HEARING: THE REFORM OF THE INCOME TAX ON INDIVIDUALS AND OTHER ASPECTS OF THE TAX SYSTEM

PERSONAL INCOME TAXATION IN ITALY

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Key observations

- *The personal income tax plays an important role in ensuring the progressivity of Italy's tax system, although there are opportunities to improve the progressivity of the tax system.*
- *In particular, there is scope to introduce a degree of progressivity into the taxation of personal capital income, particularly following the move to Automatic Exchange of Information for tax purposes (AEOI).*
- *Removal of a range of personal capital income tax concessions would also reduce tax-induced distortions to savings portfolio allocation, increasing both efficiency and fairness.*
- *Italy's current approach of using income-based tax credits is a targeted and effective way to provide support to low-income taxpayers, although such an approach can create disincentives and high marginal tax rates.*
- *Careful tax policy design can mitigate work disincentive concerns associated with the income-based withdrawal of Italy's targeted tax credits.*
- *The overall tax burden on labour income in Italy is high compared to most OECD countries. This is driven significantly by social security contributions. While the focus of this note is on the design of the personal income tax, consideration could also be given to the potential merits of a partial shift in the tax mix away from labour taxes to taxes on other less distortionary bases, such as property, consumption (including excise duties) and environmentally related taxes.*

Background on the functioning / design of the Personal Income Tax

- Across the OECD, around three-quarters of the reduction in disposable income inequality takes place through transfers, and around one-quarter through the tax system, mainly through the progressive personal income tax (PIT). The tax system plays a slightly larger redistributive role in Italy, with around three-fifths of the reduction due to transfers, and two fifths due to PIT (Causa and Hermansen, 2017).
- The design, functioning and impact of the PIT cannot be seen in isolation from the level of social security contributions (including employer contributions, which can be expected to be predominantly borne by employees).
- If the tax burden on labour income and capital income differs widely, the tax system creates a tax-induced incentive for entrepreneurs to incorporate their business and to earn income in the form of capital income rather than labour income.
- A basic tax allowance or a zero rate band in the PIT rate schedule have exactly the same impact.
- In a progressive PIT system, a basic tax allowance or zero rate band will provide a larger tax saving to higher income taxpayers than lower income taxpayers as it reduces the amount of income subject to taxation at the top marginal tax rate. A targeted tax credit will more effectively provide support to low-income households than a basic allowance or zero rate band.

Overview of PIT trends in the OECD

- Historically, most OECD countries have tended to apply broadly comprehensive tax systems that tax labour and capital income together at progressive rates (though still with certain tax concessions, such as for pensions and owner-occupied housing).
- While many countries still follow this broad approach, a significant number of countries reformed their tax systems in the 1980s and 1990s to apply dual or semi-dual PIT systems that tax capital income separately from labour income, at lower flat rates. At the same time, many countries also introduced specific tax-favoured regimes for certain forms of capital income. These reforms were generally motivated by two factors:
    - Concern about low levels of savings, and
    - Difficulty in imposing high progressive tax rates on mobile capital income due to the ability of some taxpayers to hide wealth offshore.
- Over the years, a number of countries have introduced so-called flat tax systems (e.g. Russia, South Eastern and Eastern European economies). However, these flat tax systems are not truly flat; they are rather dual income tax (DIT) systems with flat taxes on labour income, often with very high SSCs.
- A number of countries have also gradually lowered their top PIT rates and reduced the number of PIT brackets. The complexity of the PIT is typically not a result of the number of brackets, but rather the result of tax expenditures.
- Imputation systems have become less common, due, in part, to complexities associated with European Union law. Nevertheless, imputation systems remain in a number of countries (e.g. Australia, New Zealand and Mexico).
- The recent adoption of automatic exchange of financial account information between tax administrations (AEOI) makes it harder for taxpayers to evade tax by hiding income and wealth offshore. This opens up the possibility for countries that previously moved to dual or semi-

dual income tax systems to consider the possibility of reintroducing a degree of progressivity into their taxation of capital income.

- For example, a "dual progressive income tax" system could apply separate progressive tax schedules to labour and capital income (with a more progressive schedule applying to labour than to capital income).

Key characteristics of PIT in Italy (as it applied in 2020)

- Individual is the tax unit
- PIT rate schedule is applied to taxable income:

Bracket (EUR)	Rate (%)
up to 15 000	23
over 15 000 up to 28 000	27
over 28 000 up to 55 000	38
over 55 000 up to 75 000	41
over 75 000	43

Observation:

- No 0%-rate band
- Relatively high low-band PIT rate

- Regional as well as local surtax, levied on the central government's PIT liability.
- Tax allowances: Employee social security contributions (SSCs) are effectively deductible (as labour income is reported in tax returns net of employee SSC). Self-employed SSCs can be deducted as a tax allowance.
- Tax credits:
  - **Fiscal Bonus (refundable) tax credit**: EUR 0 for very low taxable income (below EUR 8 145), for higher taxable income: credit equals EUR 1 080 and reduces gradually to EUR 600 with taxable income. Once taxable income exceeds EUR 28 000, tax credit drops from EUR 600 to EUR 0. (In the budget law for 2021, this credit was increased in value to EUR 1 200).
  - **PAYE (non-refundable) tax credit**: from EUR 1 880 (for very low incomes) and gradually reduces to EUR 0 for taxable income above EUR 55 000. (The PAYE tax credit applies only to employment income so it is effectively an Earned Income Tax Credit).
  - **Crisis related (for period 01/07/2020 until 31/12/2020) additional (non-refundable) tax credit** of EUR 600, ONLY for taxpayers with taxable income above EUR 28 000 and gradually tapering out to EUR 0. (In the budget law for 2021, this credit was extended for 2021 and increased in value to EUR 1 200).
  - **Tax credit for family dependants, including spouse and children**: all tax credits taper out with income.
- An optional 15% flat tax rate regime applies to small businesses and professionals that earn less than EUR 65 000 (or for new start-ups).

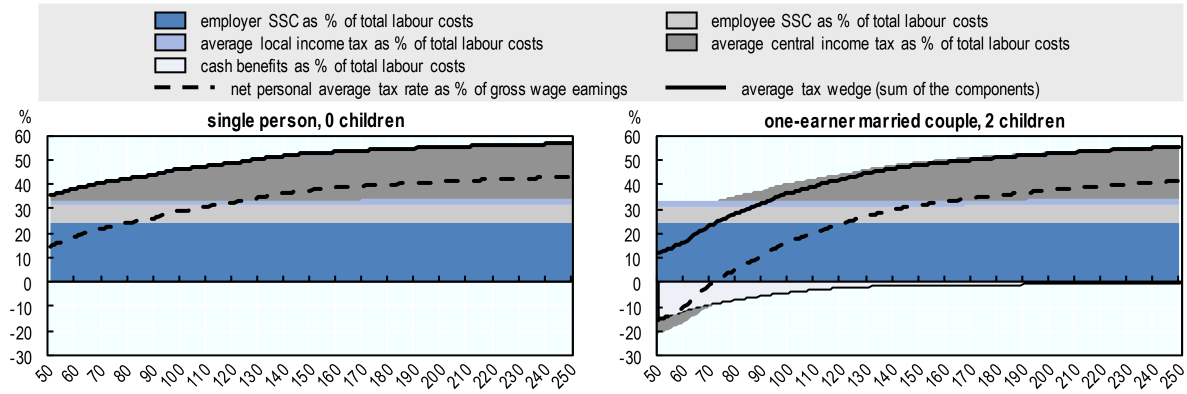
The total tax wedge on labour income in Italy

- The combined effect of the PIT and SSC systems results in substantial average and marginal tax wedges across the majority of the income distribution.

- The provision of targeted cash transfers reduces the average tax wedge for lower income families with children, but increases the marginal tax wedge as it is withdrawn.
- The withdrawal of income-targeted tax credits increases the marginal tax wedge across a wide range of incomes. In particular, the withdrawal of the Fiscal Bonus tax credit results in a significant jump in the marginal tax wedge between 90% and 96% of the average wage.
- In the Lazio region (the representative region considered in the OECD's *Taxing Wages* models), a threshold at EUR 35 000 for applicability of progressive local income tax rates (rather than a flat rate) results in a spike in the marginal tax wedge at 127% of the average wage.

Italy 2020: average tax wedge decomposition

by level of gross earnings expressed as a % of the average wage



Italy 2020: marginal tax wedge decomposition

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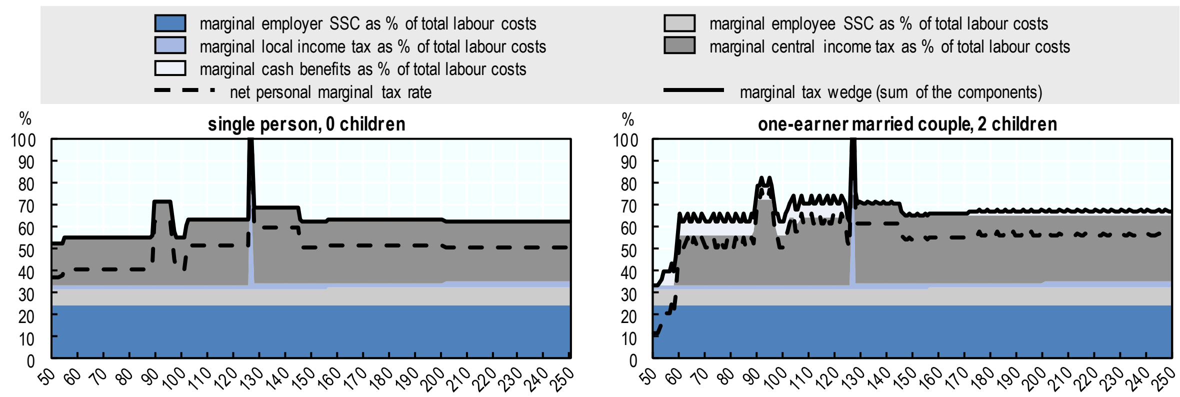
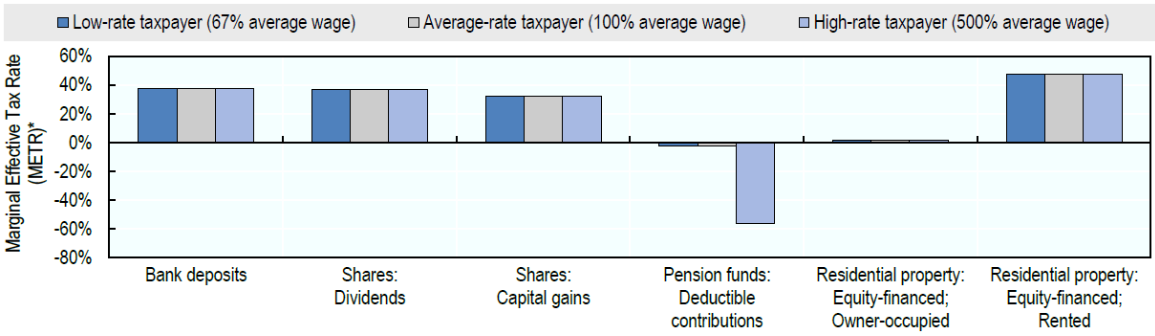


Source: OECD Taxing Wages models

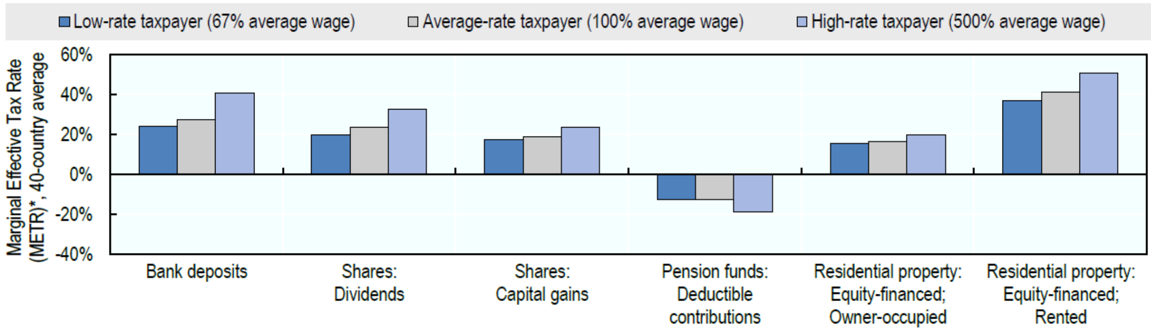
Taxation of personal capital income

- The application of flat tax rates results leads to an absence of progressivity in the taxation of personal capital income.
- There is non-neutrality across different savings vehicles due to concessionary tax rates for certain savings vehicles and deferral benefits from realisation-based capital gains taxation.

Marginal Effective Tax Rate (METR) on different savings vehicles, Italy, 2016



Marginal Effective Tax Rate (METR) on different savings vehicles, OECD average, 2016



Source: OECD (2018) "Taxation of Household Savings".

Assessment of PIT in Italy and options for reform

- The design of the **"Fiscal Bonus" refundable tax credit** was changed in 2020. Prior to 2020, the total fiscal bonus (EUR 1 080) was phased out between income of EUR 24 600 and EUR 26 600. This resulted in a significant disincentive for taxpayers with earnings in that income range to work longer or harder in order to earn more income. In 2020, the total fiscal bonus was split into two components, with EUR 480 being phased out between EUR 24 600 and EUR 26 600, resulting in a smaller increase in the marginal tax rate over that range. The remaining EUR 600, however, was now lost entirely at EUR 28 000. However, at the same time, the **crisis-related temporary tax credit** was introduced providing an additional tax credit of EUR 600 at that same point, thereby compensating for the loss of the fiscal bonus, and being slowly withdrawn beyond that level.
  - Assessment: In the absence of the crisis-related temporary tax credit, the redesign of the Fiscal Bonus would have resulted in a very large spike in the marginal effective tax rate (METR) at earnings of EUR 28 000. This would create a significant work disincentive for taxpayers at that point. To address this concern, in the budget law for 2021, Italy has turned the crisis-related temporary tax credit into a permanent measure.
- More generally, the income-based targeting of **all** tax credits increases marginal tax rates across a wide income range.
  - Assessment: Because all tax credits are currently withdrawn with income, this creates marginal tax rates that are significantly higher than statutory tax rates over a wide range of incomes, resulting in significant work disincentives for a large number of taxpayers. Italy should consider their income distribution data in detail with the aim

    - of minimising additional disincentive effects from tax credit withdrawal at the most dense parts of the income distribution. Not withdrawing one of the tax credits with income would lower marginal tax rates, but increase fiscal cost. One option to finance such a reform could be to increase the top two PIT rates (and/or lower the threshold from which the top PIT rate applies), which would also further strengthen the progressivity of the PIT.
    - **Reform option**: A tax reform could be designed that does NOT taper out the PAYE tax credit of EUR 978 above EUR 28 000 taxable income, but increases the top PIT rates in a revenue neutral manner.
- The "cliff-face" design of the regional surcharge tax in Rome (and potentially other areas) results in a spike in marginal tax rates when taxable income equals EUR 35 000 (Note: this is based on the *OECD Taxing Wages* model's representative region of Rome (Lazio)).
    - Assessment: The regional surcharge tax in Rome and other areas with similar design could be redesigned to prevent the spike in marginal tax rates that occurs at EUR 35 000, when a taxpayer moves from paying a flat rate of tax of 1.73% to a progressive schedule (which increases the tax rate applicable to income between the EUR 15 000 and EUR 28 000 threshold to 2.73%, and above that to 2.93% and then higher).
    - **Reform option**: Replace the current dual schedule (flat rate + progressive schedule) in Rome (and potentially other areas with similar design) with a single schedule. This could either be flat or progressive, given that most progressivity is achieved by the central PIT rather than the regional tax.
- Consider reforming the taxation of personal capital income.
    - Assessment: The move towards AEOI creates the opportunity for Italy to consider introducing a degree of progressivity into the taxation of personal capital income that is not currently present with the flat rate structure. Removal of a range of tax concessions would also reduce tax-induced distortions to savings portfolio allocation.
    - **Reform options**: introduce a mildly progressive rate schedule on capital income; provide a tax credit rather than a deduction for private pension contributions; remove the tax exemption for long term capital gains on residential housing; remove the option of a substitute flat-rate tax on rental income.
- Review the tax rules for small business and professional income.
    - Assessment: Currently, a flat rate of 15% can be paid on taxable income up to EUR 65 000 for taxpayers that derive business or professional income. This contrasts significantly with the progressive schedule that applies to salary and wage earners, where a rate of up to 41% is applied. This may create incentives for employees to artificially re-characterise their employment relationship as a small business relationship.
    - **Reform option**: Italy may wish to review the appropriateness of the 15% flat rate regime, balancing the desire to encourage small business development with ensuring horizontal equity and minimising tax avoidance.
- A strong message from the tax wedge graphs presented above (and in the annex) is that the overall tax burden on labour income in Italy is high compared to most OECD countries. This is driven significantly by SSCs, particularly employer SSCs. While the focus of this note is on PIT design, the PIT should not be considered in isolation, and hence Italy should also give consideration to the potential for broader reforms. For example, consideration could be given to the potential merits of a partial shift in the tax mix away from labour taxes to taxes on other

less distortionary bases, such as property, consumption (including excise duties) and environmentally related taxes.

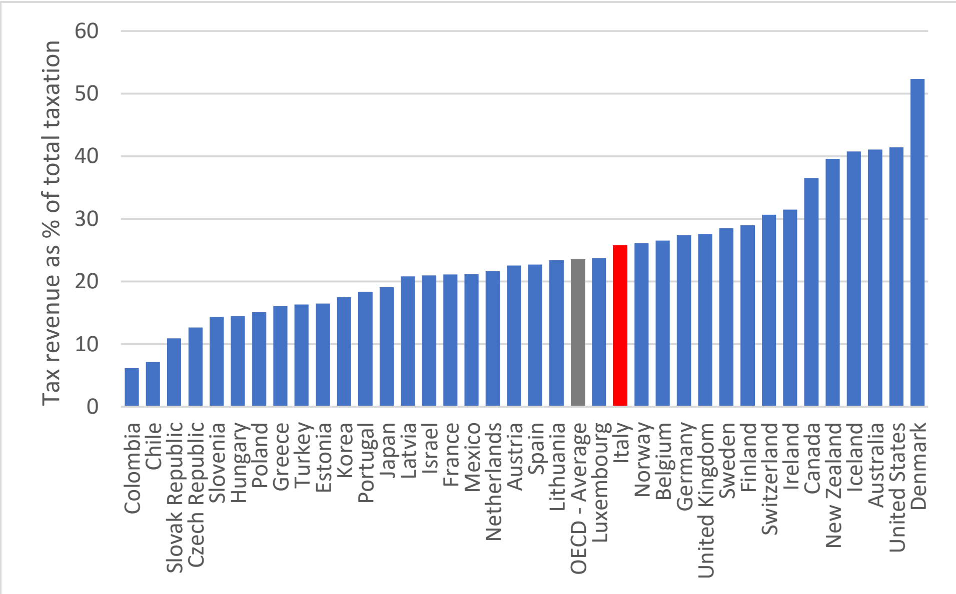
Conclusions

The Italian PIT system is well designed. It is progressive and more redistributive than many systems, and raises significant tax revenue (see annex). However, there is merit in considering whether the design of the various tax credits could be improved. The withdrawal of the tax credits result in high marginal tax rates that, for taxpayers caught at these income levels, will result in significant disincentives to work longer or harder. Italy should also consider reforming the taxation of personal capital income to introduce a small degree of progressivity and increase neutrality in portfolio allocation.

ANNEX: COMPARISON WITH OTHER OECD COUNTRIES

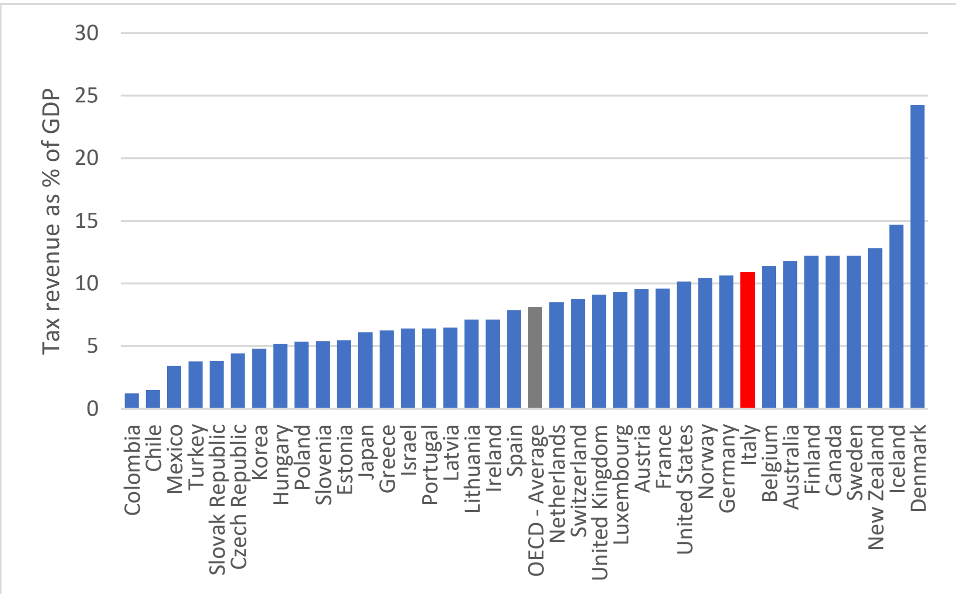
- Italy raises more tax revenue as a percentage of total taxation and GDP than the OECD average.

PIT revenue as a percentage of total tax revenue, 2019



Data for Australia, Greece, Japan, Mexico, and the OECD average are for 2018
Source: OECD Revenue Statistics

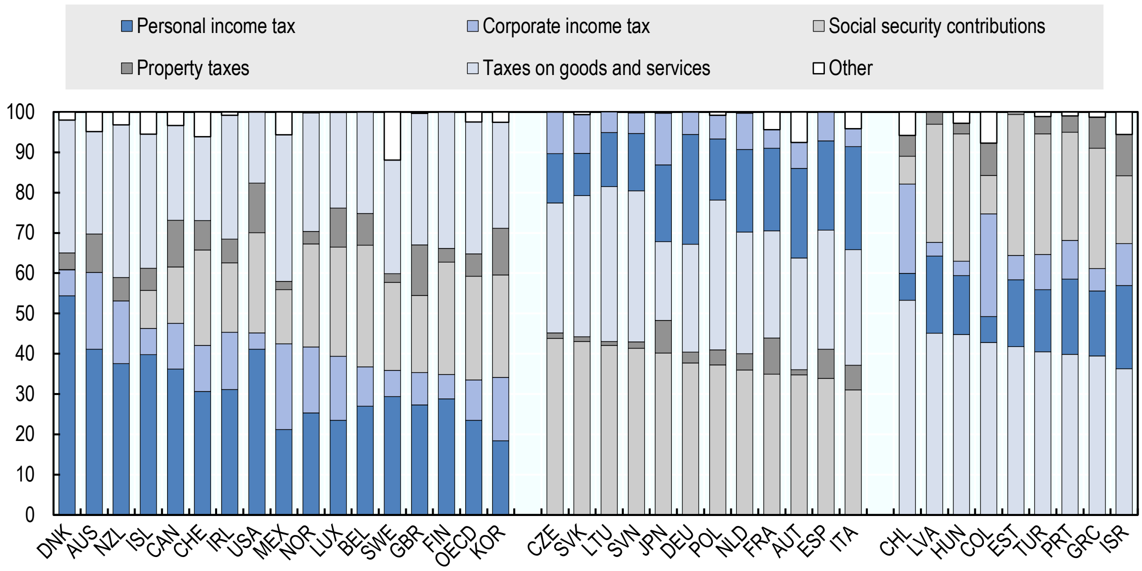
PIT revenue as a percentage of GDP, 2019



Data for Australia, Greece, Japan, Mexico, and the OECD average are for 2018
Source: OECD Revenue Statistics

- Italy relies less heavily on PIT than many OECD countries, but more heavily on SSCs (particularly employer SSCs). The total tax burden on labour is therefore still significant.

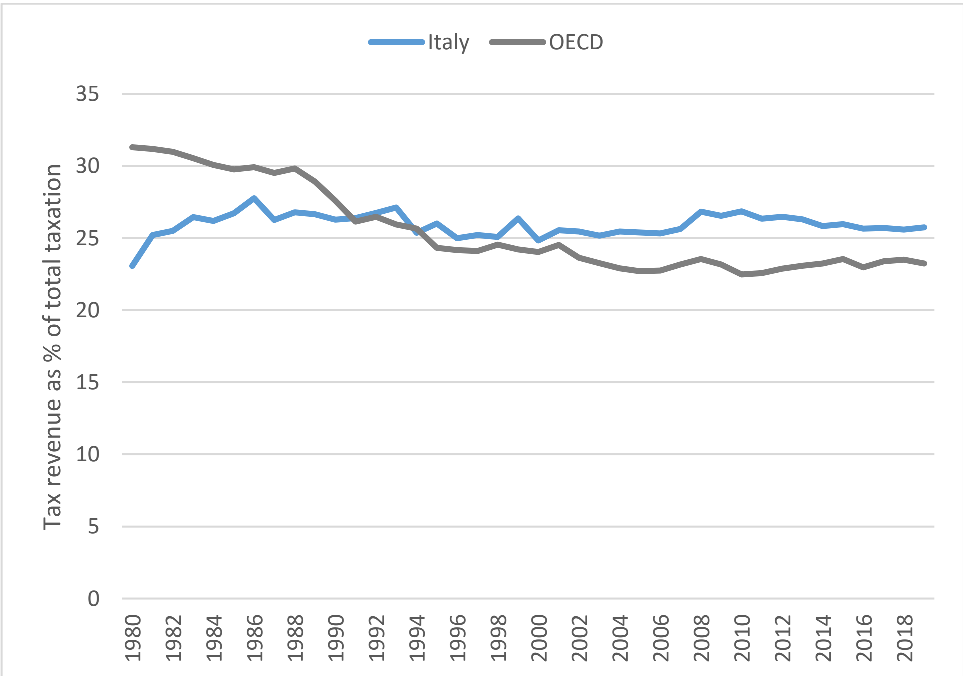
Tax mix in OECD countries, 2019



Source: OECD Revenue Statistics

- Italy's reliance on PIT revenue has remained relatively constant over the last 40 years, while across the OECD in general, reliance on PIT revenue has fallen.

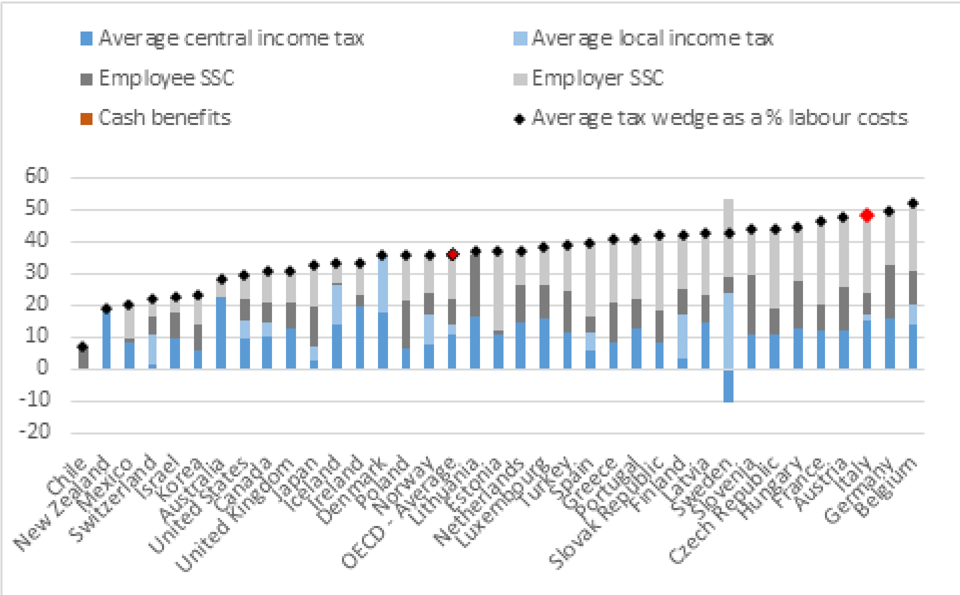
Tax revenue as a percentage of taxable income, 1980-2019



Source: OECD Revenue Statistics

- The total tax wedge on labour income is high in Italy compared to other OECD countries due, as noted above, to SSCs.

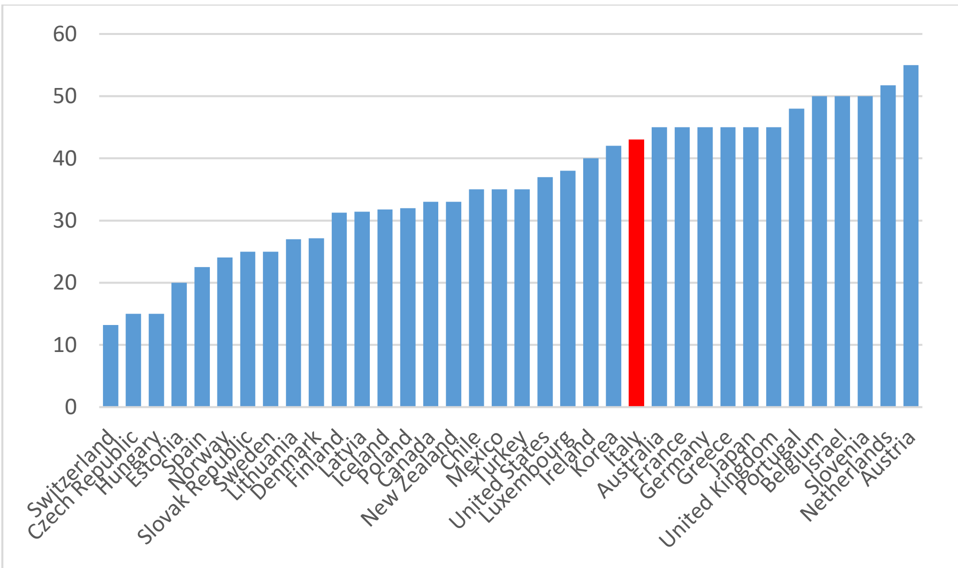
Average tax wedge, single individual, 2019



Source: OECD Taxing Wages models

- The top PIT rate in Italy is in the upper-middle range of OECD countries.

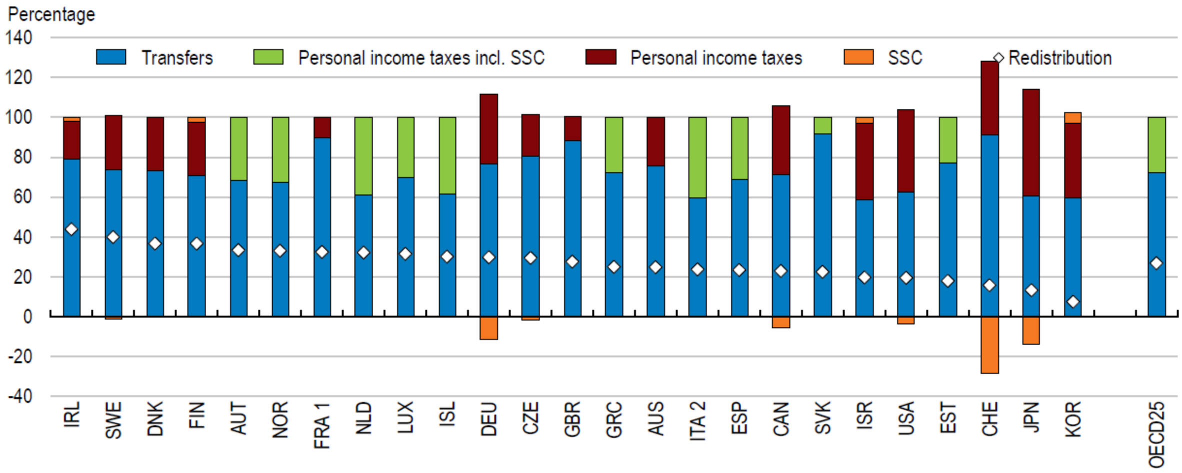
Top PIT rates in OECD countries, 2019



Source: OECD Taxing Wages models

- The overall redistributive impact of the income tax and transfer system in Italy is close to the OECD average, with a greater than average proportion (40%) of that redistribution coming from the income tax (PIT plus SSC) system. (This almost entirely comes from PIT, as the employee SSC is a flat rate in Italy).

Share of total redistribution, working-age population, 2013 or latest available year



Notes:

1. Social security contributions not available for France.
2. For Italy taxes and social security contributions are based on imputed values.

Redistribution is measured by the percentage change in gini coefficients calculated for before and after tax/transfer income. See Causa and Hermansen (2017) for more detail.

Source: Causa and Hermansen (2017) "Income Redistribution Through Taxes and Transfers Across OECD Countries", OECD Economics Department Working Papers, No. 1453.