rates, the Committee also offers proposals for the market for rented housing:

- The home valuation system will be abolished. The maximal reasonable rent will be set at 4.5 percent of the value. The rents for existing tenants will be annually increased by two percent on top of inflation until the rent reaches the level of 4.5 percent of the value. For tenants with an income exceeding EUR 43,000 the maximum annual rent increase will be five percent on top of inflation.
- The additional rent yield resulting from the above increase will be fully siphoned off by the landlords' charge that will be partially used for financing the housing allowance and for the rest it will be siphoned back by way of the afore-mentioned decrease of the rates of box 1 of the wage tax and income tax.
- The system of the housing allowance will remain unchanged. The allowance will increase as a result of the additional rent increase for tenants.

Less pumping-around of money and simplification of the system

The large number of facilities gives rise to high rates
The system of income tax and benefits has dozens of schemes that decrease the tax revenues. If these tax facilities are abolished, the same revenue can be achieved with lower rates. Therefore the tax facilities ensure that extra work is less profitable than it should be. That is a reason for the

[2] For existing cases the debt on 31 December 2013 is taken as a basis for the scheme.

Committee to thoroughly examine the tax facilities, partly because the system is rendered very complex.

More pre-filled income tax returns
Almost 13 million persons file income tax returns. In addition six million persons receive a benefit. The costs of implementation and inspection of the Tax and Customs Administration have risen as a result of the growing number of persons involved. Meanwhile the Tax and Customs Administration has started to pre-fill income tax return forms with data it receives from third parties. The tax payer downloads the pre-filled form and needs only check the data. The pre-filling of the tax returns has advantages for both the tax payers and the Tax and Customs Administration. Non-use, misuse and abuse are considerably reduced. Increasing the number of fully pre-filled tax returns is one of the reasons for the Committee to meticulously examine the existing tax facilities.
With simplification measures one stone kills two birds: more tax payers receive entirely pre-filled tax returns , need to answer less questions in the tax return programme and the rate is decreased. Pre-filled tax returns will become possible for approximately 90 percent of the tax payers. The Committee's most important simplification proposals are rendered below.

Tax treatment pension premiums to be limited for high incomes
The Committee is of the opinion that the current pension system in the Netherlands is an important achievement and that there is no reason to abolish the EET system for pension build-up. However, during the past few years the income and capital positions of the elderly increased considerably. For the lower incomes the tax treatment of pensions can be justified because of the pursuit of making the elderly financially independent. Regarding the higher incomes the Committee is of the opinion that they can make a choice themselves. To illustrate: approximately ninety percent of the ten percent households with the highest incomes live in their own homes. When the mortgages of these own homes have been redeemed, the housing costs decrease and these households can choose lower pensions, if so desired. Due to the larger financial self-reliance of high incomes the Committee proposes to cap the tax treatment of second pillar pensions to the income where the second bracket starts in the new system (EUR 62,500). The limit for pensions in the third pillar is adapted to this level. At the moment approximately seven percent of the tax payers pertain to the highest bracket. The Committee wishes to keep this percentage more or less the same, also in the future. That is why it proposes to index the bracket limit on the basis of the wage developments and not on the basis of the price developments. It will thus prevent that gradually more and more households will be outside the EET scheme with regard to their pension provisions.

Pensioners are treated equally with persons under pension age
Pensioners have exemptions for their old-age pension contributions. As a result the combined rate for this group is up to an income of approximately EUR 34,000, 17.9% lower than the rate for non-pensioners. As from 2011 this difference has been very gradually lessened by not fully indexing the upper limit of the second tax bracket of box 1 for tax payers born after 1945. The Committee proposes to step up this process by having the combined rate for pensioners increase by one percent per year. Accordingly, after a period of eighteen years one rate structure will apply for all tax payers.

Towards a new balance between self-employed and employees
The tax and contribution burden for self-employed is lower than that for employees, especially in the event of small profits. This difference has strongly grown in the past few years. This can be only partially justified. In particular in the event of small profits the facilities for entrepreneurs give rise to tension, because there the disparities with employees are the largest. That is the reason why the Committee no longer sees room for the self-employed person's relief and the relief for new businesses as their current forms. These give an incentive to become an entrepreneur, but no incentive to grow any further. The Committee proposes to phase out these facilities during an eight-year period. The yield will be used to increase the employed person's tax credit, so that all workers will profit.

Bundling tax schemes with existing benefits and subsidies
There are many tax schemes with the purpose to support the incomes of specific groups. It applies to almost all groups that these are targeted by various, partially overlapping schemes, and in addition there are often schemes outside the system of taxes and benefits which target the same group. The Committee advises to come as much as possible to a streamlining of schemes that target the same groups, such as the child schemes, and it proposes to gradually include the elderly person's tax credits and the single elderly person's tax credit in the old-age pension AOW. The Committee is also of the opinion that the young disabled person's tax credit has to be transferred to the benefit under the Invalidity Insurance for Young Disabled Persons Act (Wajong).

Complex tax schemes will be turned into subsidy schemes
Some tax schemes explicitly target non-tax purposes and demand much non-fiscal information for their implementation. The Tax and Customs Administration is badly equipped for checking this kind of information and sometimes falls back on information from other organisations. The Committee proposes to transfer these kinds of schemes to the ministries in question while retaining the budgets. Examples are the tax deductible items for specific health care costs and weekend expenses for the handicapped, the allowance for research and development work for self-employed and the allowance for expenditure on listed buildings.

Tax schemes no longer fitting in with the system will be abolished
Finally the Committee considers a category of facilities no longer fitting in with the system. Only schemes that the Committee would introduce again with today's knowledge will continue to exist. The deductible items for donations and education expenses will be abolished to a large extent. In addition the Committee has elected for reasons of simplicity to make maintenance obligations between ex-spouses tax-exempt.

Budgetary and economic effects
Figure 2.2 gives an overview of the yield of the various measures and of the method of restitution of this yield. It is a budgetary neutral package of EUR 12.6 billion at the end of the next government's term of office. Because of the fact that the yield of some measures will still increase thereafter, the structural extent of the package will be EUR 24.3 billion.

Figure 2.2 Schematic chart of the origin and spending of the yield of the Committee's measures

Yield	2017	struc
Housing (own and rented)	2,9	12,1
Pensions	2,5	3,8
Self-employed	1,1	2,1
Streamlining	0,5	0,5
VAT	5,7	5,7
Total	**12,6**	**24,3***

Spending	2017	struc
Lowering of wage tax and income tax	11,8	22,3
Housing	0,8	2,0
Total	**12,6**	**24,3**

* As a result of rounding off the separate numbers do not add up everywhere to the totals.

In line with its commission the Committee has advanced proposals that are budgetary neutral. For the major part the yield has been included in lower tax rates. As a result of this, working will be more profitable and employment will go up. At the request of the Committee the Netherlands Bureau for Economic Policy Analysis (CPB) has calculated the economic effects of the proposals. The effects for the labour market have been included in table 2.1. As a result of the proposals of the Committee employment will go up by 2.1 percent. This equals 142,000 working years. In accordance with its commission the Committee also gives back to the population the entire yield of its proposals concerning the owner-occupied houses. In the basic route of the CPB for the calculation of the election programmes the yield of the limitation of the mortgage interest relief from the budgetary agreement has not been given back in the long term. As a result the long term government balance when calculating the proposals of the Committee is EUR 1 billion net worse than in the basic route, as balance of the indeed returned yield of the limiting of the mortgage interest relief (has a negative effect of EUR 5 billion on the feasibility balance) and the positive effects of the Committee's tax proposals (that have a positive effect of EUR 4 billion on the long term government balance).

Table 2.1 Structural labour market effects

	percentage mutations
Labour supply in hours	1.6
Unemployment rate	-0.5
Employment in hours	2.1

Effects on income distribution

The proposals of the Committee lead to the image of purchasing power as rendered as a summary in table 2.2. This table shows that the proposals in general give a modestly positive picture. Employees will be slightly better off on average, persons entitled to benefits are neither better nor worse off and pensioners can be slightly worse off, whereby the persons at the bottom will be spared.

Table 2.2 Effects on purchasing power, medians of various types of households

	Average development in percentage per year, 2013 - 2017
Workers	+ ¼ to + ¾
Persons entitled to benefits	0 to + ¼
Pensioners	- ½ to + ½

The CPB has made a calculation of the Gini coefficient, an indicator of the degree of inequality. The Netherlands has a relatively uniform income distribution with a low Gini coefficient of 0.267. As a consequence of the Committee's measures the Gini coefficient will increase to 0.271. This means that the inequality will slightly grow as a consequence of the proposals of the Committee.

Looking ahead

The Income Tax and Benefits Committee has rendered its advice earlier than originally planned. Therefore the Committee has not been able yet to elaborate a number of reforms. An example is the streamlining of the tax credits and benefits in one integrated household allowance. Furthermore in its final report the Committee wishes to pay attention to the tax on income from capital in box 2 and box 3.

To conclude

It goes without saying that these proposals have not been cast in stone. Other things can be stressed or, if there is room for an easing of the tax and premium burden, financing sources can be (partially) omitted. It is also possible in the package to omit financing sources and reduce the easing of the tax and premium burden. However, in that case the economic effects and the effects on purchasing power will change.