The changing role of premiums in the Dutch first pillar pension, AOW. 
-A theory of economic equivalence tested-

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Preface

The document before you is my Master thesis, my final work as a student in the Netspar master programme Economics of Aging and Pensions at Tilburg University. In February 2007 the Social Insurance Bank (Sociale Verzekerings Bank, henceforth; SVB) invited me to write my Master thesis on the effects of a changing labour force participation, the changes in the laws governing the General old age pension act (Algemene Ouderdoms Wet, henceforth; AOW) and the relevant tax laws on the affordability of the AOW. In doing the preliminary research for this project I found myself struggling with the notion of “affordability” within the context of the AOW. And although there is a clear link between labour market participation and government finances in general, I found it difficult to separate the income streams for the AOW from income streams in general. These difficulties had two separate causes.

First; if one is to take a quick look at the structure of the AOW one would probably qualify it as a social insurance scheme that is paid out of premiums levied on the working population. However, when taking a closer look one finds that these premiums are embedded in the system of income taxes and the way this is done might make it questionable if we can still classify them as premiums. One starts to wonder what except for the name, still separates these premiums from being general income tax.

Second; The AOW is considered by many as the main pillar under the Dutch social security system. Therefore the system does not have a hard budget constraint. It is questionable in how far can one speak of affordability in a system where the financing side is always being adapted to the spending side.

When trying to find an answer to these questions I found out that there was virtually no literature on this subject. Especially the lack of economic viewpoint on this matter was striking. I therefore set out to make this the topic of my Thesis.

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1 How should affordable be defined in this case? If we look at some definitions we find that it can mean “to have enough resources/money to pay for” “to be able to do something without (severe) adverse consequences” or “reasonably priced”. From these definitions it is clear that affordability is a very subjective matter. All definitions use subjective notions such as “enough”, “severe” and “reasonable”. So to say anything about the affordability of something a benchmark should be defined. Especially in the domain of government spending since it never has a strict budget constraint and can have the power to print money.
Introduction

Statement of the issue at hand

In the Netherlands the first pillar pension is a pay as you go (PAYG) system that is paid out of premiums and general tax revenue. These premiums are governed by the social insurance bank (SVB) while the government governs the taxes.² Both the tax system and the social insurance system generate revenue and redistribute income and are therefore part of socio-economic policy. Since paying the AOW premiums is mandatory and by paying them no rights are being accrued³ these premiums could be seen as tax and the AOW benefits as a state pension. The premiums are most comparable to the labour and income tax because they are levied on the same tax base. Taxes and premiums are comparable in many important characteristics. If a change in the one or the other would have the same overall effects in all relevant (economic) areas, the two could be called (economically) equivalent.

Some legitimate reasons can be found to label a part of the income tax as a pension premium and to have a separate institute that governs the first pillar pension. However, because of interference of these two different decision making processes, this separation might come at a considerable cost. These costs can be direct, for example in the form of increased institutional costs, or indirect, by interfering with a sound socio-economic and taxation policy.

Research questions

The main questions that I will answer in this thesis;

“Is there equivalence between AOW premiums and income tax?”

And if this equivalence exists;

“What are the direct and indirect costs and benefits of ignoring equivalence of the two levies?”

² This is at least how the framework of the AOW was set up; in reality the premiums are just partially controlled by the SVB. More on the changing role of the SVB in the governing of the premiums can be found in the third part of this thesis in the paragraph entitled “Changing decision making process for premium and benefit setting”.

³ This is not an obvious truth; by not paying the premiums that should be paid according to the law, some pension rights can be lost in theory. However no rights are gained by paying the premium.
Throughout this thesis I will use insights from law, economics and theory of taxation for my analysis.
Structure of the Thesis

This thesis starts with an overview of the literature and other sources used. The core of the text is divided in three main chapters; 1. History, 2. Tools, 3. Analysis and Evaluation.

The AOW and the income tax are the two main elements of the research question of this paper. Therefore an overview of the history of the AOW and the income taxation will be given in the first chapter. I will describe the history of the AOW and the income taxation, the present situation and some recent proposals for future development. Except for reviewing the different laws that governed AOW and Income tax, the role of the AOW, why it was and is needed, and its backgrounds will also be reviewed. Special attention will be given to the history of the initial debate, between proponents of a state pension and proponents of a mandatory social insurance, which caused the separation of the AOW financing from general government finances. Furthermore an overview of basic statistics and other relevant data, such as the developments in AOW premiums and benefits and the development of payment out of general tax revenue will be presented here.

In the second chapter I will present the tools that I will use for analysing the equivalence between the AOW premiums and the income tax. In its first sub-chapter the taxonomy of the economics of aging and pensions will be discussed and I will give definitions of some important concepts such as economic equivalence, premium, social insurance and state pension. Furthermore I will review the relevant insights from theory of public economics, specifically taxation theory. Subsequently I will give an overview of past and recent frameworks that have been set up to analyse pension systems. First a very general framework, the World Bank three pillar pension framework will be discussed. Then some existing frameworks that were particularly set up around the Dutch discussion on the division between state pension and social insurance will be reviewed. From this I will derive a new classification framework, inspired by national banking theory, which moves away from classifying in a binary way. Lastly I will discuss the two methods that I will use in the third chapter for evaluating the AOW financing within the context of public finance.

In the third chapter I will analyse in what extent there is equivalence between the premiums and the income tax. In the first part of this chapter economic equivalence will
be defined in the specific context of the AOW and income taxation. Subsequently I will show what the role of the premiums is, even if there is equivalence. To test if equivalence is present in practice I will analyse the decision making process of setting taxes and premiums in parliament and analyse the correlation between taxes and premiums. Then I will derive the conditions under which equivalence will exist in theory and show that these conditions are met in the Dutch system. In the second part of this chapter I will analyse costs and benefits of the coexisting of premiums and taxes, given the economic equivalence of the two levies. Lastly I will show what can be done to bring about actual separation of AOW and other government expenditures and comment on the role that a citizen’s covenant⁴ can have in this respect.

The work ends with a conclusion on the main argument and some directions in which further research would be recommendable. We will have seen that the divide between income tax and premiums is not only theoretically impossible but also fails to endure in practice.

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⁴ Burgerpolis
Sources

Many authors, statisticians and accountants treat (part of) the social insurance contributions as equivalent to income taxes. Other, often more politically orientated writers and law scholars, strictly separate them. However, this choice is seldom motivated and the reasons for this equivalence or separation seldom identified. Virtually no literature can be found on the economic equivalence of income taxation and first pillar pension premiums. This might be partly caused by the fact that most economic research is still coming from the US. Since in the US the first pillar pension benefits are dependent on income and past contributions the redistributive role of the social security tax is smaller. Therefore the main arguments to see income tax and pension contributions as equivalent do not hold in this system. Still, Diamond\(^5\) noted in his Presidential Address delivered at the one hundred fifteenth meeting of the American Economic Association on January 4, 2004 that “While both annual income taxation and lifetime social security have received analysis of the trade-off among redistribution, insurance and distortions, there has not been much work considering the simultaneous use of both institutions”.

Although scientific literature on the AOW exists it is mostly written by scholars specialised in law and much less by economists. Economic literature does exist on related subjects, such as C.A. de Kam\(^6\) “Tax reform in a welfare state, The case of the Netherlands” focussing on the reforms in the period between 1960 an 1987 and some other authors. Other valuable material can be found in governmental documents such as explanatory memoranda accompanying new laws or reports from institutions such as the Social and Economic Council of the Netherlands (SER), the Netherlands bureau for economic policy analysis (CPB) and the Netherlands court of audit.

For the first chapter on the history of the AOW, I used books from law scholars such as Westerveld’s\(^7\) “Keuzes van gisteren…..een blauwdruk voor morgen” and a book by Rang\(^8\), “Kernproblemen van de ouderdomsverzekering”. Furthermore my sources consist of the original laws and connected materials, such as explanatory memoranda. Besides that there are many standard descriptive works such as the Schuurman and Jordens\(^9\) series. The book “studies over zekerheidsarrangementen” composed by J. van Gerwen and M.H.D. van Leeuwen\(^10\) gives a very thorough overview of the history of

\(^5\) Diamond 2004 p.12  
\(^6\) De Kam 1988  
\(^7\) Westerveld 1994  
\(^8\) Rang 1960  
\(^10\) Van Gerwen, Van Leeuwen 1998
almost any form of insurance that existed in the Netherlands in a very thorough and readable manner.

For the second chapter where the tools for analysing equivalence are discussed a wider array of literature was used. The taxonomy in this field of research is not straightforward. Many different authors use almost as many different definitions of certain things such as “social insurance” and these definitions are rarely explicitly commented upon. De Kam was one of the few authors that have set out to use a very clear and well defined taxonomy. Furthermore some international organisations such as the World Bank and OECD have developed some standard definitions. For the subchapter on public economics and taxation theory, a well developed field, I draw heavily upon work from Stiglitz\textsuperscript{11} and Diamond.\textsuperscript{12} The debate between the proponents of a state pension and those proposing a social insurance scheme is very well documented by Rang.\textsuperscript{13} Although this debate was at the origin of the current AOW system and has had a long-lasting affect on the developments in the AOW no clear analysis of this debate and its argumentative contents seems to exist and most authors suffice to remark that a synthesis of the points of view finally emerged. Therefore I have written down the contours of a framework that can be used to analyse the difference between a tax and premium financed system more accurately and for this I was inspired by literature on central banking by C.W. Eijffinger.\textsuperscript{14}

For my analysis of the practical implications of the interference between taxes and premiums I have turned to the parliamentary discussions\textsuperscript{15} and the explanatory memoranda that accompanied several of the relevant bills.

\textsuperscript{11} Stiglitz 2000.
\textsuperscript{12} Diamond 2004.
\textsuperscript{13} Rang 1960.
\textsuperscript{14} Eijffinger 2000.
\textsuperscript{15} Kamerstukken, see appendix 0.
1 History

In this chapter a historic overview of the AOW and income taxation will be presented. This chapter is divided in three sub-chapters. The first focuses on the AOW, the second focuses on income taxation, while the third summarizes the major developments in both fields.

I will start out the first sub-chapter by presenting the laws that preceded the introduction of the AOW. Then I will continue with a description of the introduction of the AOW in 1957, followed by a description of the major changes in the AOW that occurred afterward and a description of the measures proposed by the current government. The sub-chapter will end with some graphical representations of the developments concerning the AOW. For the sake of being able to evaluate the course of history in later chapters I will give specific attention to the policy objectives of the AOW. In the paragraphs on the 1952 government memorandum and the 1954 SER advice a description of the main reasons for introduction of the AOW in the political domain can be found and will be discussed in detail. A more general foundation for the existence of a first pillar pension from an economical point of view can be found in the second chapter of this thesis. The reader should keep in mind that this first chapter is purely descriptive. In many instances normative issues are presented. In these cases, these are the normative views of the actors involved and not those of the author. Even incorrect views are presented without comment in this chapter. The goal is to present developments as they have occurred, not to debate how they ought to have occurred. In the second chapter the (economic) theories are presented, giving rise to a normative interpretation in the third chapter of the developments presented in the first.
1.1 History and background of the AOW

1.1.1 Introduction

The AOW has historically been considered as one of the main pillars under the Dutch social security system. And in the decades following the Second World War it was often at the centre stage of the political debate. As social and demographical conditions changed more and more actors are pressing for a reform in the AOW. It seems however as if most politicians did not want to discuss reforms out of fear for electoral loss. Consequently the AOW has, until recently, not received much political attention.

In the academic world however the problems of an ageing society that are advancing do get more and more attention. An example is the founding of the Netspar institute in 2005. However, academic research has focused mainly on the second and third pillar pensions.

Yet, the Dutch first pillar pension has received quite some attention at the 2006 parliamentary elections. The central point of this discussion has been the question whether retirees should contribute as well.\(^\text{16}\) The discussion was, as is often the case in the political arena, oversimplified. The main element of this discussion has been the division of the costs of the system between young and old on the one hand and rich and poor on the other. As we will see, the difficulties within this debate are lying within the core of the system and have been overlooked ever since its introduction. I will argue that the main element that must be understood in order to make any valuable statement on the matter is the interaction between the income tax and the AOW premium systems.

In this thesis I will analyze this matter thoroughly and to do so I will commence by reviewing the history of the AOW and income tax systems.

1.1.2 Historic overview of the AOW

My analysis in this thesis will be on the AOW that was introduced in 1957. However, some attention will be given here, to some preceding arrangements. The Accidents law\(^\text{17}\) of 1901, the disability insurance law\(^\text{18}\) of 1913 and 1919, the old age law\(^\text{19}\) of 1919 and the Emergency Law Old age provision\(^\text{20}\) of 1947, will be discussed, since they form the practical and ideological background of the AOW.

\(^{16}\) See for example Roel Janssen and Claudia Kammer “AOW wordt inzet verkiezingen” published in NRC on june 7th 2006.

\(^{17}\) Ongevallenwet

\(^{18}\) Invaliditeitwet

\(^{19}\) Ouderdomswet
In this section I will describe the parliamentary and political history as well as the different developments within the AOW and its predecessors. In order to analyze these laws in a consistent way I will first state the framework that I will use. In all cases I will investigate the following questions;

1. Which risk is covered by the law?
2. Who is benefiting?
3. What are the benefits?
4. Who is contributing?
5. Who is carrying out the Insurance?
6. Is it a Funded or a pay as you go system?

In 1885 old age related poverty was first discussed in parliament. This led to a parliamentary inquiry committee established in 1887 that focused on loss of income due to accidents. In 1891 there was attention for the old age poverty problems in the Queen’s speech from the throne21 and a state committee lead by Van Leijden researched this issue and concluded in 1893 that there could be no old age provisions by law because this would be too expensive and would mean too much intrusion of the state in the private domain. In 1894 a committee lead by Rochussen advised the government to make an arrangement that would mandate workers to have an insurance against disability caused by old age, paid by employees, employers and the state together. The government did not take over the advice of the committee and proposed to start a state annuity bank where individuals could take out old age insurance at favorable conditions. However, a majority of parliament did not approve of the proposals of the government and consequently no new law was passed at all for the moment.

**Accidents law 1901**

In 1898 a new committee lead by C. Pijnacker-Hordijk was to investigate the need for an arrangement protecting people from poverty caused by disability and old age. This committee concluded that there was a clear need for the introduction of a mandatory insurance for employees as well as the self employed, for the risks of loss of income due to disability as well as old age. This insurance was to be financed by employees and employers together without any contribution by the state and should have an age

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20 Noodwet Ouderdomsvoorziening 
21 Troonrede; translation of the Schoordijk Institute. Comparable with the state of the union speech in the U.S.
independent premium. This lead in 1901 to the introduction of a mandatory disability by accidents insurance arranged in the accidents law\textsuperscript{22}, this law became effective in 1903. It covered the direct costs related to occupational accidents such as hospital bills, but also provided for indirect costs such as re-schooling and a compensation for loss of income that could last until death. This means that it can be seen as the first step in the direction of an old age pension, since the benefits did not stop after reaching the age of 65. However, it only covered employees in some specific “high risk” industries; within those industries it covered all employees. There was no maximum income. In total around one third of all employees in the Netherlands were covered. The employers had to pay the premium, a fixed percentage of the wage that was varying with the risk of the industry. Benefits were also dependent on previously earned income, replacing 70\% of income, capped by a maximum. In 1901 this law was carried out exclusively by the State Insurance Bank\textsuperscript{23} that later became the Social Insurance Bank. Later after opposition of the employers, private insurance companies were allowed to compete in the market. The financing system was PAYG.

\textit{Disability insurance law 1913/1919}

In 1913 finally a new disability insurance law\textsuperscript{24}(DI-law) was passed by minister Tama, based on the German model and the Pijnacker report. The law covered loss of income due to disability, which was defined as losing more than two third of the earning capacity. It was not relevant if the cause of the invalidity was in or outside of the working sphere. While this insurance covered all employees, not only those in high risk industries, it was only applicable to people earning less then € 545.\textsuperscript{25} This was a substantial part of the population, since there were only around 300.000 people who earned more than this amount.\textsuperscript{26} This insurance was to be paid for by employees and employers together and was a funded system. However, since reaching the age of 70 was qualified as being disabled this can be seen as the first predecessor of the AOW. The state was going to pay for the people who where already over 70 and was to contribute partly at the start up to make up for unpaid premiums. This transition phase was foreseen to take around 75 years.

At that time there was heavy discussion between the proponents of a state pension and those of a social insurance. Therefore only the part of the law governing the people

\begin{itemize}
  \item \textsuperscript{22} Ongevallenwet 1901
  \item \textsuperscript{23} Rijksverzekeringsbank
  \item \textsuperscript{24} Invaliditeitswet 1913
  \item \textsuperscript{25} 1200 guilders
  \item \textsuperscript{26} CBS. 1925 p.139.
\end{itemize}
already over 70 took effect in 1913 and the rest only took effect six years later in 1919. In 1919 the pensionable age was lowered from 70 to 65 years while the benefits were increased simultaneously. Furthermore benefits for widows were added. Contributions had to be fully paid by the employers and were dependent on the age, sex and trade of the employee. 60% of all Dutch employees were insured. This insurance was carried out solely by the State Insurance Bank.

The aforementioned discussion is very important for answering the question of equivalence between premiums and taxes because it is here where the concept of premium payments was at the center of the discussion. This will be the subject of the next chapter.

*Old age law 1919*

In 1919 also the old age law 27(OA-law) took effect. This gave the possibility to employees and self employed alike to take out an annuity at favorable rates, comparable to the idea of the government in 1894. Participation was restricted to people earning less then € 908 per year, around 300,000 people were earning more then that amount. The introduction of this law was necessary because until then all existing laws had just helped the employees and not other groups in society that were in a comparable situation. This insurance was optional and funded. However also in this law a provision was made for individuals that had already reached the age of 65. For them benefits were provided by government. After the introduction of this law roughly 75 %28 of the elderly population was getting a pension provided for by the state. The old age law was also carried out by the State Insurance Bank.

*Retrenchment act 1935*

In both the DI-law and the OA-law the government would finance the premiums that were not paid, the introduction costs. These funds could have been made available at once at the time of introduction of the laws by putting a huge amount of money in the old age funds, financed by issuing government debt. Instead of doing this it was decided that these payments would be paid in the form of annuity, as such being implicit government debt. Due to economic circumstances, a recession, the government passed the Retrenchment act 29 that would stop the payment of these annuities for a period of 5 years. Because these were principally funded systems there were no immediate effects on the

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27 Ouderdomswet 1919
28 Noordam 1998,
29 Bezuinigingswet 1935
benefits. It would lead however to payment problems in the future that could also affect benefits for people that contributed all their own contributions and never got subsidized by the state. The “system” that resulted is called a moderated PAYG system.

Conclusion about the pre-second-world-war years

The first arrangement that can be seen as a predecessor of the AOW is the combination of the Invalidity Insurance act and the Old-age Pensions Act. These laws provided insurance for loss of income due to invalidity and old age on a very basic level with low benefits. In the beginning only employees could be part of insurance schemes but later also others could benefit from the introduction of the social insurance laws. In all cases participation was only available for the lower income groups. Although the government contributed to the system by paying for recouping of unpaid premiums and people that never contributed the premiums for these schemes should generally be paid for by the beneficiaries or their employers. All these systems were basically funded and were carried out by the State Insurance Bank, in some cases competition from market parties was allowed.

Towards a universal arrangement

Around the middle of the 20th century public opinion on the role of the state in providing for social security and the need for diminishing the effects of a capitalistic system was changing. Although the introduction of the provisions discussed above did improve socio economic conditions, the problem of poverty amongst the elderly remained persistent. The increasing general level of wealth, made these problems more apparent and opened up possibilities for extending the reach of public social security provisions. Under these conditions the possibility of the initiation of a universal old age provision opened up. However, a long process of formation of a widely accepted view was necessary before the introduction of such a far reaching programme became reality. To illuminate this process I will in the next section, in addition to a description of the laws introduced, describe the main elements of reports written by committees on the subject of old-age pension provision.

Van Rhijn committee 1943-1945

This first report of a committee lead by van Rhijn was highly influenced by the Beverage report in the UK. It propagated a broad spectrum of social security laws. An important break with the past was that new social security should be universal and uniform.
Emergency Law Old Age Provision\textsuperscript{30} 1947

In 1947 the emergency law for old age provision got introduced that covered loss of income due to old age. It covered all individuals of 65 years of age and older with a yearly income lower than a maximum of € 624.\textsuperscript{31} The maximum benefit amounted to €506.\textsuperscript{32} This was the first complete PAYG system and was also the first system that was completely paid for by general revenue. It was once again carried out by the State Insurance Bank.

2\textsuperscript{nd} Van Rhijn committee 1948

The first van Rhijn report got a lot of critique. The proposed measures constituted an enormous break with the past and seemed to be too big a step. In the second committee much more politicians participated and their ideas were much less revolutionary. This report gave practical implementation advice; everyone mandatory insurance, level equal to the emergency law and no means/income test paid for by employers and employees. The state also had to contribute to enable a direct start with paying out of benefits.

Suurhof van Rhijn\textsuperscript{33} committee 1952

In 1952 Suurhof and van Rhijn made a final report that contemplated on the final views of the government on the new old age pension law. The most important elements were that the mandatory insurance would be applicable to employees and self-employed, would start paying benefits from the age of 65 at a social minimum level with no means test, and a possibility of a belated pension with higher benefits.

SER advice\textsuperscript{34} 1954, Policy objectives and fundamental choices in the AOW

The 1954 SER advice is the last in a long series of different reports from numerable committees and institutes. This advice gives a detailed description of a possible new old age pension act. Here I will focus on the first chapters of the report that deal with the underlying fundamental choices that have been made and the policy objectives that were chosen. It is not my intention here to check the given arguments for

\textsuperscript{30} Staatsblad 1947;H155
\textsuperscript{31} i.e. 1375 guilders. The maximum income was dependent on marital status and the general standard of living in the city of the beneficiary.
\textsuperscript{32} i.e. 1116 guilders. Dependent on the same variables as the means test mentioned above.
\textsuperscript{33} Nota inzake de toekomstige ouderdomsvoorziening van de Minister van Sociale Zaken en Volksgezondheid en de Staatssecretaris van Sociale Zaken, 1952.
\textsuperscript{34} SER 1954/3
their validity. They are just presented as they are in the report. In these arguments a
certain mode of thought can be found. In chapter three I will point out the fundamental
flaws that I believe are in this line of thought.

A significant part of the elderly has insufficient income to live on an acceptable
level. People do not save enough either because their income was insufficient during the
working part of their live or because they miscalculated the need that would arise during
old age. Inflation plays an important role in this respect. The emergency law does not
provide enough income for those who are receiving and it does not apply to all those that
are in need and was intended to be temporary. Although the private saving and annuity
market is picking up, there is still a clear need to implement a new old age pension act.

There is a moral duty to act upon the need of so many of the elderly population.
The state should take away the need as well as the cause of the need. This can be done
best in the form of social insurance, since this has been historically the way that this kind
of systems has had in the Netherlands. This is good because; 1. There is place for
individual responsibility, 2. There is place for collective responsibility, 3. Costs can be
divided fairly, 4. There the connection between rights and duties does not have to be very
strict. On this basis individual freedom can be restricted.

The new insurance should be universal. Even though there might be groups that
would take their own responsibility, there can not be any certainty that this responsibility
can be taken throughout the whole lifetime. Furthermore these groups would still not be
secured against inflation risk. Moreover, accepting that some groups are not part of the
insurance would hinder the solidarity principle and would imply a serious additional
administrative burden.

Insurance should be at a minimum subsistence level because the economic
situation does not allow for more and it is the logical consequence of the principle that
old age income is primarily an individual responsibility. Differentiation might be found
in the second pillar pension.

A choice had to be made between a uniform premium and a premium proportional
to income. A uniform premium is good because the benefits will also be uniform.
However this is not completely correct since not everyone starts earning income at the
same age. For social reasons a differentiated premium is more fair although such a
premium should be maximized, otherwise there would be unfair results for the high
income earners.

In chapter six of the report the economic and social consequences of the proposals
are being discussed. I will give a brief overview here. An in depth discussion on the
validity of the arguments that are being presented here can be found in chapter three of the thesis.

For the implementation of the AOW a new levy that is called premium was going to be raised. For wage earners it was expected that the total burden will be compensated by the employers who will not have to pay the equalization levy\textsuperscript{35} anymore. For some groups that already have some 2\textsuperscript{nd} pillar pension plan the income change will be minimal due to introduction of a franchise. For the self employed the premiums might be carried forward into the prices of their products or services. There will be no change in the income tax. All computations presented in the report were being made by the CPB and are only short term economical effects. Longer run effects could not be adequately forecasted. The most important consequences are summarized as follows;

- A small increase in the price level and a deficit of 70 million guilders on the balance of payments due to decreasing exports and increasing imports.
- Increase of consumption by the old aged of 295 million guilders.
- A small increase in employment (+2000)
- A small decrease in the real consumption of employees
- A decrease in consumption and saving of the self employed

1957 Introduction of the law

On the 31\textsuperscript{st} of may 1956\textsuperscript{36} the AOW bill was finally passed consisting of a mandatory insurance against the monetary consequences of old age for the whole population. Here I will describe the main elements of this law. The insurance will be carried out by the SVB, but the premiums will be levied by the tax authorities.\textsuperscript{37} In principle all people that live in the Netherlands and are between 15 and 64 years of age are insured, and will have a right for an old age pension when they reach the age of 65.\textsuperscript{38} The basic pension for an unmarried individual is 365 Euros per year and this amount will be indexed to the average wage rate.\textsuperscript{39} This amount will be reduced by 2 percent for every year that someone was not insured or did not pay the premium that should have been paid.\textsuperscript{40} People that already reached the age of 65 when the law passed also have a right to this pension as well as people that were between the age of 15 and 65, who are

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{35} See 1.2.2.
\item \textsuperscript{36} Staatsblad 1956 nr. 281
\item \textsuperscript{37} Art.4
\item \textsuperscript{38} Art. 6 and 7
\item \textsuperscript{39} Art. 8 and 9
\item \textsuperscript{40} Art.10
\end{itemize}
\end{footnotesize}
being treated as if they had been insured. All the benefits that are to be paid out as well as the costs for sustaining this insurance are to be paid out of premiums that will be levied on the insured (i.e. people between 15 and 64 years of age). These premiums are to be put into the old-age-fund that is governed by the SVB. The premiums that will be levied will be levied as a percentage of income that will be set, in principle for periods of five years, by the SVB. As income will be taken the income as computed in the Income Tax 1941. Premium will only be levied on income up to an amount of 2723 Euro, called the taxable maximum, and this taxable maximum will be indexed in the same way as the pension benefits. If the aforementioned income is lower then 681 Euro for unmarried individuals the premiums that are not withheld via the wage tax, will not be claimed. Those premiums will instead be paid by the state via general revenue.

1962 Increase of the level of pension benefits

On the 1st of July 1962 the pension benefits where increased by 15 percent. The main reason for this increase was that the pension at that time was not deemed sufficient as a basic minimum pension. At the time of introduction of the law a higher benefit was not possible due to economic circumstances, but had been deemed possible by then. The SER notes that although they agree that an increase in the benefits is eminent, there should be a broader view and longer horizon discussion on the principles of socio economic policy and the division of the (tax-)burden. Appendix 2 of the 3 of the SER advice, gives a table that shows the combined effect of the lowering of the income tax and the increase in the AOW premiums.

1963 government policy statement

In the 1963 government policy statement of payment out of general revenue for financing the AOW is accepted for the first time. Until then there was no financing out of general revenue. There was a general consensus that an increase in benefits to some minimal acceptable level was needed. However, at the same time increasing the premiums was not seen as an option. Although contributions out of general revenue were contrary to the “social insurance” nature of the AOW, the government decided to let

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41 Chapter 8
42 Art. 23. The SVB, Social Insurance Bank was the new name of what used to be the RVB, State Insurance Bank.
43 Art. 24
44 Art. 26 and Art. 28
45 Art. 26 section 6 and Art. 28.
46 Art. 31 and 32.
47 SER 1962/2 p.5.
pragmatism prevail over existing dogmas. Under the same government the question of belated higher benefits, was again raised, but although this question comes back now and again it was never actually introduced. The proposals by the current government, with a tax penalty for retiring early and a bonus for part time work after the age of 65 is the newest chapter in this debate.

1965 *Increase of the benefits to a social minimum and introduction of payment out of general revenue.*

Already since the introduction of the AOW there had been a clear intention for a general old age pension at a level that would keep all elderly out of poverty. Therefore the benefits of the basic first pillar pension should be at a level of “social minimum”, defined as 70% of the minimum wage. As noted before this was economically unfeasible at the time of introduction, but with growing economic prosperity this goal could finally be reached. However for this increase in benefits to be possible a huge increase in premiums was necessary. On top of that, for the first time ever, part of the costs would be paid out of general revenue. Nonetheless the maximum premium to be paid went up by almost 45%.

1970-1980 *Equalizing the net AOW benefits and the net minimum wage.*

As we have seen the AOW benefits were being increased often. At the end of the sixties a debate started that questioned what should be the optimal level of the AOW benefits.49 In 1970 the SER50 advised to put the net AOW benefits at a par with the net minimum wage. This principle is called the net-net link. By some ad hoc increases in the AOW benefits in 1971 and 1972 an actual net-net link was established. In 1980 this link was formalized into a law.

1984 *Verzelfstandiging*  
Due to stringent European law, changes had to be made in the AOW since it had some discriminatory elements. Until then the AOW had always been treated on a household level. Due to European legislation changes had to be made since men and women were unequally treated. In 1984 the Social and Economic Council of the Netherlands issued an advice concerning the equal treatment for men and women regarding the AOW. This change could be marginal, keeping the household focus or substantial constituting a change to complete individualization. Finally the following set

50 SER 1970/5
up was chosen with respect to the benefits: A married man or women will get benefits of 50% of minimum subsistence level, Unmarried individuals will get 70% while married individuals with a partner under the age of 65 can get an extra allowance that is dependent on income of the partner. The premiums changed as well: Premiums would be levied on all individuals’ income separately instead of on the combined household income. For some this meant a substantial increase in premiums. The government proposed to compensate for this in the taxes. 51

1989 Oort-laws

In 1989 the systems of income tax and social insurance premiums were reformed. The most important element of the reform was the merging of tax and premiums into on taxation scheme. I will discuss this reform in more detail later in this chapter because it is connected with both the AOW and the income tax, which I will discuss later in the chapter.

1997 Introducing a maximum to the AOW premium level, funding out of general revenue and introduction of the AOW savings fund 52

In 1997 the government foresaw problems arising with respect to the future financing of the AOW due to the ageing population. Within the framework of the AOW as it was, a need for increasing the revenues could only be solved by increasing the premiums. This is undesirable since it would mean a disproportionate increase in the governmental levies on the lower-class. Furthermore it would increase the effective tax rate on the lower incomes and would therefore decrease the incentive to work. Many measures were proposed to counter these problems such as;

1. maximizing the AOW premium, funding out of general revenue
   - If a maximum level for the AOW premium percentage is introduced, a new income source is necessary. This new source would be general revenue. The advantage is that the burden of the taxes that contribute to general revenue are more evenly spread over the population than the premiums, which is completely levied in the first income tax bracket. i.e. low incomes. Furthermore this would stop the increasing tax advantage of the elderly who do not pay AOW premiums, but do pay other taxes.

2. changing indexation of the income tax brackets

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51 MvT 18515 nr.3 p. 30.
52 MvT 25699
Premiums are only levied in the first income tax bracket. These brackets are generally adjusted for inflation, to counter tax crawl. This indexation was lagging behind however, which caused a relative shift of the premium burden to the poor. It could be changed to increase the income range over which premiums are levied.

3. increasing the AOW age
   - Increasing the AOW age would decrease the costs.

4. introduction of premium in the 2nd and 3rd income tax brackets
   - Introducing premiums in the 2nd and 3rd bracket would increase the financing base for the AOW. This would mean that premiums would be levied over all income.

5. vibrating fund
   - Since the costs of the AOW are expected to rise over time, it is proposed to start increasing revenues, to build up funds for later use. This would spread out the costs of an ageing society, however it would aggravate instead of alleviate the financing problems in the short run.

6. increasing the length of the first income tax bracket
   - This measure would have the same effect as changing the indexation of the income tax brackets. Since the tax level in the first bracket is lower then in the second this would decrease general tax revenue.

7. premium payment by people over 65 years of age
   - In line with the insurance character of the AOW, individuals aged 65 years and older do not pay AOW premiums. Thus, the individuals with supplementary pension income face a lower levy rate then individuals under 65.

8. starting a funded fund (as opposed to PAYG)
   - This is an extreme measure proposed, that would effectively phase out the AOW. This would certainly not solve the problem in the short run since it would mean a double burden on the current generation.

In addition to these measures directly related to the increasing financial needs of the AOW, more general goals were stated that would lead to more robust government finances in the future. Focus on economic growth, mainly by increasing labor force participation and decreasing other government expenditures were the main points. Two measures were actually implemented. First, a maximum level of 16,5% for the AOW premiums was introduced, while the additional funding needed was to be taken out of general revenue. The main reasons for this choice were that this would stop the increase of the rate of the first bracket, which would harm the labor force participation
and that this would broaden the financing base of the AOW. Second, an AOW saving fund was introduced. This is an accounting measure that does not constitute any actual saving and consequently is not affecting for example the budget deficit or the government debt. Most economists do not see it as an actual measure taken so I will not discuss it any further here.

Furthermore, the responsibility for setting the premiums was formally taken away from the SVB and given to the minister of social affairs; this change will be discussed in more detail in the third chapter.

1998 Increase of the proposed maximum percentage\textsuperscript{53}

From April 1998 the maximum premium percentage was increased by 1,75% to 18,25%. At the same time the 1\textsuperscript{st} bracket income tax was decreased by 1,75%. In this way the elderly were specifically targeted to benefit since they do not pay AOW premiums. This change was initiated directly by government, without any intermission by the SVB.

2001 Introduction of IB2001\textsuperscript{54} and BIKK\textsuperscript{55}

In 2001 the income taxation was changed drastically. In this section I will briefly point out the major effects that this law had on the AOW. A more in depth description of this income tax law will be given in the paragraphs dealing with the history of the income taxation. A major change was that tax credits replaced the tax free allowance. While the tax free amount only affected the income tax paid, the tax discounts where also applicable to the AOW premiums. Therefore the taxable maximum was increased in order to keep the same maximum premium paid. To compensate the AOW fund for the loss of income due to the introduction of these discounts a new article was added to the law governing the financing of the social insurances, this is known as the Bikk (bijdrage in de kosten van de kortingen). This constitutes of a compensating arrangement for the income lost by the introduction of these discounts paid out of general government revenue.

2007 Proposed changes in the law of the new government\textsuperscript{56}

Presently the focal point of the discussions on ageing and pensions is, and I think rightly so, on increasing the labor force participation of the elderly. With this goal in mind the new coalition of CDA, PvdA and the Christian Union proposed the following;

\textsuperscript{53} MvT 25914  
\textsuperscript{54} MvT 26727  
\textsuperscript{55} Art. 15 Wfsv  
\textsuperscript{56} Regeerakkoord.
Starting in 2011 an extra tax will be levied on higher income earners, with a supplementary pension of at least 18,000 Euro, unless they will keep working until they reach the age of 65. If one decides to keep working after reaching the age of 65, a tax benefit can be earned. This means that for these people the tax discount that they get on their retirement savings (not having to pay AOW premium after reaching the age of 65) will be completely or at least partly offset.

This proposal has been criticized by many and the CPB has also been critical, noting that the introduction of such a scheme is technically very demanding and it has fiscal economical drawbacks.\(^{57}\) I will come back to the fundamental implications of this proposal in the third part of this Thesis.

1.1.3 AOW in figures

In the previous sub-chapter I have given an account of the development of the AOW. Here I will give some key statistics that may provide the reader with a quick insight of the implications of the system. In appendices 2 and 4 tables are presented containing an annual overview of key figures.

Spending on AOW

In 1957 total costs of the AOW were around 400 million euros per year. Due to inflation, rising benefits and a growing elderly population, spending on the AOW has increased ever since. In 2006 a total of 24 billion euros of benefits was paid out. At the start all benefits were covered by premium revenue. In 1965, general revenue was used for the first time to supplement premium income, funding out of general revenue reached a temporary peek in 1979, coming close to 1 billion euros or over 10% of revenues. In the following recession in the beginning of the 80’s funding out of general revenue was discontinued. In 2002 funding out of general revenue was restarted due to capping of the premium percentage and reached almost 3 billion euros or more then 11% of revenues in 2005. The spending out of general revenue, including the contributions via the BIKK is expected to reach around one third of all revenues in 2008. According to some calculations done by Van Eekelen en Olieman this is expected to reach some 50% by 2038.

Population growth

Important factors for any PAYG pension system are demographic changes, especially the proportion of contributors to beneficiaries. From 1950 to 2005 the Dutch population increased by 63% from 10 to 16,3 million inhabitants. In the same period the number of people aged 65 and older almost tripled. In graph 1 on the next page we can see the development of the proportion of Dutch population aged 65 and over; we see that this proportion has been rising ever since the introduction of the AOW.

Increasing level of AOW benefits

When the AOW got introduced the level of benefits was set at a level that was reckoned to be very low. At that time it was argued that it was better to introduce a system with low benefits than no system at all. Furthermore it was expected that the economy would develop rapidly over the coming years and that it would consequently be

58 Information from SVB web site under kerncijfers.
possible to increase the benefit level at a later stage. As we can see on graph 2 on the next page, the benefits did indeed grow at a fast rate until the end of the seventies. We can see also that the benefits were growing much faster than the average wages.\footnote{Average wages as agreed upon in central bargaining arrangements.} In the later years the AOW benefits did not grow as abundantly but they did keep up with the wages.
Graph 1: Ageing population

Graph 2: Benefit growth
Graph 3: Premium percentage

Graph 4: Maximum premium
1.2 History of the Income taxation.

In this paper the interrelation between the AOW premiums and Income taxation will be researched. Therefore, in this sub-chapter the history of the income taxation in the Netherlands will be described. Exhaustive descriptions of the different tax systems would be outside the scope of the present paper. The main focus will be on the tariff structures under the different laws.

After a short introduction of the early history of income taxation in the Netherlands I will turn my attention to the income tax law introduced in 1941. Since the premiums for the AOW were introduced in 1957 it is necessary to go back in time at least to that date. At that moment income was taxed on the basis of the law income tax 1941\(^{61}\). This law was introduced in 1941 when the Netherlands was under the occupation of the Germans. Although it was changed on many occasions it stayed in effect until 1964 when the law income tax 1964\(^{62}\) was introduced. Official integration of AOW and the income taxation took place with the introduction of the proposals of the Oort committee in 1989. The last major change in the income tax system took place in 2001 with the introduction of IB2001\(^{63}\).

1.2.1 Early income taxation schemes

The concept of income taxation entered the Netherlands in the 19\(^{th}\) century and although it was often debated in parliament no such taxation was introduced until the beginning of the 20\(^{th}\) century. One of the main reasons being that politicians in those days still questioned the right of the state to inquire into someone’s income position and even if there would exist such a right, practical problems were still seen as an impediment to the introduction of an income taxation. It was only in 1914 that the first integral income taxation law was passed. Even then it was not without controversy; the first draft of such a law proposed by the minister of finance in 1906 was withdrawn in 1908. A new draft, proposed by the same minister M.J.C.M. Kolkman in 1911, caused so much uproar, that it took a long time to get the proposal through parliament. His successor, Minister A.E.J. Bertling got so many amendments that he was not able to implement the new tax and as a

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\(^{61}\) Verordening nr. 105/1941.
\(^{62}\) Staatsblad 1964; 519
\(^{63}\) Staatsblad 2000; 216
consequence he even needed to step down from his office. Finally the next minister of finance, M.W.F. Treub succeeded in passing the bill in 1914.

This law still differed fundamentally from the income taxation as we know it these days. The present Dutch income tax law is still closely related to the income tax 1941 treated in the next paragraph.

1.2.2 Income tax 1941

introduction

From 1940 to 1945 the Netherlands was occupied by Germany, the democracy was not functioning as usual. Consequently laws were being passed by decrees from Germany. Contrary to what might be expected many laws were introduced also in the field of taxation and social security. In 1941 the income tax 1941 and the equalization levy got introduced.

Income tax 1941

A convenient way to start an analysis of a certain tax would be to look at the tax base, the tax brackets and the (marginal) tax rates. This is however not possible in the case of the income tax 1941 since the income tax was constructed in a different way than what we are presently used to. The law consisted mainly of rules on how to compute the taxable income. The taxation rate could be found in article 45 of the law. The first section of this article read as follows “the amount of tax payable…can be found in the table that is connected to this law”. This table consisted out of some 483 income rows and 14 columns where one could find the tax amount. It is however almost impossible to discern the underlying “rules” that govern this table. I will come back to the some of the consequences on socio-economic policy of this in the third chapter.

One of the consequences of this system is that technically the real marginal tax rate is always zero or infinity.

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64 officially he was honorably discharged.
65 See appendix 1 for an example
66 In analyzing the tax structures of this and following laws I have put quite some effort in finding the underlying logic. I did not completely succeed and decided to trim down my aspirations and do a more partial analysis. Later I found out that in 1960 the committee of finance of the parliament had asked the government if it would be possible to summarize the tax tables in the form of a formula. The government replied that after thorough investigation into that matter with the help of mathematicians this turned out to be impossible.
T' = dT/dI

Where;
T' = real marginal tax rate
dT = change in tax payable
dI = change in income

Therefore another measure of marginal tax will be used

T'=(T_x-T_{x-1})/(I_x-I_{x-1})

Where;
T' = approximated marginal tax rate
x = row number in income tax table

If this measure is used to analyze the Income Tax 1941 more then 20 different tax brackets can be found. The rate starts out at 8%, shows a rapid increase towards 70% and finally drops somewhat to 65%. However the rate structure changed quite often, and much so on an ad hoc basis. (As opposed to for example a structured inflation correction such as we see them nowadays in most tax laws.) In the time span of 23 years that the law was in effect, 11 different tables have been applicable. Although a government project is under way to digitalize all bulletins of acts, orders and decrees those tables are not digitally available at this moment. Since each of these tables has at least 5000 cells a thorough mathematical analysis of the structure of this tax would be exceedingly time consuming.

*The equalization levy* 67

In August 1941 when The Netherlands were under German occupation the equalization levy got introduced. It consisted of a levy on employers. It was introduced to finance increases in the benefits of some of the social insurances such as the old age law and the invalidity law. However, there was a more important goal, which gave the name to the law. The taxation on labor needed to be increased so that it was more equal to that in Germany because the lower Dutch taxation rates constituted to a competitive advantage for Dutch firms relative to German firms. At introduction this levy amounted

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67 Decree 158/1941
to 4.5% of the gross wage. After the war the levy was not abolished, its rate was however lowered to 4%.

1.2.3 Income tax 1964

A new income tax law introduced was in 1964. Although preparations for the new law took many years, it did not differ much from the IT41 law. Most of the differences in the two laws are on a purely formal and technical level, with few noticeable effects for the taxpayers. After introduction the law was changed on many occasions. For our analysis the most interesting changes are the introduction of the variable-rate taxation, introduction of automatic inflation adjustment and the introduction of clear tax brackets.

The variable-rate taxation, introduced in 1970, made it possible to make temporary changes in the tax levels of the income taxation and other taxes to smoothen the business cycle. i.e. In an upturn the taxes could be temporarily increased while in a downturn they could be temporarily decreased. The automatic inflation adjustment for the income taxation, introduced in 1971, obligated the government to increase the tax brackets every year with the inflation, so that the effective tax level would not increase just as a consequence of inflation anymore. With the introduction of clear tax brackets, in 1972, succeeded the tables that had been used so far. In 1972 there were 9 brackets as opposed to hundreds of rows in the tables that existed before.

1.2.4 Simplification of the tax laws. Oortwetgeving

In 1979 parliament requested fundamental research into simplification of the tax system. At the end of the eighties the Income tax laws have become very complicated. This was for a part due to the efforts that had been made to make the tax laws more gender neutral. In 1985 Vermeend filed a motion that requested the government to do research into the possibility for unification of the income definition for taxes and premiums. As a response to this request the Oort committee was formed in September 1985. In May 1986 this committee presented their final report.

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68 Staatsblad 1964; 519
69 Staatsblad 1970; 605, wiebeltak
70 Staatsblad 1971; 259
71 Staatsblad 1972; 613
72 Based on SER 1987/17
The main conclusion of the report is that simplification can be reached by introducing one main tariff for all incomes up to such a point that the bigger part of the population falls under it. Furthermore the report centers around some themes of which two are of particular importance for my analysis. These are; 1. To merge the income taxation with the premiums of the social insurances 2. Streamlining of deductibles and some special arrangements.

Besides the report notes that fundamental changes in the foundations of the tax system are necessary. And that this needs consideration the fiscal notion of income and profit and the tax bearing capacity. But this was outside the scope of their report.

In July 1989 new tax laws took effect that were formed along the lines of this report. The most important changes that were enacted are the following. The number of tax brackets was reduced from nine in 1989 to three in 1990. The first tax bracket became so broad that the bigger part of the population fell within its boundaries. The top bracket went down from 72% to 60%. Furthermore the social insurance premiums were indeed merged into the first tax bracket. Moreover all premiums for the social insurances will be paid by the employees.

According to the SER this grossing\(^73\) is the key of the transformation. In the old tax system employers needed to pay a part of the premiums for the social insurances on top of the gross wage. The committee proposes that this method will be abandoned and that all premiums be paid by the employees. To leave the employee with the same net wage it is necessary to increase his gross wage. This is called grossing. In the execution of the grossing operation the SER is anticipating a lot of problems. Their main critique is that the operation will lead to a disruption in the labor market equilibrium and will change the existing payment structures. Furthermore it requires a lot of adjustments in the second pillar pensions and would cost a substantial amount of money, mainly due to adjustment costs. The magnitude of these problems leads them to give a negative advice on the introduction of the proposed changes.

Different alternatives for the Oort proposals are also discussed among which there is the Kombrink alternative. In this alternative no grossing operation is needed. Instead compensation is being paid to the employee. This alternative is finally chosen by the government.

1.2.5 Income tax 2001

\(^{73}\) brutering
In 2001 the income tax was drastically changed. Two of the main driving forces behind these changes were to structure the tax in such a way that it would be better suited for socio economic policy and to make it more internationally competitive. It is especially noted in the explanatory memorandum that focus will be on the income tax and the premiums for social insurances. The wedge between net and gross wages was deemed too high. Higher labor force participation is necessary while the population is ageing. The measures taken should broaden as well as simplify the income tax. The new system is analytic; this means that the income source matters for the tax applicable as opposed to a synthetic system where all income is treated the same. There are three income boxes. The first is for Income from employment, the second for profit from an owned company and the third for capital income. In the first box there is progressive tax with 4 brackets while the other boxes have just one tariff. An important change is that instead of the tax free allowance, tax credits are introduced. These have a relatively bigger impact on lower wage earners. Since the positive influence of a tax free allowance is dependent on the individual’s marginal tax rate. The integration of income tax and premiums that was introduced with the Oort laws stays intact. Premiums will be levied on the income in the first two brackets of the first box.
1.3 summary of the history

In considering the history of the AOW it is good to keep a few things in mind. I started this historical overview in 1885, more then a century ago. It was in this year that government intervention with regard to the problem of poverty among the elderly was first discussed in parliament. Needless to say that almost everything changed since then. A rigid stratification of the socio-political domain along ideological lines characterized the Dutch political landscape until the sixties of the last century. Economic thought was very much less developed than it is now.

In the beginning of the 20th century the social circumstances were much worse than they are now and welfare programs were almost non existent. In that period helping those groups of society that were the neediest had the highest priority. Thus, first a programme for workers in dangerous industries that got disabled due to accidents at work was initiated. Then a programme got introduced that included all workers under a certain income level. Later still, as the first real predecessor of the AOW, this programme got extended so that reaching the age of 70, something that was quite rare at the time was set equal to being disabled. Soon after the age was lowered to 65 and widowers were included. In 1919 three quarters of the elderly population was provided a pension by the state. Later on the self employed were also included and in the end a universal system was opened. So we clearly can see that the sphere of beneficiaries has been expanding continuously. In addition the level of the benefits that were connected to the social welfare systems was also increasing. Something else that is noteworthy is the change from programs aimed just at the needy towards the programs with universal coverage.

Before, during and after the introduction of the AOW in 1957 there has been a debate between proponents of a state pension, provided to all and financed out of general revenue and proponents of a social insurance type pension, also securing a pension for everyone but financed out of premiums. The AOW that was finally introduced was seen by some as a synthesis of the two systems and by others as a proto-typical social insurance scheme. Income dependent premiums were due from age 15 till 65 and from age 65 onwards an income independent benefit was available. The system was intended to be PAYG with current working population paying premiums to fund the current expenditures for the elderly. However, just eight years after the introduction, in 1965, partial funding out of general revenue was initiated. In 1997 a maximum level was set to the premium percentage. From that time onwards financing out of general revenue got reintroduced.
If we take a look at the development in the income tax laws we see that it was continuously getting simpler. First there was no income-taxation at all. When it got introduced it consisted out of huge tax tables. Later the current tax system was introduced, consisting of tax brackets, first there were nine later this was reduced to three. The most relevant change for my analysis is the introduction of the Oort laws that merged the AOW-premiums with the first income tax bracket.

In the background there have been huge changes in society that are making continuously changing policies inevitable. In the past century the Netherlands has had enormous economic progress. In the process equity and social security have become more important policy goals. At the same time quality of life has also raised. Now we face a greying society, with decreasing family sizes and increased life expectancy, the proportion of the population aged 65 and over is expected increase drastically.
2 Tools

In the first chapter a historical overview of the AOW and income taxation schemes was given. The goal of this second chapter is to present the economic theory that exists for analyzing pension schemes and tax systems and to present a framework for analyzing equivalence between income tax and premiums. It is the theories that will be presented here that I will use as tools for my evaluation in chapter 3. First I will consider the language that is used in the pension debate, the most basic tool needed to do anything in science. Then I will review the World Bank’s multi pillar framework, which has become a widely accepted framework for the analysis of pension systems. Subsequently I will examine public economics and taxation theory, followed by a chapter analyzing the state pension (Beverage) versus social insurance (Bismarck) debate that shaped the AOW. Lastly I will describe how I intend to use parliamentary debates and numerical research to analyze the interrelation that has existed between premiums and taxes.
2.1 Taxonomy of the pension debate

A concise description of a pension system is dependent on having a clearly defined discourse that is widely accepted. In the area of ageing and pensions weakly defined and narrowly applicable definitions of concepts lead to blurred discussions. In my view this problem is not getting the attention that it deserves. The OECD, the World Bank and other organizations have defined concepts in an effort to establish a widely accepted discourse. I will use them as a starting point for the next sub-chapter and specifically for the set up of the new framework presented further on in this chapter. Although it seems that none of these efforts has lead to the intended glasnost, it clearly indicates that clarity in the taxonomy deserves attention. For my analysis a thorough understanding of the terms social insurance, state pension, premium and economic equivalence are indispensable. The first three interrelated concepts will be discussed in sub-chapter four of this chapter while the last will be reflected upon in sub-chapter three of this chapter.

The object of my research is mainly the Dutch old age pension and tax system. Most existing literature on the subject is in Dutch. This thesis is written in English while some of the terms used are specific to the Dutch system. One of the main Dutch authors that did write in English on the subject is De Kam [1988]. I found his terminology very clear. Therefore I decided to use the same terminology wherever it was possible. A list of definitions can be found in the appendix 0.
2.2 Goals and functions of the first pillar pension within the multi-pillar framework

In this sub-chapter I will introduce the three pillar framework and give a detailed description of the goals and functions of the first pillar within such a framework. In this and further (sub-) chapters I will refer to the AOW as a first pillar pension. The framework that this relates to is the one introduced in 1994 by the World Bank. Many variations on this framework exist but it seems that the original World Bank classification mechanism is still widely accepted. See for example Bovenberg [2003].

Three definitions of First pillar pension

The idea of classifying pension plans into three pillars, which is universally accepted, originates from the World Bank book “averting the old age crisis” published in 1994. However, since this publication many different definitions, often proposed by influential institutes, have sprung up. Since the three pillar framework is the most common and accepted framework used at the moment for classification it is interesting to note that even here no consensus exists. In the document “Maintaining prosperity in an ageing society” published in 1998, the OECD proposes different definitions for the three pillar pension system. Also the International Labor Organization has proposed its own framework. Since my work is on the AOW I will focus solely on the definitions of the first pillar. These are the different definitions of the first pillar. It should be noted that the World Bank and the ILO definitions are part of a model focusing on an ideal system and are prescriptive in nature while the OECD definition is developed with the goal of describing existing systems.

World Bank
A relatively small publicly managed, pay as you go, defined benefit pillar.

OECD
Publicly managed pension schemes with defined benefits and pay-as-you-go finance, usually based on a payroll tax.

ILO
A minimum anti-poverty pension, universally available but means tested, possibly financed directly from general revenues and indexed.

74 Definitions taken from Yermo, 2002.
These definitions are not very exact. However, two conclusions with regard to the AOW can be drawn. The AOW is a first pillar pension that fits exactly in the definition of the OECD. The AOW is however not the perfect first pillar pension according to the World Bank and the ILO definitions. Although it is not exactly clear what “a relatively small” first-pillar pension is, the AOW is surely not that. Coverage is universal and benefits are at such a level that poverty in old-age is close to non-existent. The World Bank notes that the high costs of the Dutch system might lead to distortionary effects. The AOW does also not fit in the ILO prescription since it is not means tested and it is only partly paid out of general revenue. I will discuss the merits and defects of this system in the third chapter.

Goals and functions of the first pillar pension

In the first chapter of the paper we have seen what the main reasons were for introducing the AOW and the rationale behind some of the changes. There I presented the points of view of policy makers, parliamentarians and public advice institutions. Here I want to focus on the general goals and functions of any first pillar pension from the point of view of an economist.

The World Bank identifies three basic functions of any pension system: Redistribution, saving and insurance. The first pillar in the system should be a publicly managed system with mandatory participation and the limited goal of reducing poverty among the old. This pillar should be redistributive and offer part of the insurance. See appendix 5 for a figurative representation of the World Bank three-pillar model.

In most Western countries First pillar PAYG pension schemes got introduced at around the same time as in the Netherlands. At that time the conditions for introducing such a system were perfect. These conditions under which the return on a PAYG system is higher than that of a funded system are now known as the Aaron conditions. If the growth of the wage rate plus the population growth is larger than the return on capital, the return of a PAYG system is higher than a funded system. On top of that and maybe even more importantly a PAYG system can start paying benefits immediately while a funded system needs more time.75 However, currently the conditions for a PAYG system are much less perfect.

Workers may see the PAYG system as a contract, but as it is an implicit contract the value of the contract and the insurance that they really offer is questionable and

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75 This is a much heard argument. However one could argue that the state can also initiate a funded system immediately by issuing public debt.
depends a lot on the strength of the institution that governs the system. The benefits are dependent on political decisions at all time; this dependency is called political risk.

Flat benefit systems such as the AOW have the benefit that they have minimal administrative costs, avoid a high marginal tax rate and coinsure for the whole population. Although generally speaking means tested benefits are preferable according to the World Bank the Netherlands do have near perfect circumstances for a flat benefit system, since coverage is widespread and tax collection is effective.76

Universal flat benefit PAYG systems are generally paid for by general taxes while earnings related benefit systems are more often paid for by an earmarked payroll tax. Financing out of general revenue seems to be in line with the redistributional intent. Furthermore the report notes: “If benefits were truly contingent on contributions and valued as much, the payroll tax would be viewed as a price, and would have few distortionary effects on the labor market.”77 This does not hold at all for the Dutch case since individual benefits are completely unrelated to individual contributions.78 The report goes on to note that the incidence of these payroll taxes is not clear and that it may have severe impacts on the overall economy and may lead to externalities such as rising unemployment.

The report does present a list of options for improving the sustainability, efficiency and equity of first pillar pension. Two of the options presented are applicable to the AOW. The retirement age could be increased and the premium percentage could be lowered in combination with a rise of the ceiling on earnings over which premium is paid.

77 World Bank, 1994, p.121.
78 Except for some minor exceptions like unlawful omission (see 3.2).
2.3 Socio-economic policy

In the introduction to this thesis the policy concerning the AOW has been mentioned as being part of socio-economic policy, since it is redistributing income. Furthermore it has been mentioned that the way that the AOW is financed can be sub-optimal, by interfering with sound socio-economic policy. In this subchapter I will discuss different elements that are part of socio-economic policy. I will not give an exact definition of this term since many different could be given and none has a clear superiority over another. One of the elements that must always be an element of it and that I will start this sub-chapter with is the trade-off between equality and efficiency, known as Okun’s big trade-off. To use a popular metaphor this is the choice between a bigger pie and a more equally divided pie. It is on this trade-off and others that politicians will have to make decisions and decide which balance is optimal. These are normative decisions. Economists strive to describe these tradeoffs and to analyze them; they analyze the influence of different tools of policy makers, such as taxation, on the economy. This sub-chapter is divided in two parts. In the first I will describe the main trade-off of socio-economic policy and the role of taxation as a socio-economic policy tool. In the second different elements of and insights from taxation theory will be explained.

2.3.1 Okun’s Big trade-off

It is generally accepted that, under real world circumstances, there exists a tradeoff between equality and efficiency, this principle is known as “Okun’s big trade-off”. On the one hand political and social institutions protect basic “rights”, universal entitlements. These rights are first of all found in the political domain such as the right to vote and the right to come together and form groups. On the other hand there is the economical sphere of the market that is controlled by productive assets, voluntary exchange, monetary rewards and penalties and inequality. This free market is accepted, since it is generally believed that it leads us to the most efficient system with the highest possible welfare. Problems arise when the society wants to introduce rights that are directly connected to sphere of the market. As an example can be given a minimum

79 All definitions of equality have sameness as their core (see Barr [1993] for an excellent introduction into the many possible ways of definition and the connected problems) while equity seems to have a somewhat broader definition somewhat more related to fairness or justness, both terms are used often in the economic literature. Stiglitz [2000] for example has a chapter entitled “efficiency and equity” in which equity is interpreted as meaning equality.
80 Okun 1975
income guarantee, connected with the idea that is a basic right to have a respectable standard of life. The case for such a scheme is extra strong in the case of the elderly and the disabled. Transfer payments to these groups are seen as fair and augment equity, however at the cost of diminished economic efficiency. Okun considers different factors that make transfer payments costly.

The most important and hardest to measure are the indirect costs, caused by behavioral effects. For transfers to be possible taxation is needed. Taxation influences prices. In the case of income taxation it drives a wedge between the market price of income generating objects, most notably labor, and the net price retained by the individual. This can have three effects, the income-effect, the substitution effect and an increase in the gray circuit. In the longer run it might also decrease the incentive for people to get higher income, thus decreasing investment in human capital. Furthermore transfers also involve direct costs, such as the administrative cost of the tax authorities and costs incurred by citizens for filling in the tax forms.

In the literature three main goals of taxation can be found.

1 generating government revenue
2 altering behavior
3 increasing equity

Here I will briefly describe the first two, since the third was described earlier in this sub-chapter. The first and most obvious reason to levy taxes is for the generation of government revenue. Although the general consensus is that the market is more efficient in producing than the state, there are some goods that nevertheless cannot be produced by the market, these are public goods. Pure public goods are characterized by non rival consumption, non-excludability and non-rejectability; they cannot be adequately produced by the market. Non-exclusion makes it impossible for producers to let all consumers contribute, while it is not efficient to have a price on non rival goods since the marginal cost of extra usage is zero while the added utility is positive. The most classic example of a pure public good that all countries provide is national defense. Another less classical example of a good that many believe, needs to be provided by the state is education, this can be seen as a merit good, the government provides it because it believes that it would be under consumed otherwise. Another good that can be considered a merit good is the first pillar old age pension.
Since taxation has been acknowledged to alter behavior it has been used as a policy instrument to do exactly that. This can be done for example to counter the effects of non existing market (such as clean air) or because of paternalistic reasons.

We have now seen that taxation is necessary and useful for a multitude of reasons. This makes taxation policy a very important socio-economic policy instrument. However since taxation effects the economy via many channels and is never restricted to just first order effects, it is also a complicated instrument. Complexity in taxation makes the effective use of taxation as a policy instrument a demanding task. Therefore I will discuss the insights of taxation theory in the next sub-chapter.

2.3.2 Insights from taxation theory.

In this paragraph I will start with some general remarks on what taxation is. Then I will review the basic characteristics that a well functioning tax system should have according to Stiglitz.\textsuperscript{81} Subsequently I will introduce the concept of “optimal taxation”. Since some authors have argued that AOW premiums should be considered “earmarked taxes” I will afterward turn my attention to this. Finally tax incidence will be discussed as an introduction to the concept of economic equivalence of taxes.

Taxation is as old as the bible; income taxation in the western world however does not exist since that long. In the United States it was introduced in 1913 and in the Netherlands in 1914. The most distinctive feature of taxes is that paying them is compulsory and that (in most cases) there is no direct link between taxes paid to the government and goods or services received from the government. Although tax can be seen as the price for living in a good society or having an adequate public sector these two features make tax markedly different from prices paid in the market. In a market there is principally no question about the morality of a price and in a way a price is always fair. Since individuals are not free in choosing whether or not to pay taxes governments need guiding principles to arrive at a taxation-scheme that is acceptable to its citizens.

Many principles have been put forward concerning proper taxation. Stiglitz defines five desirable characteristics of any tax system.

\textsuperscript{81} Stiglitz 2000
1. Economic efficiency
2. Administrative simplicity
3. Flexibility
4. Political responsibility
5. Fairness

Economic efficiency: Most taxes are distorting, since they alter relative prices. Therefore, they alter people’s behavior and the economic equilibrium and create a deadweight loss. Dead weight losses depend on marginal tax rates. The only taxes that do not create this kind of distortions are lump sum taxes; these are taxes that do not depend on anything that can be influenced by the taxpayer. Taxes on certain goods can be avoided by decreasing their consumption of these goods and shifting their consumption to other goods. Labor tax can incline people to change their work input, since the marginal return to work decreases. It is ambiguous if the result is that people will work more or less as a result of taxations of labor, since two opposite effects are at work. People are inclined to work more to compensate their loss of income, i.e. the income effect. On the other hand people are inclined to work less since the return to labor decreased and the relative price of leisure decreases, i.e. the substitution effect. The AOW benefits can be perceived as a negative lump sum tax.

Administrative simplicity: Administrative simplicity is important since it diminishes administrative costs. Administrative costs are divided between direct and indirect costs. Direct costs are the costs of the authorities. In our context these are the tax authority and the SVB. Indirect costs are those born by the taxpayers and entail costs such as running a good administration, filling in tax forms and costs of tax advisors.

Flexibility: Flexibility of the tax system means that it should be easily adaptable to changes in economic situation. Partly these changes can be automatic as in the case when tax brackets are automatically changed with inflation. Other changes can be based on changes in political insights.

Political responsibility: Political responsibility mandates that the tax system should be transparent. This means that tax codes should be clear and that it should be clear who is bearing the burden of taxes. Who is bearing the burden of a tax is almost never a clear cut case and depends on an almost infinite number of factors and is therefore a very complex matter. It is very easy for politicians to tax faceless corporations since the common view is that they have the strongest shoulders and do not feel the pain. It is however very unclear who the final bearer of a tax burden is; in the case of a sales
tax these could be for example the customer that buys the products or the shareholders of the company that sells them.

Fairness: Fairness is a very vague term and what is fair is mainly a philosophical or political question. In general it is not the economist’s task to decide what is fair, but to find out what is optimal given what has been decided to be fair. Two basic principles concerning fairness in taxation are horizontal and vertical equity. Horizontal equity means that two people that are identical should be treated identical and those who differ in a relevant way should be treated accordingly. Vertical equity is the basic principle that taxes should be positively correlated with ability to pay.

Tax policy is concerned with designing tax structures which minimize welfare loss for any given amount of revenue raised while still attaining the aforementioned characteristics.\(^{82}\)

*Optimal taxation*

Many frameworks have been put forward to analyze the effects of taxation. Most of them do find that some optimal taxation does exist. Which tax structure is optimal depends crucially on what kind of social utility function is chosen. For my research it does not matter which structure is found to be optimal, just to acknowledge that there exists a structure that is optimal. Mirrlees\(^{83}\) came up with a framework to analyze optimal income taxation in 1971.

The use of distortionary taxes is inevitable if one of our policy goals is to redistribute income. Such taxes create deadweight losses. The deadweight loss caused by taxation is proportional to the square of the tax rate.\(^{84}\) The dead weight loss caused by taxation crucially depends on different elasticities such as the elasticity of labor supply or the demand elasticity of taxed products. Frameworks such as the one proposed by Mirrlees are not directly used by policy makers to determine the tax structure that is used. Still, Stiglitz lists three basic rules for efficient progressive income taxation\(^{85}\)

1. Impose high average tax rates with low marginal tax rates
2. Make as few people as possible face high marginal tax rates
3. Impose high marginal tax rates on those for whom the tax is least distorting.

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\(^{82}\) Stiglitz, 2000, p.519.
\(^{83}\) Mirrlees, 1971.
\(^{84}\) Stiglitz, 2000, p.519.
\(^{85}\) Stiglitz, 2000, p.560.
Earmarking taxes

Some authors, such as De Kam, classify the Dutch premiums as earmarked taxes. Buchanan\textsuperscript{86} was the first to set up a theoretical framework for analyzing the economic rationale behind earmarking taxes. He found that earmarking might be a way to simultaneously increase government revenue and spending at a time that neither might be possible separately. Moreover he found that the spending on the specific element might be more stable. However it must be noted that his framework was purely theoretical and did not take into account expenditures with redistributonal objectives such as the AOW. Halberstadt and De Kam\textsuperscript{87} have proposed the following four arguments to see all Dutch social insurance contributions as (ear-marked) taxes;

1. Tax payers do in practise not discern between the payment of taxes and premiums.
2. If the first argument holds it follows that both levies lead to the same behavioural responses.
3. In most macroeconomic analyses both levies are considered together.
4. The literature on public finance usually adheres to a broad concept of taxes.

For the line of argument that I will follow in chapter three, especially their second argument is important. McCleary,\textsuperscript{88} who reviewed the literature on earmarked taxes, made an analysis of the advantages and disadvantages of earmarking but did specifically not include earmarking in social security in his analysis. However, in his conclusion, he notes that there are examples of successful earmarking in the area of social security. Wilkinson\textsuperscript{89} also analysed the literature on earmarked taxes. Her analysis does include social security contributions, but focuses on the UK where the system of social security is quite different from that of the Netherlands. To my knowledge there is no literature available on the Dutch premiums as earmarked taxes.

In McCleary’s framework the Dutch AOW premiums are “earmarked taxes of variety A”: a specific tax for a specific end use. The main arguments against earmarking, taken from Deran,\textsuperscript{90} are;

\begin{itemize}
  \item Buchanan, 1963.
  \item De Kam 1988, p.93
  \item McCleary, 1991.
  \item Wilkinson, 1994.
  \item Deran, Y., Earmarking and expenditures: A survey and a new test, 1965.
\end{itemize}
1. Earmarking leads to a misallocation of resources, with too much being given to earmarked activities and not enough to others.
2. It hampers effective budgetary control.
3. It infringes on the powers and discretion of legislative and executive branches of government.
4. It introduces inflexibility into budgets: changes come only after a lag, and earmarking systems continue after their usefulness has been served.

The main argument in favour of earmarking are;

1. Earmarking applies the benefit principle of taxation
2. Earmarking gives more assurance of minimum levels of financing for public services that governments consider worthy, thus avoiding periodic haggling within the bureaucracy or between the bureaucracy and the legislature over appropriate levels of funding.
3. Greater stability and continuity of funding may lead to lower costs because of speedy completion of projects.
4. By linking taxation with spending, earmarking may overcome resistance to taxes and help to generate new sources of revenue.

Taking these arguments into account McCleary finds two broad criteria that earmarking arrangements should meet. First of all the arrangement should allocate an appropriate level of resources to the target goal. Second these arrangements should lead to reasonably autonomous financing for the earmarked expenditures and thus should be independent of the development in the general government budget. If this second criterion is not met earmarked funding is not longer substantially different from general revenue funding.

Wilkinson uses another framework to classify different forms of earmarking; on the one hand she distinguishes between strong and weak earmarking were strong earmarking stands for revenues from a specific tax have to be exactly equal to the expenditures that they are earmarked for without any further role for other sources of financing. Earmarking is called weak, when the funds raised by the earmarked tax do not have to match the expenditures exactly, such as in the case of the AOW at the moment. This kind of earmarking is also called information-giving earmarking. On the other hand Wilkinson distinguishes between wide and narrow earmarking where wide earmarking stands for an earmarked tax that is used for a whole spending category, such as “social security”.

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Narrow earmarking then designates taxes that are used for an exactly specified expenditure within a programme, such as the AOW. In her analysis she specifically considers the relationship between earmarking and the incidences of taxes. It is concluded that earmarking should only be used on transparent taxes. Furthermore it is noted that earmarking is most appropriate for pure public goods. She further notes that in the UK National Insurance Contribution is the closest thing that the UK has like an earmarked tax. This is considered a popular tax, due to the use of earmarked taxes, but it is not comparable to the Dutch AOW premiums since in the UK paying the premiums for the National Insurance does built up rights for benefits.

See for a schematic overview of the two frameworks appendix 6.

**Tax Incidence and the concept of economic equivalence of taxes**

In most economic books and papers on taxation tax incidence is discussed. As we have seen The World Bank report is worried about the unclear incidence of payroll taxes for public pension. Wilkinson concludes that earmarked taxes are more efficient in cases where the tax incidence is clear. Stiglitz notes, in the context of social security tax that “economic reality…does not always follow the laws passed by legislators”. I will now discuss this notion of tax incidence and the related concept of equivalent taxes.

As noted before the burden of a tax does not always weigh on the shoulders of the one that it is imposed on. When lawmakers decide about the introduction of a tax they often do not realize this and act as if the one that is designated to pay a tax is also the one that bears its burden. Policy makers often intend to divide the burden of premiums and other taxes between employers and employee. Most economists agree that the burden of wage tax and other taxes on labor, even those paid by the employer and including premiums, are shifted fully onto the employee.

The tax incidence is born by those whose real income is lowered by the tax. The incidence of a tax can be different in the short and the long run. Just after the introduction of a tax the tax incidence is often on those who are paying the tax. In the long run the economy adapts and the incidence can be on someone completely different. In competitive markets the incidence of a tax depends crucially on the elasticities of supply and demand. As we have seen one of the desirable characteristics of a tax system is political responsibility. One of the elements of this responsibility is that it is clear which groups in society are carrying the tax burden. If a tax has a clear burden of payment it is

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92 Stiglitz 2000, p.482.
said to be a transparent tax. It is important to be aware of this in the realm of social insurance.

In the economic literature it is common to call two taxes that look different but have the same incidence economically equivalent. The term is frequently used in macro-economic tax analysis. It is then for example found that under certain conditions, income tax and value-added are equivalent, or that consumption and wage tax are equivalent. Another use of the term equivalence is when two taxes have different names but the same tax base. Furthermore taxes can be called equivalent when they have the same taxes and the same name but are paid by different groups, such as social security tax by employers and employees.

There is one aspect of economic equivalent taxes that has, as far as I can see, not received any attention in the economic literature. If a government or two branches of government impose two taxes that are equivalent, these taxes will be rival and could interact directly with each other through the political decision making process. This will only happen when the decision makers also do see the taxes as equivalent. This might often not be the case with taxes that are imposed on different groups, but will almost surely be the case when the tax base is equal. As an example we could think of income tax levied by the state and income tax levied on the federal level or in the case of an income- or wage-tax in combination with tax or premiums for a social security program. Decision on different levels of government or different branches of government can influence each other since legislators might take into account the decisions made by other legislators when making socio-economic policy such as designing an optimal tax structure.

Conclusion

What can be concluded from the above is that taxation policy is an important and complex task for policy makers. Many different principles for sound policy have been put forward.

It is my belief that because the AOW (as well as other social insurances) is not financed out of general revenue but via separate premiums set independently from the taxes, the system comes less close to achieving these five desirable characteristics than possible. This might induce substantial economic and social costs. I will further analyze these costs in the third chapter of this thesis.
2.4 Framework state pension versus social insurance – payment out of general revenue versus payment out of premiums –

To be able to answer my main research question it is of the utmost importance to have a clear idea of the meaning of the word premium. A premium is generally defined as an amount to be paid for a contract of insurance.\textsuperscript{93} It is usually used in the context of the private insurance contract. In the context of the social insurance the word premium has a far more complicated meaning. Presently the Oxford dictionary defines social insurance as a system of compulsory contribution to enable the provision of state assistance in sickness, unemployment, etc. while the Dutch dictionary van Dale defines it as a compulsory insurance against the effects of sickness, (old-age) invalidity and joblessness.

A state pension is defined by the Oxford dictionary as a regular \textit{payment made by the state} to people of or above the official retirement age and to some widows and disabled people. While the Van Dale defines it as a pension paid for by general state revenue or a pension paid out on behalf of the state for which no premium is paid or nothing is delivered. To understand the differences in terminology, it is necessary to take a close look at the political debate that took place in the Netherlands before the introduction of the AOW and at debates in other countries and in more general social insurance debates.

In the Netherlands a fierce and long-lasting debate has taken place between proponents of a social insurance type and a state pension type of basic old age pension provision. In this discussion premium payment had a central role, and it is here that I will start looking for a definition of the term. In more recent literature on the subject, such as the SVB\textsuperscript{94} book, the final arrangement that was chosen in 1957 is classified as a synthesis between the two types of pension provision. This view is taken over straight from the SER report and the explanatory memorandum preceding and accompanying the original law in 1957. In my view however a real synthesis never took place. To demonstrate this I will look at historic definitions of the two systems, and then derive my own framework of classification. This is necessary to make a clear distinction between premiums and other taxes. In the last chapter of the thesis this will be used as a tool for the analysis of the premiums within the Dutch tax system.

In this sub-chapter there are two debates that are closely linked: premiums versus taxes and social insurance versus state pension. With respect to my analysis both discussions will be put into the same framework.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{93} Oxford dictionary.
\item \textsuperscript{94} SVB 2006
\end{itemize}
\end{footnotesize}
**Distinction between state pension and social insurance in the Netherlands**

A nice overview of the discussion on the choice between a state pension and social insurance around the time of introduction of the AOW can be found in the work of Rang,\(^95\) “Kernproblemen van de algemene ouderdomsverzekering”. In this work Rang analyses the AOW and its predecessors and focuses on the ideological backgrounds of social insurances and the task of the government. A substantial part of the work reviews the distinction between “social insurance” and “state pension” that shaped the debate prior to the introduction of the AOW. Two different views are put forward, one by Levenbach, considered as an authority on that field and one by him self.

**Levenbach\(^96\)**, an important Dutch professor of law at the University of Amsterdam from the 40’s to the 60’s used the following framework to distinguish social insurance and the state pension.

According to Levenbach social insurance in its most orthodox form is characterised by a clear legal foundation to prescribe a mandatory saving system. Focus should be on individual responsibility i.e. at least there has to be a link between premium paid and benefit received. A strong link between contributions and later benefits would be preferable. In an orthodox social insurance scheme there is no actual role for government outside of prescription and mandating.

The system is a state pension when it entails a basic right for everyone, who is in need, when it is paid for according to ability to pay, to the extent that some might not contribute at all and has a simple system. The following is a schematic overview of Levenbach’s distinction between (orthodox) social insurance and (orthodox) state pension.

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\(^95\) Rang, 1960

\(^96\) Rang 1960, p.101-105
Rang was a Dutch professor of law at the Universities of Utrecht and Leiden in the 70’s and 80’s and later National Ombudsman. He uses slightly different definitions of Social insurance and state pension in his thesis on the AOW. In his framework the state pension was not restricted to the needy and should be completely universal, had to be paid out of general revenue. The simplicity of a state pension system is just a result of the former principles and is not a condition that defines the existence of state pension. It is clear that this definition of a state pension is much narrower than that of Levenbach. However, Rang explicitly mentions the possibility of a mixed system, which would be a pension paid out of premium and general revenue.

<table>
<thead>
<tr>
<th>Levenbach</th>
<th>social insurance</th>
<th>state pension</th>
</tr>
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<tbody>
<tr>
<td>essence</td>
<td>legal foundation for mandatory saving</td>
<td>basic right for those in need</td>
</tr>
<tr>
<td>responsibility</td>
<td>individual responsibility</td>
<td>communal responsibility</td>
</tr>
<tr>
<td>link between contribution and benefit</td>
<td>strong</td>
<td>weak</td>
</tr>
<tr>
<td>government role in execution</td>
<td>none</td>
<td>all</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rang</th>
<th>social insurance</th>
<th>state pension</th>
</tr>
</thead>
<tbody>
<tr>
<td>essence</td>
<td>payment out of premium</td>
<td>payment out of general revenue</td>
</tr>
<tr>
<td>link between contribution and benefit</td>
<td>strong</td>
<td>none, completely universal</td>
</tr>
</tbody>
</table>

97 Rang 1960, p.73
How did policy-makers defend their choice?

SER\textsuperscript{98}

In the SER report of 1954 just before the actual introduction of the AOW, it comes forward that the main reason for giving the new arrangement the form of social insurance is that until that time all arrangements to secure an income in the case of some contingencies that cause a temporary or permanent interruption of the individual participation in the production process had this form. Furthermore they want to give the arrangement this form because it emphasises the individual as well as the communal responsibility of those who face a comparable risk. The duty to contribute to the costs and the relationship between the rights and duties can be arranged differently from the case of private insurance. The mandatory nature of the social insurance is noted separately.

Later views

In the decades following the introduction of the AOW there has been a debate concerning the nature of AOW and other social insurance premiums. This debate did not originate from the Netherlands but was primarily coming from the United States. De Kam discusses the views held in the Netherlands and observes that until the 1970s the dominant view was that premiums could not be seen as taxes. Later the view that the premiums could be at least partly classified as taxes became more accepted. The differing views can be connected to three competing conceptual theories to analyze social security are distinguished by Thompson.\textsuperscript{99} These are:

1 the tax transfer model

In this model the premiums and benefits are just seen as a transfer programme like any other tax-transfer programme. There has to be no connection between premiums paid and benefits received on an individual basis.

2 the insurance model

In the insurance model contributions to a social security system are comparable to premiums in the insurance market. The contributions and expected benefits are compared per individual on a life time basis.

3 the annuity welfare model

The annuity welfare model can be seen as a combination of the above models. In this model the system is split up in two parts, one part that represents the saving

\textsuperscript{98} SER 1954, p.24
\textsuperscript{99} De Kam 1988, p.92
aspect for the individual, which is regarded as an annuity, the other part welfare enhancing tax transfer system.

De Kam argues that in the Dutch system the welfare component has a dominant role. Therefore it makes sense to view at least part of the premiums as (ear-marked) taxes. Also other authors such as Veldkamp, Mobach and Hofstra are in favor of the view that general social insurance contributions are (ear-marked) taxes.

A new classification framework – State pension versus social insurance.

After reviewing all these different classification systems it appears that there are many different definitions and identification methods. Different writers come to contradicting conclusions and no definition seems to be broadly accepted. It may seem as if this issue is in the end just one of semantics. Especially since the system finally introduced is characterized as a synthesis. In some aspects compromises might indeed be possible. It is for example possible to have a state pension, a basic right for all, that is nonetheless conditional on some measure of wealth or second and third pillar pension income. It is however not possible in some other aspects. It seems impossible to me to have individual responsibility in combination with fully ensured pension rights by the government.100

To be able to present the development in the financing of the AOW in a refined way it is necessary to have a classification system that can give more than just binary outcomes.101 Therefore I intend to identify a broad spectrum of features, taken from the existing literature, and combine them into a measure that signifies in how far a certain contribution system is like general tax.

I The existence of a specific levy
II Link between contributions paid and benefits received
   a on an individual level
   b on a general level
III Redistributive elements
IV Paying according to ability to pay
V Role of the government in execution
VI Partial versus universal coverage
VII Semantics

100 See the interlude “on choice and responsibility” below.
101 i.e. most systems classify levies either as a tax or a premium.
The existence of a specific levy: The first and clearest distinguishing mark of a state pension is the absence of a specific levy. If there is none there is certainly a state pension. If there is a specific levy, this is an indication of social insurance; however it is not a sufficient condition.

Link between contributions paid and benefits received: Maybe the most fundamental difference between an insurance system and a state pension is the connection between premiums paid and expected benefits received on an individual level. In private insurance, under competitive market conditions, there is a direct link between premiums paid and benefit rights accrued. In this context deferred annuities can be seen as a benchmark. An insurance system is said to be actuarially fair when the expected payouts equal the premiums paid by beneficiaries. In that case a risk neutral individual would be indifferent between taking out the annuity or not. Since insurance companies face risks and make costs they need a surplus over the actuarially fair price. Consumers will still buy these annuities because they are generally risk averse. Due to competition the surplus that can be attained in the market is limited. As the state has the power of compulsion, pensions governed by the state do not have to be actuarially fair. In the most extreme cases there is no link at all between premiums paid by an individual and expected benefits received for that individual or premiums might be completely absent. In this framework we define this as a feature of a state pension, while a stronger link between premiums and benefits indicates a social insurance. An associated issue is what happens when premiums due are not paid. Separate from the question of the individual link between contributions and benefits there is the question whether contributions match benefits within the first pillar pension system as a whole. In an insurance system this is most likely to be the case.

Redistributive elements: Two of the main reasons for the government to have a role in the pension provision are to help people overcome their myopic behavior and to redistribute income. For the first goal mandatory saving can be a solution. For the second it is
necessary that some groups contribute more than they receive. This is a typical feature of a state pension.

Paying according to ability to pay: The issue of paying according to the ability to pay is related to the preceding issues, but it is still a separate element. In both systems this can be implemented. In an orthodox insurance system this would mean that individuals with a lower capacity to pay during their active period, would receive a lower pension. This is the case in the second pillar pension.

Role of the government in execution: The first pillar pension can be either executed by the government, a semi-governmental organization or the market. The more the government is involved in the execution of the program, the more it can be classified as state pension. More separation from the government indicates more social insurance.

Partial versus universal coverage: Universal coverage is a feature more associated with the state pension, however the eligibility to pension benefits can be means tested. Social insurance can be either universal or not.

Semantics: The semantics is another very important element in defining a pension system. Although the vocabulary has no influence whatsoever in most economic models, it can be very important for psychological reasons and politicians seem to attach a high value to certain terminology. The use of insurance related terms such as insurance, premium and bank are associated with social insurance.

Simplicity: Simplicity is a feature that is connected with the state pension. However, simplicity is not a feature as such and is only a result of other elements of the system. Universal benefits only conditional on the reaching of a certain age is an example of one of the features connected with a state pension that lead to a simple system.

Existence of a premium: A premium in this context is a specific levy that is due, separate from general taxes. This feature is mostly a more specific form of feature 7, the semantics. In the Dutch context this particular word has received a lot of attention. This word is generally defined as an amount to be paid for a contract of insurance and is therefore obviously a feature of social insurance. However, the word is often used in contexts that are, according to (all) other features, state pension.

Integration in the tax system: If there is a premium this can be integrated in the tax system. First of all the tax base can be equal. Second, the tariff might be integrated. The more it is integrated the more the system resembles a state pension.

Mandatory nature: State pension is always mandatory in nature. Social Insurance is also mandatory for at least a part of the population. However it is possible that some parts of the population, for example the self employed, are by default enrolled in the system but can choose to opt out or are by default not enrolled but can choose to opt in.
Who sets the premiums and benefits: The premiums and benefits could be set automatically by a provision given by the law, they can be decided upon by an organization separated from the government or they could be set by the government. The less control is in the hand of the government, the more we speak of insurance.

Interlude “on choice and responsibility”

The main reason, stated by the SER and the government, for giving the old age security the form of a social insurance as opposed to a state pension, is that it would give people individual responsibility. It is however questionable if there can be individual responsibility in the general meaning of the word, without individual choice. I think that this is not possible. Especially when we are opposing individual responsibility against communal responsibility. It often happens in debates that two opposing opinions merge or shift places. In this case that could be analyzed as follows.

1 A part of the elderly people does not have enough savings to ensure an acceptable minimum standard of living.
2 within the social contract taking care of old age pension, is principally considered an individual responsibility.
3 The society, represented by parliament and the government, notes this, finds the outcome unacceptable and takes action, forcing people to pay AOW premiums and “saving” for their retirement.
4 Thus taking away the individual responsibility and transforming it into a collective responsibility.
2.5 Parliamentary discussions and Explanatory memoranda

One of the tools I will use for my evaluation is the analysis of discussions in the parliament and explanatory memoranda from government. Here I will again look for discussions on the interrelationship between AOW premiums and the income taxation. The most logical time for such discussions to take place is in years that there are big changes in premium percentages and taxable maximum. After analyzing the table, added as appendix 3, it turns out that the biggest changes in premiums and taxable maximum, apart from the year of introduction, in 1957, where; 1962-1963, 1964-1965, 1989-1990 and 1997-1998.

In all these cases the maximum premium increases with more then 20%.\(^{102}\) As the 89-90 case is the effect of the introduction of the Oort laws and as such is not a real increase it will be not be further discussed here. The 97-98 case will be part of the correlation analysis presented in the next sub-chapter. Not in all years that the premium changed did the income tax change as well. In these cases I will look at the first income tax changes that follow after the changes in the premium. For example; the first overall major income tax reform after the introduction of the AOW in 1957 was in the year 1961.

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\(^{102}\) See appendix 3.
2.6 Numerical analysis

One of the methods to get insight into the relationship between taxes and premiums will be a numerical analysis of the different levies. If there exists equivalence between the premiums and taxes it can logically be assumed that changes in the premium will affect taxes that have a similar tax-base. In our case these are the income tax, and the wage tax which is part of the income tax. These effects are realized via the political decision making process, that I will first analyze (See 2.5 and 3.5). The goal of the numerical analysis is to quantify these effects. The analysis will be on the period starting from 1990 when the Oort-laws were established. The analysis will be a correlation analysis between the year on year change in the first bracket of the income tax and the change in level of the premiums for the social insurances in the same year.
3 Analysis and Evaluation

In this third chapter the AOW will be critically analyzed. Furthermore the development of the income taxation in conjunction with the developments in the AOW will be analyzed. For this the theories, frameworks and methods presented in the second chapter will be used. In the first short sub-chapter the performance of the AOW as a first pillar pension will be evaluated. It will be concluded that it performs well. Then, in the second sub-chapter, the AOW will be analyzed with the help of the framework that is presented in 2.4. We will see that the AOW has many elements of a state pension but also of classic social insurance. This inherent ambivalence leads to the conclusion that the premium within this system is theoretically equivalent to income tax. In the next sub-chapter, this equivalence is qualified; the AOW premium will be discussed as being an ear-marked tax.

The following part of this chapter, will deal with this question: Has the supposed theoretical equivalence between income tax and AOW premiums lead to real effects via the political decision making process? To answer this question, the decision making process concerning the AOW will be analyzed. Numerous examples will be shown where an interrelation between premiums and taxes were discussed and had influence on decisions.

In the final sub-chapter the costs and benefits that follow from the AOW system will be analyzed.
3.1 The AOW as an optimal first pillar pension

Knowledge about public finance has grown tremendously over the past decades. If we look at public economy theory and public economic decisions of the past, with the advantage of hindsight it is easy to conclude that a lot has changed.

Generally, the AOW is regarded as a good first pillar pension. The main criticism that is often heard is that it is in fact too generous. As has been noted in the last chapter, the AOW is the “relatively small” pillar, which is deemed optimal by the World Bank. This is caused by three factors, the system is universal, the benefit level is high (if compared to other countries) and the benefits start at an age, which is deemed early by many commentators.\(^{103}\)

It is outside the scope of this paper to delve deep into this diversion from the model that is deemed optimal by the World Bank. However, after reviewing the history of the system it seems that this diversion is caused by a different normative view on the goals of a first pillar pension. It does not seem to me that the methods used are wrong.

The World Bank has noted that universal, flat benefit systems are usually paid for out of general revenue. In the first and second chapter it has been shown that this divergence can be explained by the historical context, and the normative point of view of the policy makers. This discrepancy will be analyzed in the following sub-chapters.

\(^{103}\) See for example, OECD 2008 and regiegroep grijswerkt 2008.
3.2 The AOW within the proposed new framework

In this sub-chapter the AOW will be analyzed within the framework proposed in chapter two, that enables us to analyze the broad spectrum of possibilities that exist between orthodox social insurance and orthodox state pension. The focus will be on the AOW as it was introduced in 1957 and on the AOW as it is now. In some cases where changes occurred, the causes of these changes will also be investigated.

The existence of a specific levy – In the AOW system there is, and always has been a specific levy, called AOW premium.

Link between contributions paid and benefits received – In the original AOW there was a strict relation between the contributions paid and the benefits received at the general level. The contributions were set in a way that they would equal the benefits to be paid out over periods of five years. So there would be a strict link on the general level according to the Pay-As-You-Go principle. In 1965 this link was broken for the first time by the introduction of partial funding out of general revenue. This funding reached a temporary high in 1979 when over 10% of the funds came from general revenue. In 1984 funding out of general revenue was abolished and the link between contributions and benefits was reestablished. Since 2002 the AOW is again partly financed out of general revenue. With a capped premium level and demographic changes the part of the funds that are coming out of general revenue is bound to keep rising in the coming years. In 2008 one third of the funds are coming from general revenue while this is expected to be at least one half around 2040.

On an individual level the link between contributions paid and benefits received is weak at best and might even be said to be non-existent. At introduction there was no link for the people aged over 65 since they all received benefits without ever paying contributions. From 1997, 40 years after the introduction, every new beneficiary has in principle been liable to pay full contributions. There is however no link at all between the actual amount of premiums paid and the level of AOW received. In principle the AOW has benefits equal for everyone. There are just two conditions. The first condition is that one must have been a resident of the Netherlands. The second is that benefits can be cut in case of unlawful omission. (See the paragraph on unlawful omission below for more details)

Redistributive elements – One of the main goals of the AOW was to redistribute income, both between generations and within generations. It is questionable if redistribution was always good. Since premiums could be deducted from income before
taxation and a taxable maximum, the system had a distinctive regressive effect. Now the redistributive function of the AOW has diminished considerably.

Paying according to ability to pay In the AOW system the contributions have always been related to income. Furthermore people with a very low income do not pay premiums at all.

Role of the government in execution The AOW has always been executed by the SVB, a semi-governmental organization. However contributions have always been collected by the tax authority.

Partial versus universal coverage The AOW has always covered the complete population of the Netherlands and is not means tested.

Semantics Since the AOW has been instituted in accordance with a tradition of insurance based social security programs, a lot of insurance related terms are used. Although it is theoretically questionable to call the AOW insurance, it is influenced by the ideological stance behind the system.

Simplicity The AOW is a relatively simple system. This is caused by the universal nature and the flat benefit level.

The existence of a premium In line with ideological background of the AOW premium has played a central role in the AOW system. However, since the introduction of the Oort laws and the integration of the premiums within the income tax, the visibility of the premiums has diminished.

Integration within tax system At the start the AOW was not integrated in the tax system. Still there were some links, notably the premium collection by the tax authorities and the cut of level for low income earners that do not have to pay premium that was equal to the level that people start to pay income tax. After the introduction of the Oort laws, the premium system was integrated fully. The benefits however are separated from the tax system altogether.

Mandatory nature The whole Dutch population is mandatorily participating in the AOW system without any exemptions.

Who sets the premiums and benefits The premiums are officially set by the SVB. However, as is discussed in a section below, the role of the SVB is not very big. Furthermore the benefit level is always set by the government. Since 1997 the premium percentage has been fixed by law.

Unlawful omission
One of the elements in my proposed framework is the connection between payment of premium and accrued benefit rights. One of the issues connected to this is the question of unlawful omission. What happens to people that did not pay the premiums that they had to pay according to the law? Since the introduction of the AOW the law has not changed on this point. Those individuals that do not pay the premiums that they are supposed to pay should get a discount, proportional to their omission, on their AOW benefits. However, until 1993 this law was not actively used, and the number of people whose benefits where actually cut was minimal. In 1993 the law was changed in such a way that it was made easier for the SVB to cut peoples benefits on the basis of unlawful omission.\textsuperscript{104} Since then the number of people that were cut increased substantially and at the end of 2004 close to thirty thousand people were affected by this rule. Since at that moment there were around 2,5 million AOW beneficiaries around one percent of them were affected. In this respect the AOW came closer to being a social insurance as the connection between contributions paid and benefits received strengthened.

\textit{Changing decision making process for premium and benefit setting}

Within the new framework presented, it is important to know who controls the height of the premiums and the benefits. Not only is the formal division of rights on this matter relevant here. The material implementation of choices on this matter is even more important.

As we have seen in the first part of this thesis a choice was made to introduce the AOW as a social insurance and accordingly, the SVB was mandated to set the necessary premium level.\textsuperscript{105} The premium needed to be set for periods of five years at such a level that the contributions over these years would equal the benefits that would be paid in that same period plus the administrative costs. However, the government did have the possibility to overrule the decision made by the SVB and set a different premium. During the early years of the AOW government never used this ability, later they started to use this option more and more often. In 1999 the Netherlands court of audit presented a report\textsuperscript{106} on this issue (over the years 1994-1998). The procedure for setting the premium percentage was as follows; every year in June, the SVB would write in a rapport the percentage deemed necessary for the following year to keep the AOW fund in balance. In September the CPB would recommend another premium level in their Macro economic

\textsuperscript{104} Covelli, 2004.
\textsuperscript{105} Art. 28 AOW.
\textsuperscript{106} Kamerstukken; 1999-2000, 26845, nr. 2
outlook (MEV). Then in October the SCB would come with a new premium based on updated data. Finally in December, The minister of social affairs would decide on the premium percentage for the next year. In the period researched by the Netherlands court of audit, the level proposed in the MEV was chosen without an exception. Thus they concluded that the responsible ministers did not follow the premium recommendations of the SVB. These deviations from the proposals were not explained by arguments. The Netherlands court of audit concludes that these deviations were probably based on socio economic considerations such as purchasing power, employment and macro economic policy.

In 1997, with the introduction of a maximum premium, the mandate was officially taken away from the SVB. As the government noted in the explanatory memorandum, this was no material change, but a purely formal one. As the premium was bound to a maximum and it was to be expected that the premium would be set at the maximum there would be no active premium setting any more. If the government would decide to set the premium lower than the maximum this would be done on the basis of general policy considerations that are not the competence of the SVB. Be that as it may, I would say that this change completed the integration of the AOW within the income tax. All competences of the SVB that enacted any separation of the AOW from general government finances had been taken away. Any further increases in spending now needed to be paid out of government revenue and the premium level has become a integral part of the tools for socio economic policy. That is not to say that the AOW premiums are now without any function. Total abolishment of the premiums would have material effects. This issue is covered in the next sub-chapter and in 3.7.

The benefits from the AOW have been set in the law from the start. And also, as we have seen, the indexation was set there. However the benefits have constantly risen faster than was prescribed by the law. These extra increases in the benefit level were always in the hands of the government.

3.2.1 The AOW, a synthesis or a compromise?

Within the framework proposed in this paper, it is clear that the AOW can not be easily categorized as either social insurance or state pension. During the past decades many different views have been held on this subject. In this paragraph I will present some of the main positions that have been put forward to illuminate the changing attitude towards the AOW system.

107 Kamerstukken; 1997-1998, 25699, nr. 3
According to Levenbach, in the fifties, the proposed AOW system was a synthesis between the orthodox views on social insurance and state pension.\(^{108}\) This view cleared the ground for the opposing groups in society and made it possible for the proposed AOW to get accepted by parliament.

Rang,\(^{109}\) did not agree with Levenbach and the government that the AOW was a synthesis. He defended in the beginning of the sixties that it was a compromise. According to him, state pension and social insurance were in essence too diametrically opposed to be combined in one system. Although three main elements of orthodox insurance, first, a clearly defined legal foundation for state intervention, second, a direct relation between premiums paid and benefits received and third, a restricted role for the state, are not present in the AOW, it is nonetheless classified as general social insurance. For Rang, the universal coverage, the fact that the right on benefits is defined by law and fact that benefits are not received when there is unlawful omission, are clear indications that the AOW is essentially social insurance. It is not a state pension since there is only a very limited role for payment out of general revenue.

Veldkamp\(^{110}\) notes, in the seventies, that social insurance and private insurance do not have more in common then their name. In his view insurance is based on three forms of causality: Causality between contribution and benefit, risk and contribution, risk and benefit. In case of the AOW the first causality is not present,\(^{111}\) even when income is low or non-existent AOW benefits will be available. Furthermore the AOW is partially paid out of general revenue. The other two forms of causality are only there in limited form, since there is no differentiation in either premium or benefit based on risk. Although the premium paid for social insurance is thus no premium in the sense of an amount paid for an insurance contract Veldkamp stresses the importance of involvement of beneficiaries and contributors of the system. Therefore the special levies such as the AOW premium and the special organizational forms such as the SVB do still have a valuable role. If the orthodox insurance view would be abandoned the levies could be more based on socio-economic considerations and could be simplified. Most importantly this would ensure that no longer “everything should have to connect with everything”.\(^{112}\)

In the eighties, De Kam\(^{113}\) and others, such as Hofstra and Stevens, have, as we have seen before, opted to see AOW-premiums as ear-marked taxes.

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\(^{108}\) Levenbach 1955.
\(^{109}\) Rang 1960.
\(^{110}\) Veldkamp 1978.
\(^{111}\) Except for the case of unlawful omission.
\(^{112}\) Veldkamp 1978, p.17.
\(^{113}\) De Kam, 1988.
In this thesis I defend the view that the AOW-premiums should indeed be seen as ear-marked taxes. Apart from the premiums however the AOW system as a whole is much closer to what has traditionally been called state pension then to orthodox social insurance. Because the premiums are almost equivalent to income tax treating them separate from socio-economic considerations that govern the income tax is problematic. In the next subchapters, I will subsequently discuss in more detail: the notion of equivalence (in 3.3), the premium as an ear-marked tax and the problems connected to having an earmarked tax in addition to general income tax (in 3.4) and the development of the interaction between this era-marked tax and other taxes (in 3.5 and 3.6).

3.3 On equivalence

In this sub-chapter a specific definition of economic equivalence in the context of the AOW premiums and income taxation will be given. I define two levies to be economically equivalent if the effects of changes in them result in the same economic effects. Paying premiums is mandatory just like paying taxes, government uses these premiums to provide for public goods and no specific individual rights are accrued by paying them, just like in the case of taxes. Therefore from the point of view of the taxpayer the levies are equivalent.

To a considerable extent it could be argued that equivalence indeed exists. The main difference between income tax and premiums is that while the first is levied on the all citizens that have income the second is restricted to the group of citizens between 15 and 65 year old. The lower part of this constraint is not of material importance since the income generated by people under 15 years of age is negligible. The upper part of this restraint is however very important. Citizens over 65 years of age pay a lower tax rate in the first two brackets than people under 65 years of age. For citizens with no supplementary pension in addition to the AOW this does not matter since the level of the AOW would be adapted to yield the same net income. Those that do have a supplementary pension are affected directly if the pension would be paid out of general revenue instead of the premiums. Also younger generations would be affected since more should be saved for retirement to receive the same net pension benefits. Citizens that are now saving for their retirement can deduct the second and third pillar premiums from the income tax and when the income falls within the first two tax brackets also from the premiums. When retirement benefits are received later they are taxed, but no AOW premium is paid on them. This means that AOW premiums are exempted twice. This acts as a subsidy to pension saving.
Another difference that exists is the name. It seems unlikely that this difference has substantial economic effects. It is quite probable that the existence of the AOW has influence on the saving behavior of people. If they are rational then they incorporate the expected AOW benefits in their saving decisions. This would also be the case when these benefits were paid out of general revenue. Different behavioral effects can arise when the premiums increase the awareness of the existence of the AOW. This is unlikely however, since the AOW is generally well known and premiums are embedded in the income tax. More importantly, a large portion of the population does not make many private decisions on pension saving since the biggest part of saving is done via mandatory second pillar arrangements.

Another dimension of equivalence depends on the way that the revenues of the two levies are used to provide for public services. AOW premiums are used to pay for AOW benefits while tax revenues are used in a multitude of ways. As a consequence it seems that a different result would occur if the income tax changes than the AOW premium changes. In the latter case AOW benefits would go up while in the first case other spending could increase. This argument however is only valid when the level of AOW benefits is set as a consequence of the amount of premium available, and not if the level of the premiums is a consequence of the level at which the benefits are set. In AOW law it is specifically said that the premiums are set at the rate necessary to pay for the benefits.
3.4 The AOW and theory of public economics

In this sub-chapter the question will be answered whether we can find a rationale behind introducing the AOW with funding out of premiums instead of government revenue? In this thesis it is previously established that AOW premiums are not premiums in the most orthodox vocabulary of insurance. The main difference between a “real” premium and the AOW premium is that in the latter there is a complete absence of a connection between the level of the premium and the level of the benefits at the individual level. Therefore it has been proposed to classify these AOW premiums as earmarked taxes.

Next we will discuss the problems that can arise from the use of earmarked taxes in combination with general progressive income taxation by interfering with principles of efficient taxation put forward in the second chapter.

From premium to earmarked tax

When the AOW was introduced the premium was not integrated with the income tax. Although the tax/premium base was roughly equal, the premium setting was done by an independent organization, with a clear mandate to set the premium at an adequate level for financing all AOW benefits, independent from any considerations that influenced the income tax. At this moment, however, the AOW financing is almost completely integrated with income taxation, premiums levels are decided by government and are integrated in the first to tax brackets of box 1.

Buchanan’s classical arguments in favor of having earmarked taxes, simultaneously increasing revenue and spending and creating a stable income for a specific policy are both applicable in the case of the AOW.

At the time that the AOW was introduced taxes were already at a high level and all government revenue was needed during a phase of rapid development after the Second World War. However, as we have seen, there was a great need for the introduction of a basic pension. Furthermore for a first pillar pension to yield the security that is needed a stable income is necessary to secure a certain level of benefits over a longer period. If we turn our attention to the costs and benefits of earmarking listed by McCleary no straightforward conclusions can be drawn. Although the first argument, that earmarking applies the benefit principle of taxation is much used in defense of the premium system it is questionable if in this case this is a sound argument. It is true that those who contribute do benefit from the program but as mentioned many times before, there is no relation
between the contributions and the benefits. Furthermore, also people that never contribute are eligible for AOW benefits. The third mentioned argument, that greater stability might reduce cost is also valid in the case of the AOW. It is clear that greater stability within an insurance scheme greatly enhances its value.

Subsequently we will turn to the arguments against the use of ear marked taxes. Too many resources would go to the earmarked activities. In this case it seems as if that is exactly what was meant to happen at the time when premiums were still the only source of income; however, when the benefits were increased in the 60’s spending was supplemented with resources out of general revenue. Currently there are concerns of increasing spending on the AOW. This is mainly caused by the aging of society. The second argument against ear-marked taxing, that it hampers effective budgetary control is true. The third argument; it infringes of the power and discretion of the legislative is also true, especially where certain decision making powers are delegated to the SVB, and again this seems to be purposefully done in this case. The same holds for the fourth argument, inflexibility is valuable in this case. Based on the arguments mentioned by McCleary it seems that if all arguments are taken into account it is understandable that ear-making is used.

Problems related to ear-marked taxation

The fiscal institution of ear-marking taxes is used to create an independent place for the specified public service such as the AOW from the general budgetary processes. This independence can have problematic side-effects, since it can interfere with sound economic policy in general and with principles of proper taxation.

One of the central issues in the realm of socio-economic policy is the trade off between equity and efficiency. Equity is promoted through redistribution of income among different groups in society. Promoting equity is both a goal of the progressive income taxation and a goal of the AOW.

We have seen that the first desirable characteristic of any tax system is economic efficiency. For progressive income taxation this means that marginal tax rates have to be as low as possible. When the income tax is designed this is taken into account. However, for the AOW premiums this has not been taken into account, since these premiums were not seen as taxes. However, if we accept that these premiums were in effect equal to taxes, the same principles that hold for a tax system do hold for the premiums. What is more important is that for the taxpayer it is the combined rate of the two taxes that count. Thus when the AOW got introduced the presumably carefully implemented income-tax
structure was distorted. Marginal tax rates went up for those who earned less than the taxable maximum.

The introduction of a premium financed AOW is also problematic in light of the second principle put forward by Stiglitz. The administrative costs of the premium system have been high. Because of the introduction of the AOW people were getting an extra tax assessment and in addition to that it complicated the income tax assessment. First of all, premiums were deductible from income tax but also due to other contingent matters. The direct administrative costs are probably also higher due to the introduction of the premium.

Furthermore the introduction of a premium based system, especially one that is capped off and with premiums deductible from income tax, might be considered unfair, since it diminishes vertical equity.

All the problems that are mentioned until here are a direct result of the introduction of the premium based system. If policy makers realize that these problems arise, they might react by making changes in the income tax (or other taxes) to counter the aforementioned effects. I will call these reactions policy interaction. This interaction can have the benefit that it does diminish the problems that arise directly from the introduction of the system but they can also have considerable costs. The time spent by policy makers on deciding on policy measures is costly. Political responsibility might decrease with diminishing transparency of the tax code. And if the policy interaction leads to full compensation of the ear-marked tax in other taxes, the ear-marked tax becomes a pure form of demagogy. In this case those who pay the ear-marked tax do not bear the burden at all and it is fully shifted to others.

These problems were not anticipated by the SER in their 1954 report. The fundamental flaw of this report is the way that it was argued that the AOW should take the form of social insurance. The choice was based on two arguments. The first argument was that all comparable social institutions were based on the social insurance principle, i.e. the historical argument. The second argument was that social insurance propagated individual as well as communal responsibility, i.e. the solidarity argument. The first argument however neglects the fundamental difference between the AOW and preceding arrangements. In all former arrangements there was a connection between contributions paid and benefits received on the individual level and on top of that none of these arrangements had been fully universal. Furthermore the SER made the presumption that no changes would be made in the income tax. Although this was true in the short run

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we find that, due to equivalence of the two levies, this presumption could not hold in the long run.

In the next sub-chapter we will investigate this supposed interaction between the premium (ear-marked tax) and other (general) taxation.
3.5 Parliamentary discussions and Explanatory memoranda and financial analysis

In this sub-chapter the interaction of the premium for the AOW and other taxes will be analyzed. Logically it could be expected that policy interaction would mostly have influence on the income tax since this tax has the same tax base. However policy makers had explicitly blocked this possibility and did not compensate via the income tax, when the AOW was introduced. Therefore interaction with other levies is also analyzed. Most of the research of this sub-chapter is based on analysis of parliamentary discussions and National Budget memoranda.

3.5.1 1957 introduction of the AOW

In 1957 the AOW was introduced while at the same time the Emergency Law Old Age Provision was cancelled. While the emergency law was paid by the government out of general revenue, the AOW was paid by the insured out of premiums. The emergency law cost 138 million euro while the AOW cost 388 million Euro. So it seems as if the introduction is an extra burden on income earners between 15 and 65 years of age while it improves the governmental budget. However, at the introduction of the AOW in 1957 employers were expected to increase the wages of their employees to compensate them for their loss of income caused by the new AOW premium that had to be paid. On the other hand, the employers got compensated for this by the abolishment of the equalization levy, which amounted to a tax reduction of 170 million Euro. The introduction of the premium did not lead to a decrease in income taxes nor a decrease in the income of employees but to an increase of the labor costs. Still, there was discussion about decreasing the income tax because there where some groups such as the self employed that where affected by the change and did not get any compensation.

Parliamentary session, November 1956

- Reuter (Communistic party of the Netherlands) is content with the attention that is given to social security but asks how secure the current social security is. Although the business cycle is up at this time, people are not sure what will happen when the cycle goes down. In such a case social security is just as insecure as other government expenditures and benefits might be cut. To create actual security more safety can be created by making social security, at least at a minimum level, a constitutional right.

- Suurhoff (Minister of Social Services and Employment, Labour Party) does not agree with Reuter, since private property is never protected by the constitution. Furthermore he

76
notes that there are good arguments to pay the social security such as the AOW out of premiums and not out of general revenue. The main arguments are that on the one hand insurance gives secured rights and with payment out of general revenue this would be harder to accomplish. On the other hand insurance gives the employers and employees more responsibility.

*Parliamentary session, February 1957*

-Gortzak (Communistic Party of the Netherlands\(^{115}\)). The AOW premiums are not compensated for the self-employed, for many of them this is a big burden. They are not able to shift this burden away, and due to their poor economic condition they will have to cut back on basic expenditures such as food. This is not fair since employees got (partially) compensated via wage increases and the entrepreneurs got compensated via cancellation of the equalization levy. Therefore the self employed should be compensated via a decrease in the income tax.

-Hofstra (Minister of Finance, Labour Party\(^{116}\)). Not all groups can be compensated. Introduction of new policies have positive and negative sides. If the negative sides were always compensated, there would be no room for any government policy or any taxation.  

-Roemers (Labour Party). Is satisfied about the compensation that has been given to the employees by the employers and that therefore there was no increase in expenditure but just a change in expenditures.

*Conclusion on 1957*

The arguments given by the ministers on both the issues, of compensation and security, make clear that in 1957 the AOW was definitely seen as insurance and that people got some security in return for their premiums. From the point of view put forward in this paper Reuter’s point of view was quite sensible. The debate on compensation shows that compensation for the premiums via a change in the income tax was out of the question. There was no interaction between premiums and income tax. Other mechanisms brake the direct link between premiums paid by individuals and diminished resources.

3.5.2 1959-1961 Major income tax reforms

\(^{115}\) CPN  
\(^{116}\) PvdA
In December 1959 a law was passed to decrease the income tax for unmarried individuals. Although this was the first income tax reform after the introduction of the AOW it is not relevant for the questions at hand since it was a reform specifically designed to alter the tax level for unmarried individuals relative to married individuals. The underlying structure of the tax did not change so neither did the relative burden on specific income groups change.

In December 1960 another law was passed concerning a general decrease in the income tax. This was reached by increasing all the tax brackets by 10% and an increase of 29% of the tax free amount (for married couples without kids). Here an overview will be given of the argumentation of the government behind this tax change and the comments of the parliament’s finance committee.

The government deems the direct tax levels in the Netherlands too high and therefore wants to decrease the tax burden, especially there where it is disproportionately high. One of the measures already taken in this respect is the law passed in 1959 to decrease the tax level for unmarried individuals. Furthermore the tax burden is automatically increasing with inflation since tax brackets are not automatically adjusted to inflation. Taking this into consideration they propose to increase all the tax brackets by ten percent and to increase the level tax free amount by around thirty percent. Since they assume an inflation of 12.5 percent over the period between this and the last tax change, the 10 percent increase in tax brackets does not fully compensate the inflation. Since the extra increase in the tax free amount weighs more heavily for the average tax rate of the lower income earners, they get over-compensated while the higher income earners get under-compensated. For around 425,000 people this will mean that they will not have to pay tax anymore. The parliamentary committee notes that by this uniform tax reduction the distribution of the tax burden over the population stays largely untouched. Besides, the government shows the tax changes in a graph with income on the horizontal and average and marginal tax rates on the vertical axes. Income ranges from 0 to 150,000 guilders. The committee would like to see a graph with a range from 0 to 30,000 guilders since 99% of the population is in this range. Moreover the committee asks if it is possible to capture the tax tables in the form of a formula. Interestingly enough the government replies that this is impossible.

Conclusion on 1959-1961

In the years 1959 to 1961 tax rates were reduced. These reductions can be split up into three parts. First, the rates for unmarried individuals where reduced. Second, tax brackets
where increased by ten percent. Third, the tax free amount was increased. The introduction of the AOW premiums did not play any direct role in the political decisions for these changes in the income taxation. However, this third change has some relation to the premiums, when seen as taxes, for they have a comparable effect to the tax structure, albeit in the opposite direction.

3.5.3 1962

From 1962 to 1963 the maximum premium amount increased by almost thirty percent. Although the premium increased to 6.8% an increase of more then 1 percent, this was only 0.05 percent higher than the premium had been in the first three years.

-Peschar (Labour Party) is commenting on the increasing burden of the premiums for social insurance that has reached twelve percent of disposable family income and is set to increase even more because of the plans for increasing AOW benefits to the minimum subsistence level. The system of the social insurance premiums works regressive, because of the premium maximization and the deductibility for the income tax. Therefore a good way to decrease the burden for lower and middle income earners would be to pay part of the insurance out of general revenue.

-Van Leeuwen (Liberal Party) is also commenting on the high tax burden. He agrees with Peschar that in setting income tax and determining its progressiveness, the premium burden should be taken more into account. The burden is especially high for the lower income self employed. And for the higher income earners the benefits do not increase with increasing premiums. The increase of the premiums should have been synchronized with the decrease of the income tax in 1961, and the increase of the benefits.

-Zijlstra (Minister of Finance, Anti-Revolutionary Party) replies on the comments of Peschar on funding out of general revenue. He holds that the AOW was contentiously introduced as a general social insurance with premiums that are a direct burden on the real wages. He relates to England, where the old age pension is paid partly out of general revenue, and due to that economic performance was not very impressive. This is caused by the fact that there is a relatively heavier burden on the profits (Capital) than on wages (Labor).

117 See appendix 3.
118 VVD
119 Recalling some interesting things on his father and uncle.
120 ARP i.e. protestant party
Van den Berge (State secretary of Finance, Independent) comments as well on the high tax burden and the relationship between taxes and premiums. Since the 2nd world war income tax tariffs have been high. With the coming tax cuts focus will be on decreasing the burden for the low and middle income earners and not on decreasing the top (70%) tariff. The digressive effects of the premiums are a logical consequence of the insurance system.

**Conclusion on 1962**

In the 1962 parliamentary discussion there is already debate on how the premiums interact with income taxation on socio economic policy level and it is especially interesting to see that this point of view is carried forward by liberals as well as the labor party. Focus is on the interaction of a progressive income tax with digressive premiums. The remarks of both the minister and state secretary on this point seem to be not quite to the point. The minister points to the importance of the division between tax on capital and labor, but his analysis is not quite thorough. Synchronizing tax increase and premium decrease as well as payment out of general revenue are both noted. However, both are not discussed in detail.

**3.5.4 1964**

As has been noted in the first chapter, the parliamentary year 1964-1965 saw a sharp increase in AOW benefits and AOW premiums as well as the introduction of funding out of general revenue. The reasons for increasing the benefits were quite obvious, and there was henceforth virtually no disagreement among the different parties on this subject. In this section I will give an overview of the discussion that consequently took place on the interrelation between the increasing premiums, a decrease in income tax rates and the introduction of funding out of general revenue.

Vondeling (Labour Party) notes that premiums will increase and this will probably be just partly offset by wage increases. He asks if there will be an offsetting tax decrease. Schmelzer (Catholic Popular Party) relates the decrease in income tax to the sharing of the burden of the increasing costs for the AOW. He notes that not only the percentage but also the taxable maximum will rise.

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121 KVP
-Geertsema (Liberal Party) notes that the burden of the AOW premium will increase dramatically and that this is not offset for the self employed and only partly for the employees. Principally the AOW should not be financed out of general revenue, as they have always argued. However, there can be a temporary exception to this rule. Since the tax burden is already so high it would be a good idea to decrease the tax at the same time of a premium increase. At this time the economy is overheating and the wages are exploding. Therefore, tempering inflationary pressures is a more important goal at the moment.

-Notenboom (Catholic Popular Party) argues that the increase in premiums and the decrease in income tax should be as much as possible at the same time. People experience taxes and premiums as one burden. On macro as well as micro level taxes and premiums are at least partly interchangeable.

-Joekes (Liberal Party) argues that the increase in premiums and the decrease in income tax do not have to be at the same time when the economy is booming.

-Beernink (Christian-Historical Union122) argues that it should be possible to finance part of the benefits increase out of general revenue. Another possibility would be to let people deduct their premiums for 150%.

-Smallenbroek (Anti-Revolutionary Party) argues that it is a good thing that AOW benefits are increasing. Nevertheless, He has always held the opinion that the AOW should a pension on a basic level. The financing of the system causes trouble, now that the government is planning to pay fl150.000.000 out of general revenue. He opposes this since the AOW is meant to have the characteristics of insurance. And the fact that premiums are deductible means that they weigh heavier on the low income earners.

-Marijnen (Prime – minister, Catholic Popular Party) agrees that in making decisions on the decrease of the income tax and increasing of the premiums, not only macro economic but also micro economic factors such as psychology should be taken into account. However a fast implementation, i.e. together with the increase of the premiums on January 1st 1965, will not be possible due to technical reasons and the present state of the economy. Partial implementation will be possible by July 1st. In the famous Wassenaar agreement it was agreed that taxes would not rise any further and that any possible tax increase would be offset by a tax decrease in another tax.

-Witteveen (Minister of Finance, Liberal Party) also agreed that the increase in AOW premiums can be a reason to decrease the income tax.

122 CHU i.e. protestant party
- Vondeling in discussion with Schmelzer says that a difference in opinion whether or not to finance out of general revenue was reason not to form a coalition together the year before.
- Geertsema notes that it was him who proposed the simultaneous action on changes in premium and tax on a liberal party conference in Eindhoven.
- Witteveen reacts on the proposal by Beernink. Using an extra deduction up to 150% would have the unwanted effect that this is worth more for people with a higher marginal tariff.

**Conclusion on 1964**

1964 was a breakthrough year for the AOW debate, for the first time ever payment out of general revenue and active synchronization are accepted.

3.5.5 Results

From the above it must clearly be concluded that for policymakers there was a strong connection between changes in the premiums and changes in the taxes. It follows that even when premium levels would be set completely independent from anything but the financial need of the AOW system, there would still be a direct effect on the taxes, other expenditures and as a result the deficit. How changes in the premiums are effecting other variables depends on the political decision making process. There are a limited amount of options in case of a premium increase;

1. taxes do not change → disposable income of people decrease → real effects on economy
2. taxes do not change → employees get compensated by employers → real effects on the economy
3. taxes do decrease → government spending goes down → real effect on economy
4. taxes do decrease → government deficit goes up → real effect on the economy
5. taxes do decrease → other taxes are increased → real effects on the economy
6. a combination of the above
If the AOW is paid out of general revenue the same effects could generally occur when spending on it would increase. There are however still some differences that might come from the choice between general revenue and premiums.

1. If the premium setting and setting of the benefits is done by an independent organization that has power to enforce its will, having these premiums could be insurance for a safe and sure pension benefits. (Compare central banking theory)

2. When we see the premiums as an ear marked tax this could have behavioral effects on politicians and might improve the acceptance of the tax payers.

3. Distortion of socio-economic policy

4. Tax discount for retirement saving
3.6 numerical results

3.6.1 Correlation analysis 1990-2008

In this sub-chapter the correlation analysis for the years 1990-2008 between premiums and income tax will be presented. In 1990 the introduction of the Oort laws simplified the tax code of the Netherlands and integrated the AOW and other premiums into the income tax. The first bracket of the income tax became a combination of tax and premiums. It is possible to compute the correlation between changes in the tax and the premium components of the bracket because, from 1990 and onward the tax base and the premium base are exactly equal. If the total rate of the first bracket is more important to policy makers than the tax and premium rates individually, it might be expected that an increase in one will be accompanied by a decrease in the other. When it is indeed the case that premium increases lead to tax decreases, the premium increase is not actually paid for by those who pay the premium since they get compensated. Then the real burden of the increase should be on something else.

A complicating factor in this analysis is that the AOW premium is just one component of the premiums that are levied in the first income tax bracket. Other components were the AAW, AWW, ANW and AWBZ.\textsuperscript{123} If there is any correlation between premiums and tax it makes sense that the relation is between tax and all premiums taken together instead of just the AOW premium. A correlation analysis between the tax component in the first income tax bracket and the premium component of the same bracket revealed a strong negative correlation efficient of -0.87.

\textsuperscript{123} These are other social insurance schemes. A thorough investigation into these schemes falls outside of the scope of this thesis. The most important of these in monetary terms is the AWBZ a scheme for special health care costs that are uninsurable for individuals. The main argument of the paper would also be applicable to this scheme. Just as in the case of the AOW there is no connection between contributions paid and benefits received. Just as with the AOW even people that never contributed are covered.
3.6.2 Abstract representation of interaction between tax and premium

In this section I will show in abstracted form the interaction that can take place between premium paid for social insurance and income tax. This should increase the understanding of the process of interaction that takes place between two levies that are equivalent (see 3.3). The following four graphs show the proposed effect in abstracted form. In the first two graphs the income tax and the premium are shown independently. In the first graph an income tax scheme is presented. In this example it is a flat tax,\textsuperscript{124} with a constant marginal tax rate (x). In graph 2 the social insurance premium is presented with a fixed premium percentage (y) with a taxable maximum (a).

In graph 3 the two levies are simply added up. This thus shows the resulting total marginal levy on income when no interaction would take place between the different levies. The tax structure is effectively changed by the introduction of the premium. Individuals on the lower part of the income distribution now face the marginal rate (x+y). The result could be inefficient since if the tax structure was the result of a carefully designed tax policy. If the premium is seen as equivalent by policymakers and thus rival to the income tax, they might decide to change the income tax structure to return to a total governmental levy structure that is deemed optimal. In graph 4 the ultimate result of such

\textsuperscript{124} i.e constant marginal tax rate.
interaction is shown. Here although the level of the new total marginal rate is higher ($z$) than the old marginal tax rate ($x$, the dotted line in graph 4), the form of the total marginal levy is equal to the marginal income tax in the starting situation presented in graph 1.
3.7 Costs and Benefits

In the preceding text many arguments have been put forward regarding the premium based financing system of the AOW. There were arguments in favor of the separation between AOW premiums and tax, arguments against, but also arguments that might seem to lead to the conclusion that the whole matter is inconsequential. Although I am of the opinion that even when there would be no effects of having a premium that is essentially equal to a tax, it is still important to establish insight into this equality, for intellectual reasons. Nonetheless I am certain that there are real consequences. Furthermore misunderstandings about the essence of the AOW premiums have blurred a lot of the recent discussions on the subject of the AOW. In this sub-chapter the benefits and costs of a premium based system will be analyzed first. Then some of the misunderstandings in the recent debates and proposals will be analyzed.

3.7.1 Costs

Increase bureaucracy and red-tape Institutional costs and costs of extra debate.
Interfering with sound socio-economic policy The income taxes as well as the AOW system redistribute income. When both are seen as completely separate entities, and partial analysis of redistributive effect dominate, while combined effects are neglected, socio-economic policy goes astray. Although this problem has always received some attention in parliament it did not get much attention while the dominant view was still concerned with preserving the insurance character of the AOW. The magnitude of the problem was revealed by the Oort committee; the marginal tariff of taxes and premiums combined was extremely high and volatile.

Creating a false sphere of security Another problem that arises with a premium based first pillar pension scheme, is that it presents the benefits as secure rights. It blurs the difference that exists between an insurance contract bought by a consumer in the market and social insurance organized via governmental institutions. Market based contracts are in principle secured by law, insurance companies are not allowed to change the contract after purchase. Social insurance benefits are contingent on the democratic process and do not offer the same kind of security. The abolishment of the VUT\textsuperscript{125} schemes in the Netherlands provides a vivid example of this problem.

\textsuperscript{125} payg early retirement scheme
3.7.2 Benefits

Creating new government spending at a time that this would otherwise be impossible. As we have seen in the earmarking literature, separating a specific program from the general budget can decrease resistance against augmented taxation and thus facilitate the introduction of a new program.

Increasing the popularity of tax. Also in the long run separation of a specific tax can make taxation more popular. Especially in the case of a program that the whole population is expected to benefit from. However, since the full integration of the premium in the income tax, it is unlikely that people are very much aware of the premium they are paying. Therefore the importance of this argument is likely to be minimal.

Imposing own responsibility. This has been one of the main arguments for introducing a premium based system. It may help to create awareness of the importance of sufficient retirement provision. However, the individual responsibility argument seems illusionary to me and might be categorized as paternalism. (see the interlude “on choice and responsibility”)

Diminishes discussion on spending

Creating a sphere of security. Although “creating a (false) sphere of security” is mentioned in the list of costs it can also be seen as a benefit.

Dignity. The relevance of a premium to preserve individual dignity was stressed in the Beveridge Report: “The popularity of compulsory social insurance today is established, and for good reason; by compulsory insurance, ... the individual can be assured that [his] needs will be met ...; by paying ...a contribution, he can feel that he is getting security not as a charity but as a right”126

3.7.3 Recent debates and proposals

In recent years the term “public funding”127 has formed the center core of often heated debates about changing the AOW system. In its most extreme form it would mean that the AOW premium would be abolished and the AOW benefits would be completely paid out of general revenue. Plans in this direction are often vehemently criticized. There are two popular arguments against public funding. The first argument is that it is contrary to the insurance character of the AOW. We have seen however, that the insurance argument was useful at the introduction of the AOW but has become outdated given the

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126 Barr 1993
127 i.e. fiscalisering
current integration of the premiums within the income tax. The second, connected, argument is that it is unfair that people over 65 years of age, receiving AOW, should contribute to the AOW. This is a sensible argument to start out with, but there are several things that need to be kept in mind. Since the premium is fixed at 17.9% and premium income alone is not sufficient anymore to cover the costs of the AOW, the elderly are already contributing via the general revenue. Furthermore elderly with the AOW benefits as only income source would not be affected since the benefits are fixed in after tax terms. The most important consequence of abolishment of the premiums would be the loss of the lower tax level that the elderly now face in the first two tax brackets.

The changes proposed by the new government in 2007 would change the AOW system at this one core point that has become the main function of the AOW premiums. The AOW premiums are not paid by people over 65 years of age, as is consistent with the insurance idea that no premiums are paid when the insured risk has occurred.

Another idea that has enriched the discussion on the AOW is the introduction of a citizen’s covenant. One of the problems connected to social security is that because of the wide range of often technically difficult arrangements most ordinary citizens do not have clear insight into their rights and duties. This plan entails the introduction of a kind of digital documentation that shows citizens all the rights and duties that are connected to all the social security programs. The plan is proposed in two forms. In the first weak form the aim would be just improved information provision for citizens. In light of the aim of political responsibility the introduction of such a covenant would be a favorable development. In the second strong form the covenant would be a contract that binds the state by law. This proposal seems to be very problematic. It is the essence of social security provisions that they are constantly dependent on the policy choices of the government. This is essential for all public governmental activities. Therefore even the insinuation of a legal binding contract should be avoided. This is essentially the same problem as touched upon by the double mention of creating a sphere of security by the use of premiums under costs as well as benefits. While the rigid adoption of insurance based concepts and thoughts may have helped the development of the AOW in its early years the development of a less dogmatic approach should be celebrated.

128 Except in some cases were the government is acting in the market sphere.
Conclusion

The first conclusion that I would like to draw from the above is quite general, nonetheless it might be the most important. Over the last century economic thought has developed enormously and its influence has increased tremendously. While in the early stages of the development of the AOW legal discourse and legal arguments dominated the debate a shift has been made to economic discourse and economic arguments. Although the aging society and particularly the impact of the baby boom on the first pillar pension finances presents some new problems, the general problems that need to be faced are in essence the same.

Indeed, I found that theoretically, premiums for a universal scheme with no link between premiums paid and benefits received at the individual level, and general tax are equivalent in most respects. Although the separation of premiums from tax has come at a considerable cost, there are benefits to having separate premiums, even if they are mostly equivalent. It is impossible to measure these costs and benefits exactly.

In the short run it is possible to separate premiums and taxes to a large degree. In the intermediate run it seems inevitable that the two levies interact. In the long run, it seems that socio economic goals are better served by reducing the categorical separation between the two.

Another conclusion that must be drawn is that the focus on income tax alone is not warranted. The most directly affected tax in the short run was the equalization levy. This tax however indeed has the same tax base as the income tax. It is in fact consistent with standard economic theory that it is irrelevant (in the long run) that this tax is levied from the employer and not from the employee. In the long run the income tax was affected. It is highly unlikely that the Netherlands would have a tax rate of 2.45% in the first tax bracket in absence of premiums for social insurances such as the AOW.

The current system of integration of the premiums within the tax system seems to be a perfect mixture between integration and segregation. The costs of interference with socio economic policy have been taken away by integrating the premiums within the income tax. The other point, creating a false impression of security is much more ambivalent and therefore I also added it to the benefits. Over the course of history the AOW has been able to provide considerable security and insurance against poverty in old
age. However this security is dependent on the parliamentary democracy. Changes in
demographic structures and a changing morale with more focus on individual
responsibility are putting pressure on the first pillar pension system. The uproar following
the abolition of the VUT schemes might serve as an example of the faith that people have
in the continuity of PAYG systems. However the stakes involved in the case of the AOW
are much higher than in the case of the VUT.
Further research

From the start of the discussions on how the social security for the elderly should look like, one of the main arguments in favor of an arrangement that included the payment of premiums has been the following: The payment of premium emphasises the individual as well as the communal responsibility of those who face a comparable risk. This might increase the willingness to pay these levies. Therefore, to complement this thesis on the role of premiums and taxes within the Dutch system, it would be interesting to know how the taxpayers perceive these two different levies. With this knowledge it would be possible to get a more refined insight into the behavioral differences between the “labels” tax and premium. There might well be psychological effects that lead to real economic effects.

As mentioned in the history chapter early income taxation schemes have been quite complicated in tariff structure. It might be worthwhile to do a study on the combined effect of income taxes and social insurance schemes. Such a study could start from 1957, the introduction date of the AOW, or even earlier from 1903, the introduction date of the Accidents law. This could help to give us a better understanding of how interaction of different policies have lead to ineffective and exceedingly complicated situation that the tax system in the Netherlands was in, in the eighties. To be able to do a numerical analysis on the interrelationship between premiums and taxes in this period, a logical method must be used. Since, to my knowledge, no literature exists that compares these figures a method has to be made from scratch.
Appendices

Appendix 0 – Taxonomy

Employee social insurances; werknemersverzekeringen
General old age pension act; Algemene Ouderdoms Wet, AOW
General social insurances; volksverzekeringen
Grossing; brutering
Macro Economic Outlook ; Macro Economische Verkenning, MEV
Netherlands bureau for economic policy analysis; Centraal Planbureau, CPB
Netherlands court of audit; Algemene Rekenkamer
Old-age-fund; Ouderdomsfonds
Queens speech from the throne; troonrede
Public funding; fiscalisering
Social and Economic Council of the Netherlands; Sociaal-Economische Raad, SER
Social Insurance Bank; Sociale Verzekerings Bank, SVB
State pension; staatspensioen
Tax credit; belasting-korting
Tax free allowance; belasting vrije som
Taxable maximum; premie-inkomensgrens
Unlawful omission; schuldige nalatigheid
Welfare programs; sociale voorzieningen
Wobble tax; Wiebeltax

OECD definitions
Social insurance schemes; Social insurance schemes are schemes in which social contributions are paid by employees or others, or by employers on behalf of their employees, in order to secure entitlement to social insurance benefits, in the current or subsequent periods, for the employees or other contributors, their dependants or survivors
Social Security; Social security funds are social insurance schemes covering the community as a whole.
First Pillar Pension; Publicly managed pension schemes with defined benefits and pay-as-you-go finance, usually based on a payroll tax.

parliament
Reports of the parliamentary debate; kamerstukken
Explanatory memorandum; Memorie van Toelichting MvT
### Appendix 1 – Example of a tax table

| Year | Aantal inwoners | Stb. | Antwoord
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<th>Tariefgroep II</th>
<th>Tariefgroep III in geval van kinderabteek voor:</th>
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## Time series

### AOW

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Appendix 3 – AOW premium percentages, taxable maximum and maximum premium table\textsuperscript{129}

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<th>Year</th>
<th>Premium percentage</th>
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<th>Max. premium</th>
<th>Increase in max. premium</th>
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<tr>
<td>1968</td>
<td>9,000</td>
<td>€ 6,966,-</td>
<td>€ 627</td>
<td>6,70%</td>
</tr>
<tr>
<td>1969</td>
<td>9,100</td>
<td>€ 7,351,-</td>
<td>€ 669</td>
<td>12,41%</td>
</tr>
<tr>
<td>1970</td>
<td>9,500</td>
<td>€ 7,918,-</td>
<td>€ 752</td>
<td>12,23%</td>
</tr>
<tr>
<td>1971</td>
<td>9,900</td>
<td>€ 8,531,-</td>
<td>€ 844</td>
<td>17,06%</td>
</tr>
<tr>
<td>1972</td>
<td>10,300</td>
<td>€ 9,597,-</td>
<td>€ 988</td>
<td>16,09%</td>
</tr>
<tr>
<td>1973</td>
<td>10,400</td>
<td>€ 11,027,-</td>
<td>€ 1,147</td>
<td>12,12%</td>
</tr>
<tr>
<td>1974</td>
<td>10,600</td>
<td>€ 12,139,-</td>
<td>€ 1,286</td>
<td>16,49%</td>
</tr>
<tr>
<td>1975</td>
<td>10,400</td>
<td>€ 14,408,-</td>
<td>€ 1,498</td>
<td>12,15%</td>
</tr>
<tr>
<td>1976</td>
<td>10,400</td>
<td>€ 16,155,-</td>
<td>€ 1,680</td>
<td>8,99%</td>
</tr>
<tr>
<td>1977</td>
<td>10,400</td>
<td>€ 17,607,-</td>
<td>€ 1,831</td>
<td>8,08%</td>
</tr>
<tr>
<td>1978</td>
<td>10,450</td>
<td>€ 18,945,-</td>
<td>€ 1,979</td>
<td>4,80%</td>
</tr>
<tr>
<td>1979</td>
<td>10,400</td>
<td>€ 19,944,-</td>
<td>€ 2,074</td>
<td>4,05%</td>
</tr>
<tr>
<td>1980</td>
<td>10,250</td>
<td>€ 21,055,-</td>
<td>€ 2,158</td>
<td>8,67%</td>
</tr>
<tr>
<td>1981</td>
<td>10,600</td>
<td>€ 22,122,-</td>
<td>€ 2,345</td>
<td>22,00%</td>
</tr>
<tr>
<td>1982</td>
<td>11,050</td>
<td>€ 25,888,-</td>
<td>€ 2,861</td>
<td>12,97%</td>
</tr>
<tr>
<td>1983</td>
<td>11,650</td>
<td>€ 27,749,-</td>
<td>€ 3,232</td>
<td>2,82%</td>
</tr>
<tr>
<td>1984</td>
<td>11,650</td>
<td>€ 28,520,-</td>
<td>€ 3,323</td>
<td>0,96%</td>
</tr>
<tr>
<td>1985</td>
<td>11,700</td>
<td>€ 28,679,-</td>
<td>€ 3,355</td>
<td>-2,15%</td>
</tr>
<tr>
<td>1986</td>
<td>11,350</td>
<td>€ 28,928,-</td>
<td>€ 3,283</td>
<td>4,81%</td>
</tr>
<tr>
<td>1987</td>
<td>11,750</td>
<td>€ 29,292,-</td>
<td>€ 3,441</td>
<td>-1,05%</td>
</tr>
<tr>
<td>1988</td>
<td>11,500</td>
<td>€ 29,609,-</td>
<td>€ 3,405</td>
<td>-5,14%</td>
</tr>
</tbody>
</table>

\textsuperscript{129} Taken from SVB’s brochure “inkoopregeling vrijwillige AOW-verzekering”, yellow emphasis added by author, indicating the 4 biggest year on year increases.
<table>
<thead>
<tr>
<th>Year</th>
<th>Shares</th>
<th>Value</th>
<th>Price</th>
<th>Change</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>10,800</td>
<td>€ 29.904</td>
<td>€ 3.230</td>
<td>-15.39%</td>
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</tr>
<tr>
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<td>14,300</td>
<td>€ 19.115</td>
<td>€ 2.733</td>
<td>0.22%</td>
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<tr>
<td>1991</td>
<td>14,050</td>
<td>€ 19.497</td>
<td>€ 2.739</td>
<td>2.15%</td>
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<tr>
<td>1992</td>
<td>14,350</td>
<td>€ 19.497</td>
<td>€ 2.798</td>
<td>-1.75%</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>14,000</td>
<td>€ 19.634</td>
<td>€ 2.749</td>
<td>0.87%</td>
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<tr>
<td>1994</td>
<td>14,125</td>
<td>€ 19.634</td>
<td>€ 2.773</td>
<td>5.59%</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>14,550</td>
<td>€ 20.125</td>
<td>€ 2.928</td>
<td>8.16%</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>15,400</td>
<td>€ 20.568</td>
<td>€ 3.167</td>
<td>1.39%</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>15,400</td>
<td>€ 20.856</td>
<td>€ 3.211</td>
<td>21.71%</td>
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</tr>
<tr>
<td>1998</td>
<td>18,250</td>
<td>€ 21.411</td>
<td>€ 3.908</td>
<td>0.13%</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>17,900</td>
<td>€ 21.861</td>
<td>€ 3.913</td>
<td>1.69%</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>17,900</td>
<td>€ 22.233</td>
<td>€ 3.979</td>
<td>-0.43%</td>
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</tr>
<tr>
<td>2001</td>
<td>17,900</td>
<td>€ 27.009</td>
<td>€ 3.962</td>
<td>2.80%</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>17,900</td>
<td>€ 27.847</td>
<td>€ 4.073</td>
<td>3.19%</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>17,900</td>
<td>€ 28.850</td>
<td>€ 4.203</td>
<td>2.55%</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>17,900</td>
<td>€ 29.543</td>
<td>€ 4.310</td>
<td>3.18%</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>17,900</td>
<td>€ 30.357</td>
<td>€ 4.447</td>
<td>-0.18%</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>17,900</td>
<td>€ 30.631</td>
<td>€ 4.439</td>
<td>0.99%</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>17,900</td>
<td>€ 31.122</td>
<td>€ 4.483</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendix 4 – List of bills

Regarding the AOW
1956 – staatsblad nr. 281. Introduction of the AOW

Regarding the Income tax
1953 – staatsblad nr. 592
1955 – staatsblad nr. 370 General decrease in tax level
1959 - staatsblad nr. 497 Decrease of tax for unmarried individuals
1960 – staatsblad nr. 568 General decrease of tax against tax crawl
1961 – staatsblad nr. 443 setting introduction date for 1960/568 at July 1962
1965 – staatsblad nr. 72 Decrease of tax.
Appendix 5 – Three pillar framework

Reliance on individual pillars will vary with a country’s circumstances over time, but every country should have a multipillar system.

Figure 3. The Pillars of Old Age Income Security

<table>
<thead>
<tr>
<th>Objectives</th>
<th>Form</th>
<th>Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redistributive plus co-insurance</td>
<td>Means-tested, minimum pension guarantee, or flat</td>
<td>Tax-financed</td>
</tr>
<tr>
<td>Savings plus co-insurance</td>
<td>Personal savings plan or occupational plan</td>
<td>Regulated fund</td>
</tr>
<tr>
<td>Savings plus co-insurance</td>
<td>Personal savings plan or occupational plan</td>
<td>Fully funded</td>
</tr>
</tbody>
</table>

Mandatory publicly managed pillar
Mandatory privately managed pillar
Voluntary pillar

---

130 Table taken from World Bank [1994]
# Appendix 6 - Frameworks for earmarking

## Table 1. Varieties of Earmarking

<table>
<thead>
<tr>
<th>Type</th>
<th>Revenue</th>
<th>Expenditure</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Specific tax or fee</td>
<td>Specific end use</td>
<td>Gasoline taxes and motor vehicle fees for highway investments. Social security, unemployment funds. Support of public enterprises.</td>
</tr>
<tr>
<td>B</td>
<td>Specific tax or fee</td>
<td>Broad end use</td>
<td>Lottery proceeds and sin taxes (on tobacco and alcohol) to finance social sector programs. Taxes and royalties from petroleum to finance development.</td>
</tr>
<tr>
<td>C</td>
<td>General tax</td>
<td>Specific end use</td>
<td>Fixed percentage of total revenue devoted to specific programs (such as education). Revenue sharing for a specific purpose.</td>
</tr>
<tr>
<td>D</td>
<td>General tax</td>
<td>General end use</td>
<td>Revenue sharing.</td>
</tr>
</tbody>
</table>

## TABLE 3

<table>
<thead>
<tr>
<th>Classification of Types of Earmarking</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Wide</strong></td>
</tr>
<tr>
<td><strong>Narrow</strong></td>
</tr>
</tbody>
</table>

(1) *Strong, wide earmarking.* With this, a whole spending programme, for example education, would be matched by its own tax. Supply would be matched to demand by changes in spending and/or revenue. Higher spending would require a larger tax revenue, saving on expenditure would mean less tax to pay, not more resources for other programmes.

(2) *Strong, narrow earmarking.* An example of this is the financing of roads by the gasoline tax in the US. The effect should be to match supply and demand by the tax price of roads.

(3) *Weak, wide earmarking.* The British system of NICs is an example of nominal earmarking for a whole spending function (contributory benefits).

(4) *Weak, narrow earmarking.* 'Narrow' would normally define a particular part of a programme — for example, an extra lp on the income tax rate for nursery education — with the tax raising revenue but not determining the amount spent.
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