CPB Netherlands Bureau for Economic Policy Analysis

Capital Tax Reform in the Netherlands?

Towards a more uniform taxation of capital income

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Summary

- Current taxation of capital income in the NL is a mixed bag:
  it is complex, fragmented and unequal

- This leads to tax arbitrage and distortions of decisions
  of households and firms concerning wealth and capital

- With a number of steps the divergent treatment
  of different forms of capital income can be made more uniform

- This would curb tax arbitrage, contribute to economic welfare,
  and reduce the sensitivity of households and firms
  to the swings of the business cycle

- Six steps are identified – some of them are modest reforms
  - others involve a more major overhaul of the tax system

Different forms of capital income:

- returns to savings – interest
- pension income

- rents, royalties
- owner-occupied housing*

- returns to equity – dividends
- returns to debt – interest
- profits of closely-held business

- capital gains
- wealth transfers – bequests and inheritances

* other real estate, and objects of art and jewelry – *not discussed*

Low revenues of capital taxes in NL compared to EU

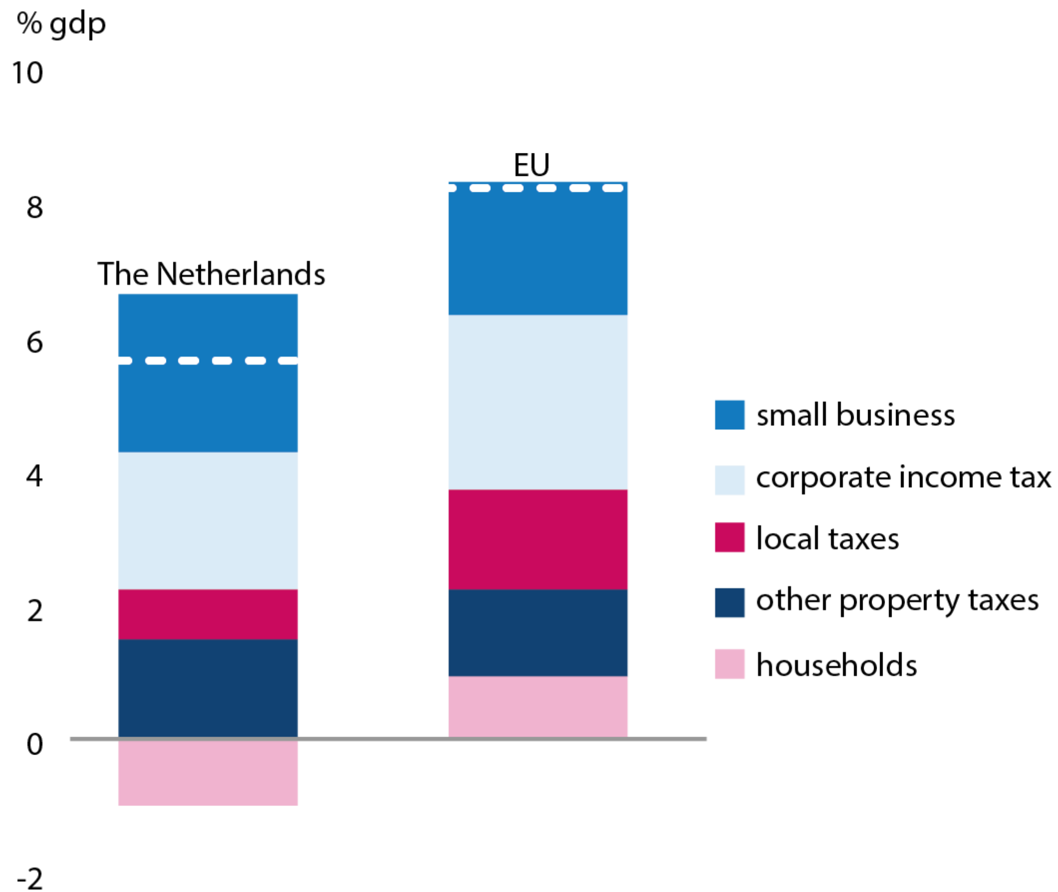
% gdp

12
10
8
6
4
2
0

Luxembourg
France
Italy
Belgium
Denmark
EU (28)
Austria
Ireland
Finland
Germany
UK
Sweden
The Netherlands

Idiosyncrasies of the Dutch tax system I

mortgage interest tax reduction makes net capital tax revenue on households negative



Idiosyncrasies of the Dutch Tax System II

- System of Boxes since Tax Reform of 2001

- Box 1: labour and pension income
  progressively taxed, top rate = 52%
- Box 2: dividend income of owners (>5%) of corporations
  flat tax of 25% (on top of CIT)

- Box 3: "capital gains tax"
  flat tax of 30% on a fixed, ficticious, return of 4%
  therefore *de facto* a wealth tax of 1.2%

  with low realized returns effective tax rates may exceed 100%

- Higher realized returns to larger capitals make Box 3 a regressive tax (CPB, 2015)

Divergent treatment of different forms of capital income I

Who?	Components	Profit	Interest	Dividend	Capital gains	Transfer	Property
Households	Savings		0	15[1]	0	10-40	1.2 **box 3**
	House		-42; -51	42; 52	0	2; 10-40	0.13
	Pension		0	-17	0		0
	> 100 k		0	0[6]	0		0
Small business owners (sbo)	Equity	42; 52	0		42; 52	*	1.2
	Debt	42; 52 **box 1**	-42; -52				
	Pension		0	-17			0
Sbo-corporated			0	25	25 **box 2**	*	1.2
	Pension		0	..			0
Corporations	Equity	20; 25	0		0		0
	Debt	20; 25 **CIT**	-20; -25				

Divergent treatment of different forms of capital income II

- savings: box 3 – fictitious return
- owner-occupied housing: mortgage interest tax deductable (*HRA*),
  imputed rental income is taxed (*EWF*), net remains a huge subsidy
- pension savings: Exempt-Exempt-Taxed but also subsidy
- no taxation of capital gains (but for *DGA's*)
- interest payments deductable (debt is tax favoured over equity)
- retained profits not taxed: lock-in effect
- double taxation of owners of small corporations (*DGA's*) CIT and PIT

Tax all capital income – as uniform as possible

- alternative based on Optimal Tax Theory and Mirrlees Review (UK, 2010/11)?

- one view: capital income tax is double taxation = inefficient
  - Atkinson & Stiglitz (1978), Chamley, Judd, ..

- recent: some taxation of capital income is optimal given objective of income redistribution and distortionary effect of labour taxation
  - Diamond & Saez (2011), Jacobs (2013), ..

- different forms of capital are transferable, e.g. personal savings (of *DGA*) can be made equity in closely held corporation, etc.

- avoid tax arbitrage: i) tax all capital income
  ii) as uniform as possible

Six steps towards a more uniform taxation of capital income

i. tax savings and capital gains based on actual returns

ii. reduce fiscal subsidy on pension savings

iii. tax owner-occupied housing as a capital component

iv. tax equity and debt more equal

v. tax distributed and retained profits more equal

vi. reduce double taxation of profit income

i. tax savings and capital gains based on actual returns

- eventually tax actual returns – equitable, not pro-cyclical
- a tax on interest, dividend and capital gains, not a wealth tax
- administratively difficult?
  - most countries have a form capital gains tax (see Jacobs, 2015)
  - banks etc. can provide most information
  - some areas remain difficult
- Dutch political context: (*belastingplan*) 5 billion Euro cut in labour taxes
  - but progressive wealth tax? (3 fixed ficticious rates of return)

ii. reduce fiscal subsidy on pension savings

- pension savings tax favoured: EET and *AOW*-exemption for pensioners
- leads to substantial personal wealth in illiquid savings
- leave EET – treatment in tact but 'fiscalise' *AOW*,

  i.e. let pensioners also pay *AOW* – contributions

  (speed up the pace of the 'fiscalisation')

  and lower the threshold of the EET - treatment

iii. tax owner-occupied housing as capital component

- house is consumption and investment
- favourable fiscal treatment: mortgage interest deduction

- has led to substantial household debt (mortgage) and high housing prices
- households vulnerable to shocks in the economy

- reform: value of house minus debt to be treated as savings, i.e. box 3

- accompanying reforms of rental market and end of transaction tax
- combined a considerable welfare gain (CPB, **: 8.7 billion euro)

- in most plans some tax deduction for own house
  probably an important detail

iv. tax equity and debt more equal

- most countries have favourable tax treatment of debt over equity:
  interest payments deductable, firms more debt financed
- also firms more vulnerable to economic shocks

- more stringent thin capitalization rules

- more symmetric treatment of debt and equity:
  ACE = allowance for corporate equity
  CBIT = comprehensive business income tax

  latter option still taxes the normal return to capital

  consequences in the international arena – mobility of capital

v. tax distributed and retained profits more equal

- distributed profits (and sales of equity) are taxed in box 2 (*DGA's*)
- retained profits are not: tax deferral / lock-in effect

- avoiding taxation all together? emigration, business tranfers to children?
- waiting for a tax holiday? (2007 and 2014, from 25% to 22%)

- three possible reforms
  - *Van Dijkhuizen*: yearly tax on fictitious return, then upon distribution (or sales) settle with realized return
  - Final withholding tax: no tax at personal level, i.e. PIT [several European countries]
  - Dual Income Tax (DIT): reverse tax order   [Nordic countries] first tax capital income (flat) then labour income (progressive)

Possible reforms of taxing *DGA* - income

	Current situation	Van Dijkhuizen	End of box 2	Dual income tax
Owner salary	Box 1 PIT	Box 1 PIT	Box 1 PIT	
Profit	CIT	CIT	CIT	CIT
Retained profit		Withholding	Final withholding	Withholding
Distributed profit	Box 2 PIT	Box 2 PIT (- withholding)		Box 1 PIT (- withholding / CIT)

vi. reduce double taxation of profit income

- profit income is taxed twice: CIT and Box 2 (PIT)

- when routes for tax avoidance all together are closed
- and when distributed and retained profits are taxed more equal

- then double taxation could be reduced
- for instance with a lower rate in Box 2

- needs careful examination ...

Outline of a more uniform taxation of capital income

Who?	Components	Profit	Interest	Dividend	Capital gains	Transfer	Property
Households	Savings		30	15	30	10-40	0
	House		-30	30	30	10-40	0.13
	Pension		0	0	0		0
	above treshold		30	15	30		0
Small business owners (sbo)	Equity	42; 52	0		30	*	0
	Debt	42; 52 box 1	0				
	Pension		30	15	30		0
Sbo-corporated			0	15	15 box 2	*	0
	Pension		30	15	30		0
Coporations	Equity	25	0				0
	Debt	25 CIT	0		box 3		

Current divergent treatment of different forms – compare!

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- Concluding:

- With a number of steps the divergent treatment
  of different forms of capital income can be made more uniform
- This would curb tax arbitrage, contribute to economic welfare,
  and reduce the sensitivity of households and firms
  to the swings of the business cycle
- Six steps are identified – some of them are modest reforms
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- The CPB Policy Brief presents an outline, a vista of a possible reform (*vergezicht*)

  – with tax reform however <u>the devil will be in the detail</u>
  – moreover budgetary consequences would need to be assessed