

# Flat but Fair:

A Proposal for a Socially Conscious  
Flat Rate Tax

By Raymond Gradus





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## CREDITS

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# Table of Contents

<b>Executive Summary .....</b>	<b>5</b>
<b>1 Introduction .....</b>	<b>6</b>
<b>2 The European experience with a flat rate .....</b>	<b>8</b>
<b>3 The Dutch tax system.....</b>	<b>11</b>
<b>4 The Dutch social security system .....</b>	<b>13</b>
<b>5 The Dutch health care system .....</b>	<b>16</b>
<b>6 Problems with the current tax system.....</b>	<b>17</b>
<b>7 A proposal for a socially conscious flat tax .....</b>	<b>20</b>
<b>8 Conclusions.....</b>	<b>27</b>
<b>References .....</b>	<b>30</b>

# C E S

Flat but fair

## Executive Summary

This paper advocates the introduction of a flat rate income tax in the Netherlands. Such a system would lead to a better functioning labour market and fewer administrative costs for employers. Progressivity would be achieved through tax credits at the household level. By itself, a flat rate tax usually has adverse distributional effects. However, if we allow the income-dependent health care contribution also to be given a flat rate, the distributional effects would be substantially less significant. This paper further gives some recommendations for lowering the flat tax rate by shifting away from income taxes, increasing value-added taxes and broadening the tax base. It concludes by showing that a marginal tax rate plus social security contributions of 33.25% is possible. The focus of this proposal is the Netherlands, but several aspects of it may be relevant to other EU Member States.

## Introduction

As in other European countries, in the Netherlands there has been an ongoing debate about introducing a flat rate tax on income. In 2001, the Research Institute for the Christian Democratic Appeal (CDA) published a proposal for a flat rate income tax (WI CDA 2001). Interestingly, in 2001 the Dutch government applied a flat rate tax of 30% to the fixed assumed yield of 4% on the total value of personal savings and assets. In addition, the tax reform of 2001 substantially reduced the tax rates on labour incomes. The basic tax rate was decreased by 1.55% to 32.35%, and the highest rate was decreased by 8% to 52%. Moreover, the Earned Income Tax Allowance was converted into an Employment Tax Credit which, for earners of low wages, was considerably higher than the Earned Income Tax Allowance, thereby lowering the replacement rate (Gradus 2002).<sup>1</sup> Additionally, the cabinets of Balkenende I–III introduced several special tax credits for housing, health care and child care, in which taxpayers—especially low-wage earners—were compensated for these high costs.

Recently, the Research Institute for the CDA introduced a new, more detailed proposal for a flat rate income tax rate (CDA WI 2009). The introduction of a flat rate system is seen by many economists as a reform that can boost efficiency, employment and growth through simplification and better incentives. At the same time, inequality is expected to increase in Western countries (for the Netherlands see Jacobs et al. 2009; for Belgium see Decoster and Orsini

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<sup>1</sup> The replacement rate shows the loss of income incurred when one loses a job and receives social security or assistance.



2007; and for Germany see Fuest et al. 2008). Importantly, in 2006 the Dutch government implemented a major health care reform, financed in part through a new income-based health care contribution by employees with incomes of up to €32,369. As will be shown in this paper, introducing a flat rate income tax in combination with a flat rate health care contribution results in minimal overall inequality. Moreover, in such a system a firm would be able to make a single payment to the government based on the total of its employees' wages, substantially lowering administrative costs.

In this paper we describe this proposal in more detail. First, we discuss the implementation of the flat rate in several European countries, especially in Eastern Europe. In addition, we present the ongoing debate in the economic literature of a flat tax rate in other European countries. Second, we explain the current Dutch tax system, which is flatter than one might expect. Third, we explore the Dutch social security system and its relation to the tax system. Fourth, we clarify the health care system, with special attention to the health care reform of 2006. Fifth, we detail problems with the current income tax system, in particular the high administrative burden. Sixth, we describe the proposal for a flat rate in more detail, focusing on the income effects of this new system. Finally, we provide some conclusions.

# The European Experience with a Flat Rate

In Europe, especially in Eastern Europe, many countries have introduced a flat tax on income in recent years. The main features of each are summarised in Table 1, which is based on an overview by Keen et al. (2008). Here, we focus on the introduction of flat rates in Europe and on income tax reform.

**Table 1: The introduction of flat rates in Europe (rates in per cent)**

	Flat rate adopted	Rate before	Rate after	Rate in 2007	Basic Allowance
<i>Estonia</i>	1994	16–33	26	22	Modest increase
<i>Lithuania</i>	1994	18–33	33	27	Substantial increase
<i>Latvia</i>	1997	25 and 10	25	25	Slight reduction
<i>Russia</i>	2001	12–30	13	13	Modest increase
<i>Ukraine</i>	2004	10–40	13	15	Increase
<i>Slovak Rep.</i>	2004	10–38	19	19	Substantial increase
<i>Georgia</i>	2005	12–20	12	12	Eliminated
<i>Romania</i>	2005	18–40	16	16	Increase
<i>Macedonia</i>	2007	15–24	12	12	Unchanged
<i>Iceland</i>	2007	36.72–38.72	35.72	35.72	Modest increase
<i>Albania</i>	2007	1–20	10	10	Increase
<i>Montenegro</i>	2007	15–23	15	15	Increase
<i>Czech Rep.</i>	2008	12–32	15	12–32	Substantial increase
<i>Bulgaria</i>	2008	10–24	10	10–24	Eliminated

Source: M. Keen et al. (2008), Table 1.

In their analysis Keen et al. (2008) focus on those tax reforms that were introduced before 2006 (the first eight shown in Table 1<sup>2</sup>) and after 2006 (the last five shown in Table 1). The table shows a sharp distinction between the first wave of reforms, in the Baltic states, which were characterised by tax rates set at moderately high levels—at or close to the highest marginal tax prior to the reform—and the second wave, starting in Russia, marked by tax rates that are closer to the lowest of the pre-reform rates (and in Romania even lower): less than 20% in all cases.

There are other significant structural differences between these flat tax reforms. In Estonia, Latvia, the Slovak Republic and Romania, when the flat tax was adopted the rate of the income tax was set equal to the rate of the corporate income tax (CIT). The merit of equating these two rates is that it removes the tax distortions that occur when taxpayers choose between conducting an activity in corporate form or acting as individuals. Most strikingly, the Slovak Republic is unique in setting a single rate of VAT equal to a common rate of income taxation and CIT. Moreover, Table 1 shows that except in Latvia and Georgia, adoption of the flat tax has been associated with an increase—in some cases quite substantial—in personal allowances (or general tax credits); evidently, the motive is to limit the increase in the tax burden for the less highly paid. However, these measures to protect those on lower incomes are relatively costly. Therefore, according to Keen et al. (2008), an adoption of the flat tax was followed by a reduction in personal income tax revenue, except in Latvia, Lithuania (which both set the flat tax rate at the highest marginal tax rate prior to reform) and Russia. Interestingly, improved compliance in Russia seems to have been enough to offset the effects of rate reductions in the

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<sup>2</sup> In this table the first eight are in italics.

upper income ranges and of increased basic allowances. We turn now to the distributional effects. In order to achieve revenue neutrality, several of these income tax reforms have been accompanied by changes in base-broadening or by the implementation of other taxes such as excise tax or VAT. The distributional impact of the income tax, considered in isolation, is therefore of little interest: what ultimately matters is the distributional impact of the tax (and benefit) system considered as a whole. However, empirical studies show that the distributional effects of movement toward a flat tax are not straightforward: reforms that involve an increase in the basic tax-free amount benefit both the lowest and the highest earners, and compliance effects and base-broadening may in themselves lead to an increase in effective progressivity. There is thus no general consensus that movement to a flat tax in itself implies a reduction in progressivity; in fact, the commonly used summary indices of progressivity, reflected in the few studies of this issue, show an increase in progressivity (Keen et al. 2008, 729).

Keen et al. stress that the lessons that can be drawn are limited by the relative paucity of careful empirical analysis (2008). Except for Russia and the Slovak Republic, there seems to be no analyses of tax reform based on income effects at a household level. However, there are some simulation studies in other European countries along similar lines, even though a flat tax has not yet been implemented in these countries (see Jacobs et al. [2009] for Netherlands; Larsen [2006] for Denmark; Decoster and Orsini [2007] for Belgium; and Fuest et al. [2008] for Germany). The overall conclusion of this literature is that a low flat tax rate and a low basic allowance yields positive welfare effects and boosts employment and growth through simplification and better incentives. At the same time, however, inequality is expected to increase. The increase in income inequality can be avoided

by combining a higher tax rate with a higher basic allowance. But in this case, the efficiency gain vanishes. Therefore, it is important to investigate a flat tax rate proposal for the Netherlands that does not increase the general tax credit for every person but generates alternative revenue through social security or health care contributions. In the following paragraphs we first describe the Dutch tax, social security and health care system and then present the proposal.

## The Dutch Tax System

The Dutch income tax system that has been in place since 2001 has three distinct income categories, each with its own tax tariff. They are referred to as 'boxes'. Box I contains income from labour and housing.<sup>3</sup> In the current system, the Netherlands adopts a progressive tax structure on the personal income tax of Box I (see also Table 1). In 2009, there was a general labour tax credit<sup>4</sup> with a maximum of €1,468 and several other credits targeted to specific groups. While the tax system is in principle individualised, its individual character does not apply to the general tax credit. In particular, non-participating partners in couples can transfer their credit to their working spouses. The offer of various tax credits implies that employed people do not pay tax for at least the first €10,000 of their taxable income. Beyond this level, a piecewise linear tax structure applies,

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<sup>3</sup> In most cases the taxable income is the income from current or previous work plus the imputed gain from homes owned (0.55% of the home price) minus mortgage interest payments. In addition, there can be deductions for gifts and training costs.

<sup>4</sup> For elderly people (over 65 years) the general tax credit is €661.

with rates ranging from 33.5% to 52% (see Table 2). The highest rate applies to incomes above €54,776.

**Table 2: Personal income tax in 2009**

	Taxable income (euros)		Rates %	Tax %	Premium %
	from	to			
Bracket 1	0	17,878	33.5	2.35	31.15
Bracket 2	17,878	32,127	42	10.85	31.15
Bracket 3	32,127	54,776	42	42	-
Bracket 4	54,776	∞	52	52	-

The tax rates of the first two brackets contain social security contributions (premiums) at a rate of 31.15%, distributed among the state old-age pension (AOW: 17.90%), exceptional medical expenses (AWBZ: 12.15%) and survivor benefits (ANW: 1.1%)<sup>5</sup>. Taxpayers over the age of 65 are not required to pay state old-age pension contributions and therefore face a tax rate in the first two brackets of 15.6% and 24.1%, respectively.<sup>6</sup>

Income from capital is taxed separately in Boxes II and III. In Box II there is a flat tax of 25% on income from a substantial business interest, usually meaning a shareholding (direct or indirect) of at least 5% in a private limited company (BV).<sup>7</sup>

<sup>5</sup> Dutch, these acronyms mean Anw: Algemene nabestaandenwet, AOW: Algemene Ouderdomswet and AWBZ: Algemene Wet Bijzondere Ziektekosten.

<sup>6</sup> As a result, the general tax credit for persons over the age of 65 is lowered to €935.

<sup>7</sup> If the fiscal partner of the taxpayer or a blood relative (first of kin) holds a substantial interest in a company, the shares of the taxpayer constitute a substantial interest, even if they do not amount to 5%.

Because profit is already taxed, the overall tax rate of this income is approximately 40%. In Box III there is a flat tax of 1.2% per year on the total value of savings and investments. This is a nominal part of the income tax, namely a 30% tax on a fixed assumed yield of 4% of the value of the assets. Of the value of the assets, €20,014 (higher for those 65+ with a low income) is exempted. The amount of money invested in approved 'green' investments (up to €53,421) is exempted. Moreover, an annual tax credit of 1.3% of the value is applied for these investments. This credit counts only towards Box III.

## The Dutch Social Security System

In the Netherlands the social security and tax systems are closely related, as the overall tax rate of the first two income brackets contains several social security contributions (see also Table 2). Furthermore, employer contributions to disability and unemployment funds are collected by the Dutch tax administration. We shall describe the system briefly. There are five social security programmes in the Netherlands (see Table 3; for AWBZ see next section). The most significant social security contribution is for the state old-age pension, AOW. Each individual aged 65 or over (in 2008 this was 2.5 million out of a total population of 16.4 million) is entitled to AOW if he or she lived in the Netherlands between the ages of 15 and 65.<sup>8</sup> The pension is

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<sup>8</sup> Every person is entitled to 2% of the maximum amount allowed for each year he or she lived in the Netherlands between the age of 15 and 65.

financed through wage income on a pay-as-you-go basis.<sup>9</sup> Each individual (of married couple) receives 50% of the minimum wage, regardless of their earnings and the individual is not means-tested; a single person receives 70% of the minimum wage. In 2008, federal spending on AOW was more than €26 billion. Due to the ageing of the population, the costs of the AOW are projected to rise from 4.7% of GDP in 2006 to 8.8% of GDP in 2040 (van Ewijk 2006). Therefore, the cabinet Balkenende IV has proposed increasing the retirement age at which people become eligible for a public pension. Commencing in 2020, the age at which people can start to draw their state old-age pension would be raised by one year and in 2025 by another year. By 2025, the state pension age would then be 67.

**Table 3: Social security contributions and spending, 2008**

Programme	Persons (x 1000)	Number of contributions (FTE)	Spending (% of GDP/ billions of euros)
AOW	2,698	2,477	4.45%/26.45
WIA	835	698	1.96%/11.62
AWBZ	810	219	3.35%/19.90
WW	171	154	0.44%/2.62
ANW	119	99	0.20%/1.20

An important benefit programme in the Netherlands is Work and Income, established by the Labour Capacity Act, WIA<sup>10</sup>.

<sup>9</sup> Wage income for those below 65 is 240.1 billion euros. Due to the fact that premium is fixed on 17.9 % there is a state contribution of 7.5 billion euros in 2009.

<sup>10</sup> In 2008 the total labour force was 7.7 million persons; the disability rate was 11%. In Dutch, this acronym means Wet werk en inkomen naar arbeidsvermogen.



This insurance covers employee loss of income due to long-term illness and disability. In cases of long-term full disability, workers in the Netherlands below the age of 65 are entitled to a benefit of 75% of their previous earnings. In cases of partial disability, the amount of the benefit is proportional to the grade of disability for a limited period. The number of disability recipients relative to the labour force is among the highest in the world. Because of this there was a policy change in 2006 which tightened the entry conditions (van Sonsbeek and Gradus 2006). Since 2006 WIA contributions have only been made by employers.<sup>11</sup>

In the Netherlands all workers are entitled to an unemployment benefit of 70% of the previous wage. This benefit, WW<sup>12</sup>, is payable for a limited period of time ranging from 0.5 years to 3 years and 2 months, depending on the worker's age; it is therefore less attractive than the disability benefit. In 2008, the number of unemployed was relatively low at 171,000, and the fund was almost €3 billion (see Table 2).<sup>13</sup> However, due to the financial crisis the forecasts for the coming years are not so positive.<sup>14</sup> In 2009, WW contributions are financed solely by employers.<sup>15</sup> Finally, the National Survivor Benefits Act, ANW, provides limited financial support for people whose partner has died and for orphaned children. The maximum benefit level is equal to the level of social

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<sup>11</sup> In 2009 the total (average) disability premium was 6.3% of wage income (up to €47,802).

<sup>12</sup> In Dutch, this acronym means Werkloosheidswet.

<sup>13</sup> In 2008 the unemployment rate was 2.2% of the labor force, which is also rather low from an international perspective.

<sup>14</sup> When the WW benefit has come to an end, unemployed persons can receive social assistance. However, it is means tested and those with household wealth are excluded. Moreover, it is paid out of taxes, and therefore it is not a social security programme.

<sup>15</sup> In 2009 the total (average) unemployment premium is 5.5% of wage income above a minimum of €16,443 (up to €47,802).

assistance, which is means-tested. In 2008, 134,000 persons received financial support through the ANW, for a total of €1.2 billion. In the future ANW funding will be further limited due to an increase in funded pensions.

## The Dutch Health Care System

The Dutch health insurance system is divided into three pillars. The first pillar is compulsory national health insurance (AWBZ). The AWBZ provides coverage to the whole of the population against catastrophic risks such as hospital care exceeding one year, nursing home care and institutional care for mentally and physically handicapped persons. It accounts for approximately 44% of total health care expenditures, which in 2009 amounted to €19.90 billion (see Table 3). In 2009 the AWBZ premium was 12.15% for incomes up to €32,127.

The second pillar is the basic health insurance scheme, which also applies to the whole population. It covers physician services, hospital care (up to one year), prescription drugs, essential dental care and some physiotherapy, and comprises about 53% of health care expenditures. In 2006 a major reform took place in the second pillar, allowing private health insurance companies to compete in price and quality. At that time the Health Care Insurance Act (Zorgverzekeringswet) came into effect. The nominal premium for all citizens older than 18 years is now neither income-related nor risk-rated.<sup>16</sup> This nominal premium covers 50% of the total costs, and the

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<sup>16</sup> Children below the age of 18 are exempt from paying a premium.

average premium is approximately €1,200 per citizen. Furthermore, employees cover 50% of the costs themselves, and in 2009 the income-dependent contribution is 6.9% of the wage for incomes up to €32,369 (see Figure 2).<sup>17</sup> Self-employed and elderly persons must pay this contribution themselves, but the level is substantially lower (4.8%). Insured persons are allowed to switch once a year to another insurance company. Insurers are required to accept all applicants for the basic package. Finally, the third pillar consists of luxury health services such as hotel services within a hospital, luxury dental care and prolonged physical therapy. The premium is risk-rated. This pillar is rather small, accounting for only 3% of total health expenditures (Bovenberg and Gradus 2008).

## Problems with the Current Tax System

It is well known that the current Dutch income tax system hampers efficiency, aggravates unemployment and stunts growth (Council of Economic Advisers 2005). Progressivity can reduce incentives for seeking jobs and working more hours. Moreover, progressive income tax schedules can negatively affect individuals' decisions to pursue higher education. Indeed, the OECD points out that there are sizeable adverse effects of progressive income tax schedules on GDP per capita (OECD 2009).

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<sup>17</sup> To be precise, the income-related health care contribution is levied on employees by means of a deduction from wages. Employers are obliged to compensate their employees fully for this contribution.

Furthermore, the current system also causes a high administrative burden, especially for employers. Currently, every month employers must calculate the personal incomes of all employees, along with several tax credits, such as the general tax credit and the earned income tax credit. In addition, the tax bases for income tax, employee contributions to the Health Care Insurance Act and social security contributions for unemployment and disability are all slightly different.<sup>18</sup> This causes an extra administrative burden for employers and employees alike.

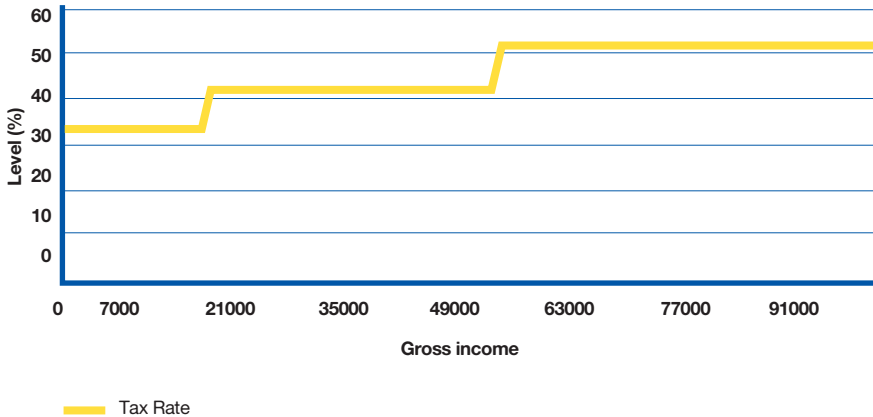
Moreover, a large majority of the Dutch population is confronted with a high marginal tax rate. Starting at an income of nearly €18,000 (comparable to the minimum wage in the Netherlands), the marginal tax rate is 42% (see Figure 1). It is well-known that the Dutch marginal tax rate or progressivity for individuals at average earnings is rather high (OECD 2008, 13). In other Western European countries the starting marginal tax rate is much lower. For example, Denmark starts with a marginal tax rate of 8% (Larsen 2006) and Germany starts with 15% (Fuest et al. 2008). Interestingly, Germany is the only country in Europe that uses a complex tax schedule formula of steadily increasing marginal tax rates instead of piecewise linear brackets (Fuest et al. 2008, 625).

For incomes above €54,776, the top marginal tax rate is 52%. From an OECD perspective, the top rate of the personal income tax rate was an unweighted average of 43% in 2006 (OECD 2008, 13). In the Netherlands the top

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<sup>18</sup> There are three differences between the income tax base and the social security base (de Kam and Stevens 2008). First, a company car is taxed for income but not for social security. Second, the life-course support system (RI 2002) is free of income tax but not of social security. Third, as pointed out in footnote 8, only annual incomes above €16,443 are taken into account for the unemployment premium.

Figure 1: The marginal tariff



rate begins at a relatively low level of income. Based on empirical evidence, the OECD (2009, 153) suggests that a high top marginal tax rate hampers growth and productivity in industries that have potentially high rates of enterprise creation.

Moreover, taxes in Boxes II and III other than the income tax are flat, creating arbitrage towards the lowest tax rate level. Homeowners and small firms, in particular, are tempted to demand too many credits, making them more vulnerable to interest shocks.<sup>19</sup>

<sup>19</sup> Homeowners can make unlimited use of the right to deduct interest payments on mortgages against the maximum tax rate of 52%. However, household wealth is taxed at 30%, so there is an incentive to have the largest mortgage possible.

# A Proposal for a Socially Conscious Flat Tax

One way to deal with these problems is to implement a flat rate tax, allowing all income from labour (and also housing) to be taxed at one marginal rate. Such a system has several advantages. Under a flat tax, companies could simply make a single payment to the tax administration every period, covering all employee wages and reporting net salaries after the deduction of taxes. In addition, the ‘loonbelastingverklaring’ (income tax declaration), which currently applies to every individual job, could be avoided. Since everybody would pay the same proportion, marginal decisions would be unbiased; decisions within a household would not be influenced by tax considerations year after year. A fair tax system can be reached by applying income-independent tax credits at the household level. In the Netherlands special tax credits for housing, child care and health care have already been introduced.<sup>20</sup> A flat tax rate of 38.3% will keep the government budget balanced *ex ante*.

According to Jacobs et al. (2009) in the mean the Dutch marginal tax rate would fall across the board by 2.9% as a result of a flat rate, so for most people there would be a lower marginal tax rate. Lower marginal tax rates would also encourage training by increasing income differences between skill levels, raising the rate at which workers would transition from low- to high-skilled labour. As a result, the labour supply would expand and unemployment rates would

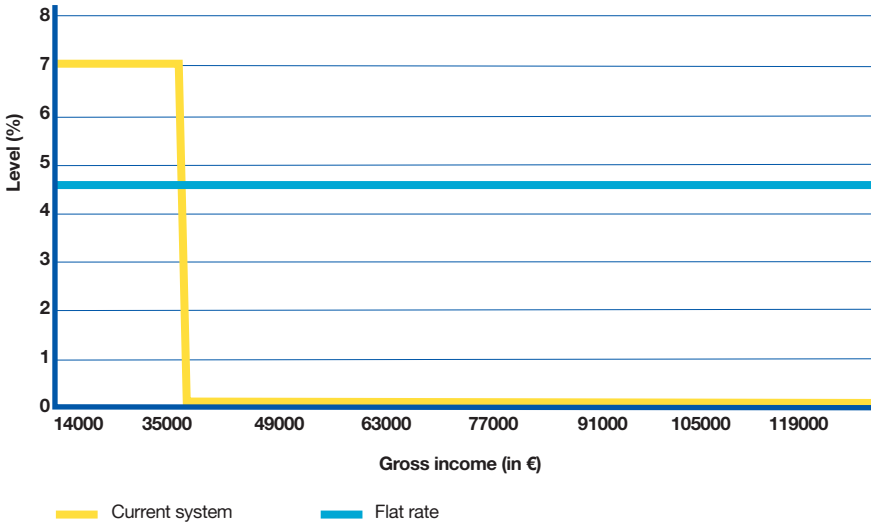
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<sup>20</sup> Especially for the housing tax credit we suggest changes such as a normative rent instead of a factual rent.

fall slightly. Jacobs et al. (2009, 8–9) show that this phenomenon is the result of two offsetting effects. On the one hand, after the reform recipients of benefits typically collect lower incomes than workers. Hence, the replacement rate falls. This increases job searching and reduces the reservation wage in the search-matching model. Moreover, it moderates wage claims in the bargaining model, where the lower replacement rate reduces the bargaining position of the workers due to less attractive outside options. On the other hand the lower marginal tax exerts upward pressure on wages in the bargaining model. On balance, the first effect dominates so that the unemployment rate falls by 0.1%.

However, it is well known that a flat rate as such increases inequality. Jacobs et al. (2009) show that inequality as measured by the Theil coefficient rises by 6.5%. The flat tax rate is especially harmful to people with low incomes, due to the increase of the tax rate in the first bracket from 33.5% to 38.3%. There are several ways to compensate this group. First, we can increase the general tax credit for every person in the Netherlands. However, this would decrease the replacement rate, and if everyone were to receive this compensation it would be rather expensive. Overall, labour market distortions would become larger. This compensation is therefore not advisable. Alternatively, compensation could be made by altering the regressive income-dependent health care contribution (see Figure 2).

Figure 2: Health care contribution



By changing the health care contribution so that it applies to all wages (including those higher than €32,369), low incomes would be compensated. Furthermore, the positive income effects for higher incomes would become substantially smaller. In 2009 the premium was 6.9% of their gross wage income (up to €32,369); by applying the contribution to all wages this would become 4.5%.<sup>21</sup>

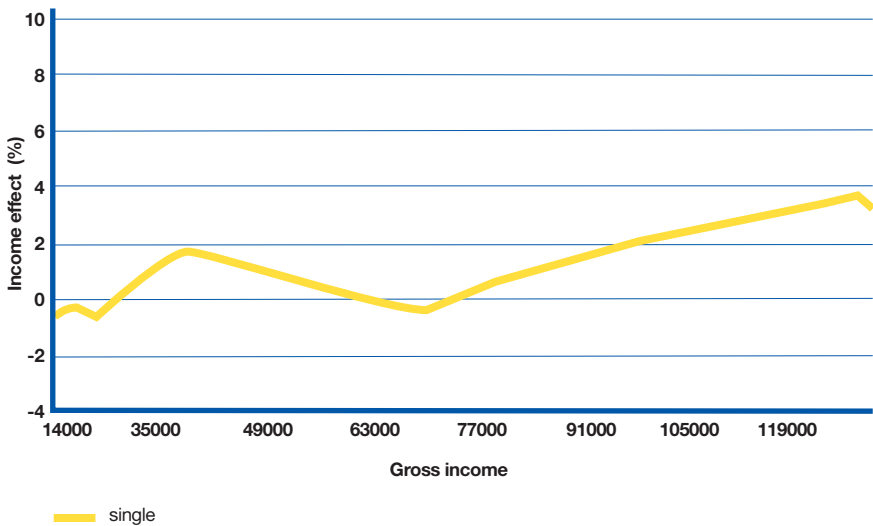
For almost all income categories up to €90,000 the income effects would be rather small, amounting to a variation of

<sup>21</sup> The income-dependent premium is paid by the employee but is compensated for by the employer. The obligatory health care compensation that the employee receives from the employer is carried as taxable remuneration, on which the employee pays taxes. Therefore, in the report it is suggested that gross income should be raised one-off by the employer contribution to income-related health care (CDA WI 2009). This would result in the tax base for employee contributions and income tax becoming equal. An alternative would be a fully nominal premium and compensation for low-wage earners through the health care tax credit. However, this would lead to a relatively high burden for low-wage earners (see CDA WI 2009, 46).



less than 2%. For middle class incomes the tax burden would be lower or nearly the same.<sup>22</sup> It would be possible to add an extra surcharge of 5–10% to top incomes (those above €125,000, for example).<sup>23</sup> However, it is desirable that the marginal rate be limited to a maximum of 50%, including for top incomes. This means that every employee would keep at least 50% of his or her marginal income. If such a surcharge were to be introduced, the complete range of incomes would be largely unaffected by income-impacting steps (see Figure 3 and 4 for the percentage effects on net incomes after the flat rate).<sup>24</sup>

**Figure 3: Net income effects of flat rate**



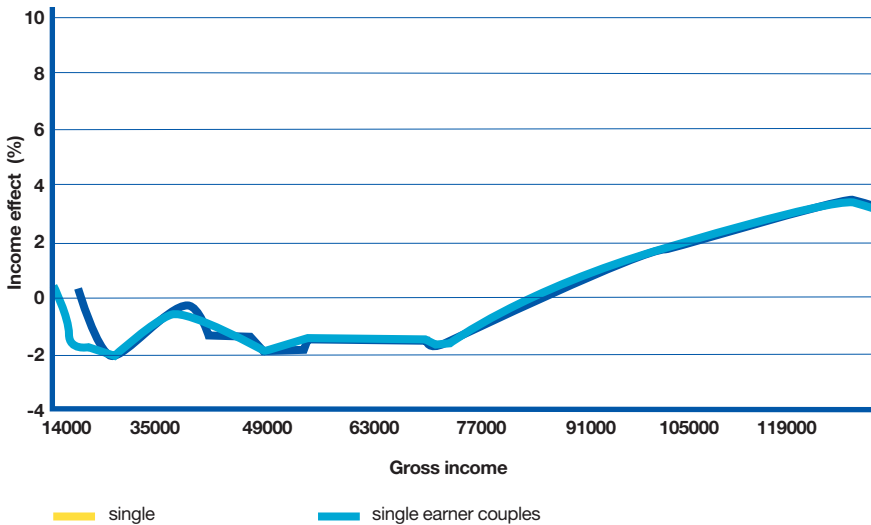
<sup>22</sup> Therefore, we do not agree with Fuest et al. (2008, 634), who conclude that ‘another robust result is that flat tax reforms will increase the tax burden of the middle-class’.

<sup>23</sup> Another possibility would be the German ‘Reichensteuer’ on incomes of €250,000 or more.

<sup>24</sup> In Figure 3 and 4 a top-income surcharge of 7.5% has been taken into account. Because of this, the marginal rate will amount to 50%.

In Figure 4 the net income effects of a flat tax rate proposal for elderly people (those above 65 years old) are presented. Taxpayers over the age of 65 are not required to pay state old-age pension contributions and therefore low-income pensioners face a tax rate of 20.4%.<sup>25</sup> The income effects on the elderly are more or less comparable the effects on those below 65.

Figure 4: Net income effects of flat tax rate (65+)



<sup>25</sup> To be precise, for taxable income below €32,127 the tax rate would become 20.4%, and above this amount it would be 38.3%. As a consequence, for those families whose members are over the age of 65, there would be no flat rate.

Furthermore, it is important to tax individuals directly for this surcharge. This would ensure that overall wage income could be taxed at the firm level and would still require no personal administration by employers. In addition, modest compensation for low-wage earners could also be given. In that situation the earned-income tax credit would be more appropriate than the general tax credit.<sup>26</sup>

Through a partial shift away from income taxes to value added taxes, we believe it is possible to introduce a flat rate income tax that is lower than the current rate of 33.25%. Since 1990 the Dutch VAT rate has been increased only slightly. Compared with some other European countries, the Dutch standard VAT rate is thus relatively low (see Table 4). Also, many goods and services have been exempted from the standard-value tax rate.<sup>27</sup>

**Table 4: Standard value-added tax rate (1990 and 2007) in per cent**

	1990	2007
Germany	14	19
Netherlands	18.5	19
France	18.6	19.6
Belgium	19	21
Sweden	23.46	25
Denmark	22	25

Source: OECD (2008, Table 2).

<sup>26</sup> To get the effects shown in Figure 3 and Figure 4, the earned income tax credit for low-wage earners has been raised by €302 and the tax credit for the elderly with an income below €34,282 is raised by €302 as well.

<sup>27</sup> According to *Miljoenennota* 2009 (2008, 129), these tax reductions amount to €4 billion.

In order to achieve a low marginal tax rate on income, we propose several measures:

1. The standard VAT tax rate should be raised from 19% to 22% and the lower VAT tax rate for necessary goods from 6% to 7%.
2. The types of specialty goods that are allowed to be taxed at the lower VAT rate (such as flowers and special entertainment) should be restricted.
3. Some tax credits, especially those aimed at single parents and self-employed persons, should be reduced.
4. The rate in Box III should be raised to 33.25%, so that there is no arbitrage between boxes I and III.<sup>28</sup>
5. The regulations surrounding property taxes should be relaxed, thus allowing local governments to charge higher rates.

These taxes draw on an immovable tax base, whereas in this period of the globalisation of economic activity many other tax bases are mobile across tax jurisdictions (see, e.g., OECD 2009). The shifting of income taxes to a combination of value-added and property taxes has income effects which are comparable to the flat rate package.

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<sup>28</sup> For arbitrage between Boxes I, II and III, the rate in Box II should be lowered as well, to a level of 20%. Taking profit taxes into account, there would then be virtually no arbitrage.

## Conclusions

In Eastern Europe, many countries have introduced a flat rate income tax in recent years. In the first wave of flat taxes, the Baltic states typically set the single rate at the highest of the pre-reform marginal tax rates. In the second wave, countries such as Russia typically set the rate at the lowest pre-reform rate. In most countries the basic allowance was increased to offset some adverse distributional effects. However, such an increase has been shown to have negative effects on the functioning of the labour market, and since there is little room for tax cuts in the coming years, the literature seems to indicate that flat rate reforms are unlikely to spill over to Western Europe (see for example Keen et al. 2008 and Fuest et al. 2008). In our view, however, there is still room for a well-designed and administratively effective tax reform that combines flat rates with other social security contributions.

In this paper we have proposed such a flat tax reform for the Netherlands, but several aspects of it are relevant to other EU Member States as well. This flat rate would lead to a better-functioning labour market and, more importantly, fewer administrative costs for employers. In particular, companies could make a single tax payment covering all wages of their employees. In the Netherlands, progressivity in the tax and benefit system could come through an advanced system of tax credits focused at the household level. Over the past few years important steps towards such a system have already been taken, introduced by the previous Balkenende cabinets. In addition, a flat tax would make the arbitrage between boxes negligible; thus there would be fewer distortions for investment in housing and

firms—an advantage that is highly neglected in most of the empirical studies based on household data.

The Dutch starting marginal tax rate (42% at minimum wage) is much higher than those of other European countries such as Germany and Denmark. The flat rate in the Netherlands is therefore paired with less distributional effects than in Europe generally. As a consequence, the labour market effects of the Dutch reform are relatively small, but they are still positive. Combining the Dutch flat tax with a flat health care contribution of 4.5% to all wage incomes would make the distributional effects substantially smaller. Finally, it is possible to implement an extra surcharge of 5–10% for top incomes above, for example, €125.000.

This paper further includes some suggestions to lower income taxes to the flat rate of 33.25%, which could be made possible by shifting the emphasis away from income taxes and toward value added taxes. Empirical analysis shows that consumption or VAT taxes are less harmful to growth and employment than are personal income taxes (OECD 2009). In addition, we propose raising the level of taxation in Box III (savings and assets) to 33.25%, so that arbitrage between boxes will no longer exist. It should be noted that we have limited our analysis to revenue-neutral policies. If we were to allow for cuts in government spending, the efficiency gains would be larger. A common approximation in economics is that the economic distortion (or excess burden) from an income tax is proportional to the square of the tax rate (e.g., Kaplow 1998). A high marginal income tax rate raises the incentive for both legal avoidance and illegal evasion. Thus there should be room for a further cut in income taxes through a cut in government spending, but this is something for future research.

A flat tax rate also improves taxpayer compliance, even though there are other important incentives for better compliance. In the Netherlands tax administration is rather complicated—especially for firms—and therefore one should use the proposed tax reform in favour of a flat rate to reduce red tape for firms and employees. In addition, a single-rate VAT has large administrative advantages over the current multi-rate system. It is important that this debate take place.

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