OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Tax Policy Reforms in Italy

CTPA

CENTRE FOR TAX POLICY AND ADMINISTRATION

2. TAX REFORM IN ITALY

2.1 Tax structure and trends

1. The fiscal adjustment needed to fulfil the Maastricht parameters in the 1990s was primarily achieved by revenue increases and reduction in interest payments on public debt rather than by cuts in public expenditures. This is reflected in the tax-to-GDP ratios. During the 1980s this tax ratio increased by 8.5 percentage points (from 30.4 to 38.9 per cent). The process continued in the 1990s until 1997 (the Maastricht year), when the tax-to-GDP ratio peaked at 44.2 per cent. After 1997, the total tax ratio started to fall, but since 1999 it has been reasonably stable, as can be seen from Table 2.1.

2. Table 2.1 reveals that the role of income and profits taxes, social security contributions and specific consumption taxes, measured as a share of major taxes in total tax revenues, have decreased since 1990 while general consumption taxes (VAT) have remained stable. This decrease has been offset by an increase of property taxes and "other taxes", mainly the introduction of the new regional tax, IRAP, in the 1997-98 tax reform. After the recent reductions in the corporate tax rate from 36 per cent in 2002 to 34 per cent in 2003 and further to 33 per cent in 2004, the revenue from corporate income tax has started to decline.

Table 2.1: Tax structure in Italy – Revenue of major tax categories measured as a percentage of total tax revenue.

	1990	1995	1999	2000	2001	2002	2003
Income and profits taxes	36.5	35.3	34	33.2	34.2	32.5	30.9
Personal income tax	*26.3*	*26.0*	*26.4*	*25.7*	*25.9*	*25.5*	*25.1*
Corporate income tax	*10.0*	*8.7*	*7.7*	*7.5*	*8.6*	*7.6*	*6.6*
Social security contributions	32.9	31.5	28.5	28.5	29.0	29.4	29.5
Employees	*6.3*	*6.6*	*5.5*	*5.4*	*5.5*	*5.6*	*5.4*
Employers	*23.6*	*20.7*	*20.0*	*19.8*	*20.1*	*20.4*	*20.6*
Payroll taxes	0.3	0.3	0.0	0.0	0.0	0.0	0.0
Property taxes	2.3	5.6	4.6	4.3	4.8	5.1	8.0
Goods and services taxes	28.0	27.3	27.5	28.4	25.6	26.9	25.7
General consumption taxes	*14.7*	*13.8*	*13.7*	*15.8*	*14.8*	*15.0*	*14.2*
Specific consumption taxes	*10.6*	*11.1*	*11.2*	*10.0*	*8.5*	*9.0*	*8.9*
Other taxes	0.0	0.0	5.4	5.6	6.4	5.8	6.0
Total tax revenue (per cent GDP)	**38.9**	**41.2**	**43.3**	**43.2**	**43.0**	**42.5**	**43.1**

Source: Revenue Statistics 1965-2004.

Table 2.2: Tax structure in Italy compared to some other OECD countries and the average OECD and EU15 (unweighted). Revenue of major taxes as a percentage of total tax revenue 2003

	Austria	France	Germany	Italy	OECD (2003)	EU15 (2003)
Personal income taxes	23.1	17.5	23.9	25.1	24.9	25
Corporate income taxes	5.1	5.7	3.5	6.6	9.3	8.1
Social sec. and other payroll	39.9	40.2	40.5	29.5	27.0	29.8
Property taxes	1.3	7.3	2.4	8.0	5.6	5.2
Goods and services taxes	28.2	25.5	29.4	25.7	32.1	30.4

Source: OECD Revenue Statistics 1965-2004.

3. The tax structure in Italy is relatively balanced compared to the OECD- average. The increased reliance on property taxes and the reduced importance of corporate taxes and taxation of goods and services in recent years (as is seen from table 2.1), Italy has moved somewhat away from the OECD-average.

2.2 Recent tax reform initiatives

4. Tax policy in the 1990s (up until 1997) was almost exclusively focused on raising revenues to fulfil the international fiscal targets, and implied the introduction of both structural (permanent) and transitory (extraordinary) tax measures. From 1999 up to mid-2001, the main changes in the tax were related to the implementation of the tax reform of 1997-98. In recent years, Italy has reformed both the personal income tax and the corporate tax.

5. The reform of the Personal Income Tax (PIT) aimed at reducing the burden on tax payers by a considerable cut in revenue, flattening the rate structure by reducing the amounts of tax brackets and minimising distortions in the system of tax credits and tax allowances. The reform was implemented in two steps in 2003 and 2005.

6. The reform of the corporate tax, which was implemented in January 2004, aimed at simplifying the system and at reducing the tax burden on companies. The reform includes a reduction of the corporate tax rate and introduced exemption measures on dividends and participations. More specifically, the full imputation system for distribution of profits, (including the dividend tax credit) was abolished**.** It was replaced by a 95 per cent exemption of distributed dividends from PIT.

2.3 Tax reforms in detail

2.3.1 PIT reform

Introduction

7. In Italy, personal income tax (PIT) is one of the most important sources of revenue. During the 1990s, the tax burden on individuals has strongly increased. Over the period 1990-2002 the share of PIT as a percentage of total revenue raised from 8.3 per cent to 9.6 per cent of GDP. This increase was mainly driven by the need to meet the Maastricht requirements. However, since 1997 the tax burden has been perceived as being too high and representing a constraint to economic growth. At the same time, since 1990, the overall increase in the tax burden has been partly offset by several measures concerning the system of allowances for dependent relatives; namely, from 1995 to 2003, tax credits have been progressively differentiated according to income, number of family members and types of dependents (spouse, children, and children under three years of age). As a consequence, the family allowance system has become particularly complex and has no longer been able to allow families to take full advantage of the system, as well as to guarantee horizontal equity objectives.

The flat tax rate as the reference model for the reform

8. Since 2003, the personal income tax reform aimed at reducing the tax burden on taxpayers and at minimising the tax distortions due to the complex system of tax credits and tax allowances. Before the tax reform of 2003, the progressiveness of the PIT was ensured by a high number of income brackets and by statutory tax rates ranging from 18 per cent to 45 per cent (in 1995, statutory tax rates varies from 10 per cent to 51 per cent within 7 income brackets).

9. The reform has focused on reducing the number of statutory tax rates. Between 2003 and 2005, the number of income brackets was reduced to three; the tax rates are between 23 per cent and 39 per cent. In addition, a 4 per cent solidarity surcharge tax is levied on income exceeding 100.000 Euro. Progressiveness is now achieved by a system of income deductions. The development of the reduction of the tax brackets can be seen from table 2.3.

10. The reform has not been budgetary neutral. It implied a cut in total revenue arising from the PIT by 11.4 million euro. Although the initial proposals for a PIT reform were based on a flat rate tax model, the final implementation had had to take into account the related costs and losses in tax revenue. However, the broad objectives of the personal income tax reform have been largely achieved: the minimisation of tax distortions and the flattening of the rate structure.

Table 2.3: Income brackets (Euro) and statutory rates (per cent) of the personal income tax

<table>
<tr><th colspan="2">Income brackets</th><th>1995</th><th>1999</th><th>2000</th><th>2002</th><th>2003</th><th>2005</th></tr>
<tr><td>0</td><td>3,719</td><td>10</td><td rowspan="3">18,5</td><td rowspan="4">18,5</td><td rowspan="4">18</td><td rowspan="5">23</td><td rowspan="7">23</td></tr>
<tr><td>3,719</td><td>7,437</td><td>22</td></tr>
<tr><td>7,437</td><td>7,746</td><td rowspan="4">27</td></tr>
<tr><td>7,746</td><td>10,329</td><td rowspan="3">26,5</td></tr>
<tr><td>10,329</td><td>15,000</td><td rowspan="2">25,5</td><td rowspan="2">24</td></tr>
<tr><td>15,000</td><td>15,494</td><td rowspan="3">29</td></tr>
<tr><td>15,494</td><td>26,000</td><td rowspan="3">34</td><td rowspan="3">33,5</td><td rowspan="3">33,5</td><td rowspan="3">32</td></tr>
<tr><td>26,000</td><td>29,000</td><td rowspan="5">33</td></tr>
<tr><td>29,000</td><td>30,987</td><td rowspan="2">31</td></tr>
<tr><td>30,987</td><td>32,600</td><td rowspan="6">41</td><td rowspan="4">39,5</td><td rowspan="4">39,5</td><td rowspan="4">39</td></tr>
<tr><td>32,600</td><td>33,000</td><td rowspan="4">39</td></tr>
<tr><td>33,000</td><td>33,500</td></tr>
<tr><td>33,500</td><td>69,722</td><td rowspan="4">39</td></tr>
<tr><td>69,722</td><td>70,000</td><td rowspan="5">45,5</td><td rowspan="5">45,5</td><td rowspan="5">45</td></tr>
<tr><td>70,000</td><td>77,469</td><td rowspan="4">45</td></tr>
<tr><td>77,469</td><td>100,000</td><td rowspan="2">46</td></tr>
<tr><td>100,000</td><td>154,937</td><td rowspan="2">39+4(*)</td></tr>
<tr><td>154,937</td><td></td><td>51</td></tr>
</table>

Amounts in Euro
(*) solidarity levy

The main features of the reform

11. In order to reduce the budgetary impact, the reform has been implemented in two stages.

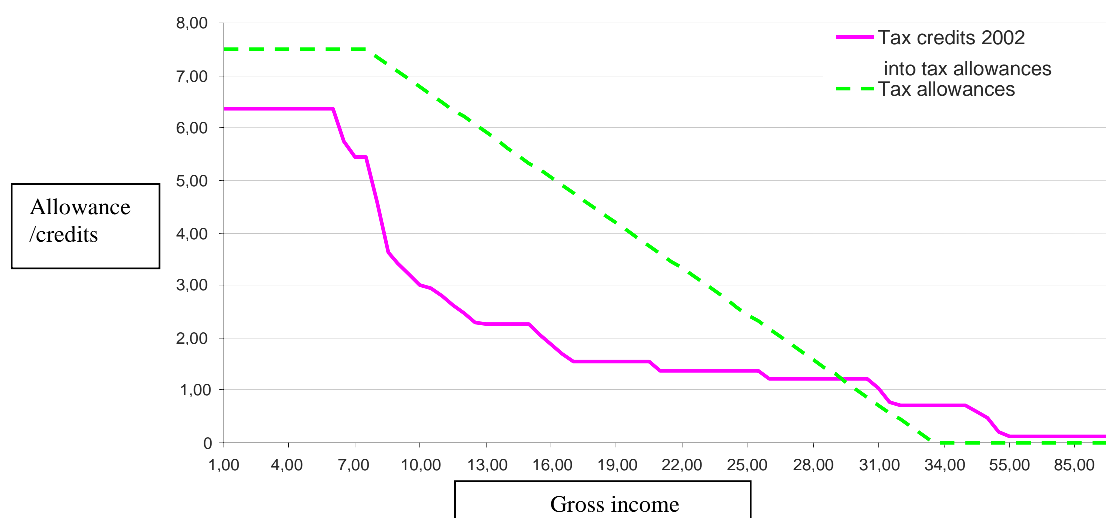
12. *The first stage* (2003) involved a shift from income related tax credits to income related tax allowance and introduced a tax free basic allowance (the "no tax area"). The "No tax area" is the result of the calculation of income related tax allowances. The basic allowance (no tax area) is 3,000 euro. However, this amount might be higher, but the maximum allowance is 7.500 euro. Details of the "no tax area" can be seen form table 2.4. Furthermore, income brackets have been changed even if their number has not been reduced (see the change from 2002 to 2003 in table 2.3).

Table 2.4: The "No tax area"

Type of income	Basic allowance (a)	Additional allowance (b)	Standard allowance (a+b)
PAYE	3,000	4,500	7,500
Pensions	3,000	4,000	7,000
Self-employed Business income	3,000	1,500	4,500

13. As it is shown in the figure 2.1, the shifting from the tax credits to the tax allowances turns out to widen the deduction area.

Figure 2.1: Tax allowances in 2003 versus tax credits in 2002 (Single employee)
1 000 EUR



14. In the *second stage* of the PIT reform (2005), the number of brackets is reduced to only four (see table 2.3.) Tax credits for dependent relatives were changed into allowances which decrease in income. The "Family area" is the result of the calculation of income related tax allowances. The maximum tax allowances for family dependents are described in Table 2.5.

Table 2.5: Maximum tax allowances for family dependents.
EUR

	Family allowances
Spouse	3,000
Child	2,900
Child under three years of age	3,450
First child (single parent)	3,200
Disabled child	3,700
Other dependent relatives	2,900

15. As a result, the shift from tax credits to tax allowances has broadened the no tax area and has reduced the tax burden for low-income families and for large families in the middle income bracket. Over a certain level of income (varying in accordance with the number of family members), tax allowances are no longer granted. This partly offsets the reduction in the top personal income tax rate.

The outcome of Personal Income Tax reform

16. The first stage in the PIT reform implied a reduction in the average tax rate for the low incomes deciles, while the second stage resulted in gains to the high end of the income scale. Table 2.6 shows the effects on the average and marginal tax rates for an APW with dependent spouse and two children.

Table 2.6: Average and marginal tax rates for Average Production Worker with dependent spouse and two children

Budget law 2002		Budget law 2005		Differences	
Average rate	Marginal rate	Average rate	Marginal rate	Average rate	Marginal rate
11.2	44.1	10.3	39.5	- 0.9	- 4.6

17. As a result, the average rate and the marginal rate are lower than before the tax reform. This might positively influence the decision to enter the labour market and the number of hours worked. Even considering the difficulty in estimating the total effects on the labour market, the number of taxpayers that face a reduced MTR exceeds the number of taxpayers that face a higher MTR. The reduction of the top marginal income tax rates will reduce the personal income tax distortions as well.

2.3.2 Corporate tax reform

Corporate Income Tax (IRES)

18. The reform of the corporate tax implemented as of January 2004 implies a radical change. The aim of the new reform is to simplify the corporate income tax system and to reduce the tax burden on companies. Moving towards a tax system which is more in line with tax systems elsewhere in the EU, will increase the international competitiveness of Italian companies and might attract foreign investment. The existing system has proved to be ineffective because it has been mainly used by large companies. In addition, it has induced mature and profitable companies to overinvest, instead of distributing profits. This gave a disadvantage to newly created companies that have not yet accumulated profits.

19. The reform includes a reduction of the corporate tax rate from 36 per cent in 2002 to 33 per cent as from 2004. It also provides for a general system of capital gains exemption with no deductibility of the corresponding capital losses. Furthermore, the imputation method previously used to eliminate double taxation of dividends has been replaced with a (partial) exemption method under which corporate profits are subject to income tax at the company level and are partially exempt at the level of the shareholder (dividends are exempted up to 95 per cent for taxpayers subject to IRES). The change from a system of full imputation to a system of partial inclusion is similar to the change in some other OECD-countries during the 1990s (for instance in Finland, France and Germany).

20. One of the most important innovations is the introduction of a consolidated tax regime for groups. Companies belonging to the same group can choose consolidated taxation, which allows profits and losses to be offset among the members of the group[1]. Group taxation can also be extended to non-residents subsidiaries, although in this case consolidation must include all foreign subsidiaries, and their income can be attributed to the parent company only to the extent of the percentage of ownership. In the domestic case, there is no such restriction. Another important innovation in the corporate income tax is the introduction of a participation–exemption regime, where inter-corporate capital gains are exempted from taxation and dividends are exempted along with the abolition of the full imputation dividend tax relief. The participation-exemption percentage is currently 91. The general reasons underlying these rules relate to the avoidance of double taxation of intercorporate income (capital gains and dividends). The post-reform regime also sets specific regulations against thin-capitalization.

[1] The control requirement for consolidation is met when a company holds, both directly and indirectly, more than half of the share capital of another company and the parent company can select which controlled companies that will be included in tax consolidation.

21. The reform also includes provisions for a gradual abolishment of the, “Imposta regionale sulle attività produttive” (IRAP). This is a regional tax on business activities paid by corporations and unincorporated firms. As IRAP represents the basic source of revenue for the National Health System, its abolishment will necessarily be gradual.

22. The overall effect of the tax changes will be to reduce the tax burden on corporations, and to introduce a tax system that will be more in line with the corporate income tax systems in the other European countries.

2.3.3 Reform of environmental taxes

23. A green tax reform has recently been proposed. The main components of the proposed reform are a re-structuring of excises on mineral oil according to their carbon content and to their use, and the introduction of a consumption tax on coal, petrol-coke and natural bitumen used in combustion plants (as defined by EC Directive 88/609). The increased revenue will be used to finance reductions in the tax wedge on labour. The proposed reform was originally going to be gradually implemented over the period 1999-2005, but the implementation of it has been postponed.