TAXATION IN EUROPE

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What did 2007 bring in terms of fiscal reforms in Europe?

IREF, the Institute for Research on Economic and Fiscal Issues, asked eleven experts from the four corners of Europe to report on the main trends in their countries and neighboring countries. All the reports are available on IREF's website. Below you will find a special report on **Italy** including the most recent changes in the fiscal policy presented by **Giorgio Brosio**.

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ITALY

by Giorgio Brosio

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Italy is among the most heavily taxed economies. It has also, at the same time, a huge problem with tax evasion, although the size of evasion may be somewhat overstated in the public, and partly in the academic, discourse. In fact, legal tax rates in Italy are not exceedingly higher than those of other European countries with similar level of tax pressure.

The illustration of the most recent evolution of tax policy in Italy is not an easy task. The two party coalitions that have alternated in power since 1994[1], i.e. the Centre-right coalition headed by Mr. Berlusconi and the Centre-left coalition headed by Mr. Prodi have pursued conflicting tax policies on the basis of opposed views on tax systems and on their role in the economy. After coming to power each coalition started to dismantle the reforms the opposed coalition had introduced. Personality of finance ministers, Mr. Tremonti for the Centre-Right and Mr. Visco for the Centre-Left, has also to do in the shifting of tax policies.

Since 1994, two opposing views have been ruling the country: Berlusconi's view bends towards tax cuts while Prodi's view promotes a new (and fair) tax structure

Centre-right governments have been a strong proponent of the reduction in the tax burden and of the containment of the size of the public sector. Centre-left governments traditionally put more emphasis on fighting tax evasion and on rationalization of the structure of the tax system with a view also of a fairer distribution of the tax burden.

The main areas of conflict between the two coalitions have been taxation of individuals, taxation of companies and regional taxation.

1. Personal income tax

The most important measure taken by the Centre-right coalition has been the reduction, between the years 2002-2006, of the burden of personal income tax through a general reduction of progressive schedule of tax rates applying to the personal income tax. The top marginal tax rate was reduced from 45 to 39 percent (although income in excess of € 100,000 had to pay a temporary surcharge of 4%). Another important aim of the reform was the simplification of the tax system, particularly of the tax rates that at the end of the process should have been reduced to two only, namely 23% and 33%. Also encouragement to growth by reducing the adverse effect of progressive tax rates on work effort and entrepreneurship played an important role in the rationale of the reform.

While the Center-right had lowered the top marginal rate from 45 to 39% and was moving in the direction of flat tax, the Center-left reintroduced more progressiveness and increase top rate at 43%

[1] More precisely, the Centre-Right coalition has been in power from 1994 to 1996 and from 2001 to 2006, while the Centre-Left coalition has been in power from 1996 to 2001 and fro 2006 to 2008 (April).

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The centre-left government has had traditionally to satisfy a very different constituency, made above all of low-salaried people. When it came back to power in 2006 it made the main axis of its economic policy the redistribution of income in favor of the poor, be they workers or retired peoples.

It did in fact reintroduce more progressive tax rates with a top marginal tax rate of 43%. This measure was coupled with minor increases in tax allowances to dependent workers with low incomes and/or a large number of dependent family members. More substantial tax measure have been adopted with the finance law for 2008.

2. Company Taxation

The Centre-left government introduced in 1997 a substantial reform of company taxation that was based on two innovations. The first one was the introduction of the so-called Dual Income Tax (DIT). The second one was the substitution of a number of local and national business taxes and contribution by a new regional business tax (IRAP). The Italian DIT is based on a double-rate regime of corporate taxation aiming at limiting the bias in favor of debt finance implicit in the traditional system, where interest on debt can be freely deducted from revenues for the determination of taxable profits. Italian DIT worked as a partial allowance for corporate equity by exempting from taxation part of the normal return on equities.

One of the pillar of company taxation under the center-left government was the dual-income tax (DIT)

More precisely, with DIT the corporate tax was levied on a notional return from equity at a reduced rate - 19 per cent - and on other profits at the ordinary rate. Furthermore, in 1999 an incentive scheme to investment was introduced. It consisted in the extension of the share of profit benefiting from the reduced rate of 19 per cent, by the amount of the net investment realized by companies and financed by equity issues or retained earnings. In other words, the share of low rate profit allowed by DIT could be raised by an amount equal to the lesser of the net investment in specified assets and the increase in equity of the year.

DIT aimed at penalizing debt strategy and rewarding equity and investment.

In 2001, soon after coming to power after election, the new Centre-Right government approved a package of measures to sustain the economic activity. Among such measures, the DIT mechanism was “frozen”, by limiting the equity increase qualifying for the reduced tax rate to that injected until 30 June 2001. Moreover, the notional rate for the computation of the low-tax-rate profit was significantly reduced to 3 per cent. In 2003 the statutory rate was lowered to 34 per cent.

When center-tight came back to power; the DIT-approach was frozen with the perspective to abolish it.

With a further prospective of the complete abolition of *DIT*, a reduction of the statutory rate of company tax rate to 33 per cent was announced , and the gradual elimination of *IRAP* *(see next section)* as well.

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The rationale for elimination of *DIT* and *IRAP* was the view of Centre-Right government, that both taxes aimed at orientating financial decisions of firms, thus introducing distortions in the economic agents' behavior. The abolition of *IRAP* was intended to be gradual, in order to avoid compromising the budget of the Regions', and to start from the labour cost component of the tax base.

DIT is accused of creating biases in financial decisions made by companies.

In the framework of the reform the government introduced an incentive scheme in favor of investment that amounts to a substantial reduction of the burden of the corporation tax for investing firms. More precisely, under the terms of this scheme (called Tremonti since it closely parallels a similarly named incentive offered in 1994-96) firms are entitled to immediate expensing of 50 percent of the amount by which qualifying investments exceed the lowest of the averages of such expenditures over any four of the preceding five years. The range of qualifying assets is wide, including most investments in new business assets and intangibles and training. The scheme was due to expire at the end of 2002, but it has been constantly renewed during the year when the Centre-Right coalition has been in power.

The idea is to replace it with other tax-incentives for investment

3. Regional taxation of businesses

The reform of company taxation introduced by the Centre-Left coalition in 1997 was accompanied by a complete reshuffling of business taxation at the sub-national level.

A new tax IRAP (*Imposta regionale sulle attività produttive*) was introduced in 1998. IRAP replaced a number of sub-national taxes, including a local business tax on profit (ILOR), a tax on net assets and, also importantly, payroll contributions levied to finance the National Health System, which were assigned to the regions. IRAP is a tax payable by businesses on the difference between their sales and the sum of their material purchases and depreciation.

In 1998 various taxes paid by companies to sub-national administrations were replaced with a single tax paid to the region (IRAP).

Assignment of IRAP tax base to regions was also justified on the ground that it is close to a benefit tax, since regionally produced services are reflected in increased profits and/or wage earnings, while sensitivity of location decision of firms to inter-regional differences in the tax rate should be negligible.

IRAP is an origin-based income-type VAT, whose payment is determined by the subtraction method. Basically, its tax base is the sum of wages, profits and interests.

IRAP is a kind of origin-based income-type VAT.

The statutory central rate is 4.25 percent, but regions can vary this, in either direction, by 1 percentage point, and may differentiate the rate by sectors. Regions make extensive use of their autonomy mostly by lowering tax rates applied to agriculture, cooperatives and by increasing rates applied to financial services, insurance and the energy sector. General government is also subject to IRAP, with a tax base that is limited to wages and salaries paid and with a tax rate of 8.5.

Its rate was fixed at 4.25% by central government with the possibility for the regions to reduce or increase by 1%

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Even with its present relatively low tax rates, revenue from the IRAP is substantial, in the order of almost 2.5 percent of GDP. It represents broadly more than one/third of VAT collections, one/fourth of PIT collections and more than two/thirds of CIT collections

revenues from IFRAP are substantial (almost 2.5% of GDP)

Being a regional tax, although administered by the central government, the tax paid by business with plants in different regions is allocated according, for manufacturing firms, to their regional wages bills, for financial services to specific indicators of activities, such as deposits, while for agricultural firms the area under cultivation is used. [2]

it is administrated by the central government

4.

Emerging convergence about gradual elimination of local and regional taxation

As previously mentioned, the Centre-Right took coming back to power in 2001 a commitment to eliminate IRAP as soon budget conditions allowed it. The Centre-Left coalition had an opposite view, IRAP being its own previous creation. However, the Centre-Left government that came back to power in 2006 took a softer stand on this issue. In the framework of a policy orientated to stimulate economic growth it planned a decrease in taxes impacting on labor cost, of which IRAP is surely a component. The first step in this direction has been the elimination in the year 2007 from the tax base of IRAP of a small component, more precisely the cost of labor consisting on social security contributions.

IRAP is now largely criticized for increasing labor costs and, therefore, reducing growth

More worrying is the *de facto* convergence between the two coalitions about the gradual reduction, or outright elimination, of the municipal property tax, ICI.

More worrying, is the now widespread opinion against the municipal property tax.

The process started just recently with the finance law for 2008 that has granted a very disputable and general tax relief, referred to the municipal property tax to first home owners. The relief amounts to €200 per year to taxpayers with an annual income up to €50,000, but is extended to all first home owners. This tax relief –which is a typi

New tax relieves reduce municipalities' incomes

[2] Introduction of IRAP was legally challenged on two distinct grounds. First IRAP was against the constitutional mandate for equality in front of taxes. The reason advanced by those who brought the case to the Constitutional Court was that income from professional activities was taxed twice (one with the personal income tax and the second time with IRAP). The second challenge was that IRAP infringed the EU discipline on turnover taxation that prohibits two distinct tax instruments on the same tax base.

The European Court of Justice had ruled on October 3, 2006, that IRAP does not infringe legislation on turnover taxes. This ruling has important implications for the tax policy of EU Member States, since the introduction of an IRAP type of tax has been taken in consideration by a number of them.
Article 33 of the Sixth VAT Directive allows EU Member States to levy "any taxes, duties or charges which cannot be characterized as turnover taxes." This is designed to protect the integrity and functioning of the single European market. It prevents Member States from introducing any tax similar, even if it is not identical, to VAT. The Court observed that IRAP does not have those characteristics.

cal example of pork barrel politics applied to taxation[3] - has a huge impact on municipal finances by decreasing the amount of own revenue.[4] The central government took commitment to compensate municipalities through an increase of its general transfers.

the center-right coalition pushes for the complete abolition of municipal property tax on the only ground that it is unpopular

The Centre-Right coalition has made of the complete elimination of the municipal property tax one of the crucial components of its electoral platform for national election to he held on April 13, 2008. The rationale, if any, is the assumed widespread unpopularity of this tax.

5. Taxation of interest, dividends and capital gains

Italy has a long tradition of taxing interest income by final withholding levied at flat rates. Presently two distinct rates apply: a rate of 27 percent being charged on bank and post office accounts, and on bonds of less than 18 month maturity; and a rate of 12.5 percent on other debt instruments. There has been a long debate about harmonizing taxation of interest income. The Centre-Left coalition is favoring a single unique rate of 20 percent that it is said to be close to European average. So far, however, no steps have been taken to reform.

Italy taxes interest income by final withholding levied at rates of 27% and 12.5%

Dividends were traditionally taxed by a full imputation system. That is, shareholders, personal or corporate, were entitled to a credit against their own tax liability on the dividend equal to the corporate tax underlying that dividend.

dividends are taxed with a two-tier system: part of it is taxed as ordinary income and the rest being taxed with a final withholding.

the split between the two depends on taxpayer's income

This system of imputation has been abolished with the reform of company taxation brought about by the Centre-Right coalition in 2001. Instead, some as yet unspecified fraction of dividends received will be taxed as ordinary income in the hands of the final shareholder, while the remaining fraction is taxed with a final withholding. The relative size of the share depend on the total income of taxpayers, with the result that taxpayers with low income will have their dividends taxed with the final withholding system only.

For capital gains taxation Italy adopted in 1998, in the framework of the introduction of the DIT, a quite innovative approach. The conventional approach is based on

[3] The relief was requested by one partners of the Centre-Left coalition, namely a split of the former Christian Democrats, as tangible tax concession that could be visibly ascribed to their action in favor of their electors. The other components of the coalition showed more skepticism about the measure, but were forced to accept it in the framework of a wider bargain.

[4] To extend the relief to tax payers without home ownership a tax credit of €300 on the rent paid for the first home and referred to the personal income tax has been given to taxpayers with an income not exceeding €15,500 (the tax relief decreases to €150 for taxpayer with an income between that figure and €301.000). Persons with low incomes who are unable to exploit completely the personal income tax relief will receive an amount equal to the portion of the relief they are unable to benefit from; the procedures have yet to be determined.

realization, that is to tax gains when the underlying asset is sold. This leads to a "lock-in" problem: taxpayers with an accrued gain have an incentive to postpone the sale of the asset since deferment allows them to postpone their tax liability (and, conversely, taxpayers holding an accrued loss have an incentive to realize it quickly). According to Michael Keen[5] the 1998 reform in Italy represented "the most thorough attempt that any country has yet made to mitigate this distortion of holding period decision".

capital gains are taxed when the underlying asset is sold, leading to a "lock in" problem

For managed funds, all gains that have accrued within the tax year, whether or not they had actually been realized, are taxed. For other gains, tax is charged at realization but with an adjustment that allows to broadly offsetting the advantage that has been enjoyed by postponing realization of the gain. Capital gains, so calculated, are subject to the same two rates of substitute tax as interest income, depending on the nature of the asset.

6. Recent surge in tax collections and dispute about ascription of merits

Since 2006 Italy has witnesses an impressive dynamics of tax collections. Both political coalitions are trying to ascribe the present surge in tax revenue to the effect of the policies followed by their government.

tax revenues amounted to 40.6% of GDP in 2005, 42.3% in 2006 and even more in 2007

The incidence of tax revenue on GDP rose to 42.3 per cent in 2006. This figure has to be compared with 40.6 per cent in 2005. Growth of tax revenue continued in 2007 at a similar speed. This growth of tax revenue has to be ascribed to the improvement of the economy, to some structural changes and also to the effects of measures implemented to fight tax evasion and the erosion of the taxable base.

all parties claim the merits for higher growth and higher tax revenues.

The Centre-right coalition claims the merit of both the improved economic conditions and of its anti-evasion and anti-erosion policies. While the claim on growth is hardly granted- in fact, Italy shares in 2006 and 2007 the economic recovery taking place across all Europe, although at a lower degree – the second claim has clearly more grounds, although it is challenged by the Centre-left government, which is stressing the announcement effect of its anti-evasion policies.

growth in Italy was not above EU average

increase in tax revenues could be imputed to anti-corruption, anti-evasion policies

More details of the possible explanations of the tax revenue surge are in order. As for direct taxes - whose growth has been the most notable – a strong impact on revenue growth derived from the strong dynamics of withholding of the income tax from wages paid to full-time workers in the private sector. The strong growth does not reflect the historical elasticity normally seen between these taxes and wages, but rather the *regularization* of workers previously engaged in the black economy.

some workers have left the black economy

Another reason of the growth of direct taxes, which is worth mentioning, is the restructuring in industry and in the distribution sector that resulted in businesses being

[5] Michael Keen, Tax Reform in Italy Tax Notes International, Vol. 17 February 2003

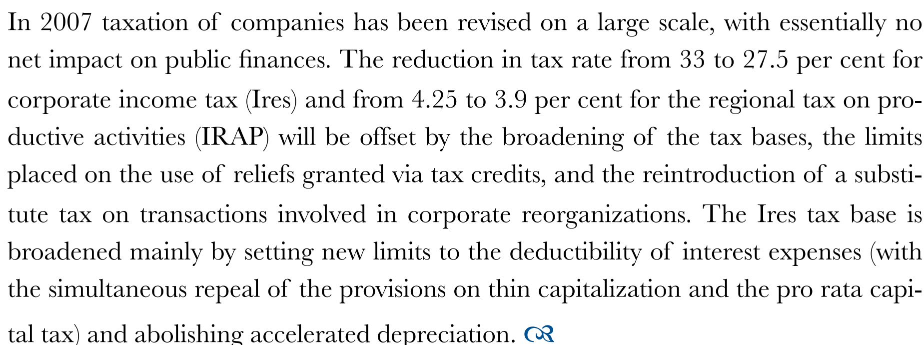
channeled into sectors that offer fewer chances for tax evasion.

restructuring of industry has made tax evasion less likely

Also, the positive trend of property values and the real estate turnover may have had an impact on direct taxation, in addition to the impact on indirect (registration) taxes.

Turning to indirect taxes, growth of VAT receipts reflects a shift in the composition of demand towards goods taxed at higher rates - namely, purchases of durable goods- while consumption of food products declined. The favorable trend in value-added tax collections is also partly due to a change in tax regulations resulting from specific measures implemented to reduce tax evasion. In addition to measures to fight tax evasion, audit activity in 2006 was stepped up, particularly with regard to the real estate sector, and this may have prompted some taxpayers to increase their tax compliance.

the structure of consumption has evolved in favor of goods taxed at higher rates



7.

Recent changes in company taxation

In 2007 taxation of companies has been revised on a large scale, with essentially no net impact on public finances. The reduction in tax rate from 33 to 27.5 per cent for corporate income tax (Ires) and from 4.25 to 3.9 per cent for the regional tax on productive activities (IRAP) will be offset by the broadening of the tax bases, the limits placed on the use of reliefs granted via tax credits, and the reintroduction of a substitute tax on transactions involved in corporate reorganizations. The Ires tax base is broadened mainly by setting new limits to the deductibility of interest expenses (with the simultaneous repeal of the provisions on thin capitalization and the pro rata capital tax) and abolishing accelerated depreciation. ☙

tax rates has been reduced (from 33 to 27.5 for corporate income and from 4.25 to 3.9 for regional tax on product activities), but this was offset by a broadening of tax bases.

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