

# The 1973-74 Tax Reform in Italy: A Partial Success with Many Shortcomings

## I. Introduction

1. The debate over taxation policy has grown increasingly heated in Italy in the last few years. Vast groups of the population organized in trade unions and associations have mobilized over tax issues. The government is struggling to find ways of meeting both the demands of an extremely high and still expanding public expenditure, and the pressures for a distribution of the tax burden that is fairer and offers greater incentives. The experts are asking themselves whether the tax reform introduced barely ten years ago has been a failure, what are the causes of its shortcomings, and what changes need to be made to eliminate them.

In today's debate old questions are re-emerging as regards the new tax situation produced by the reform. Is taxation in Italy excessive or insufficient — and by what standards? Has it grown too sharply over recent years as compared with its relative immobility in pre-reform years? Has increased taxation been spread too unevenly among social categories, types of income and classes of income? Are the results of the tax reform as regards the level of taxation and its distribution among the population due to external factors that could not have been foreseen when the reform was introduced, or are they also to be ascribed to the foreseeable behaviour of legislator, taxpayer and financial administration? Why does the reform seem only to have succeeded in its purpose of increasing the tax yield while failing to achieve the other objectives it was designed for? What objectives can still be assigned to our tax system above and beyond that of supplying the revenue required for financing (to what extent?) public expenditure? Is our tax system still capable — and if so, how far — of ensuring a more equable distribution of income and riches, of regulating the Italians' purchasing-power and

overall expenditure, of eliminating distortions and inefficiency, and of stimulating investments and production? What kind of tax structure is capable today of pursuing these aims without entailing unacceptably high costs in administration and compliance? How is the public choice process affected by a high taxation rate, and how is the behaviour of legislator, taxpayer and financial administration affected when the overall revenue from taxation amounts to about half of the gross domestic product?

The answer to these traditional questions must take into account the trends that have emerged and the experience accumulated in the ten years since the tax reform came into effect. The aim of this article is not to give direct answers to the questions just listed,<sup>1</sup> but to draw attention to a number of results of the Italian 1973-74 tax reform which may offer useful elements for finding such answers. It will thus deal with the fundamental changes in the level and the composition of taxation in the post-reform years in Italy with reference to the earlier situation and to that obtaining in comparable countries; it will suggest how the undeniable success of the reform in increasing the tax yield is actually the source of the present difficulties of our tax system, and it will touch on the most important outstanding problems in the light of recent experience as well as on what prospects there are of a solution — however hard to find and shortlived this may be.

A convenient occasion to re-examine these issues is supplied by the recent publication of Cesare Cosciani's papers on public finance,<sup>2</sup> which are an excellent guide to the possibilities and limits of any tax reform. Cosciani's direct involvement in the drafting of the two main post-war Italian tax reforms (1951 and 1973-74), his thoroughgoing analyses of their theoretical bases and their applicability to the Italian situation, his critical reservations on many choices made over-hastily or not made at all, and his suggestions for alternative technical solutions make him an exception to that tendency to neglect the concrete problems of taxation policy that James Buchanan sees as characteristic

of the Italian tradition of public finance.<sup>3</sup> The contribution of Cosciani and other authors during the period after the second world war to enriching the Italian tradition in Public Finance will help us to get a clearer idea of which changes in the level and the structure of taxation produced by the reform were expected and wished for, and which, on the other hand, were unforeseen and unsought it will also help us to analyse the reasons for the imperfect implementation of the reform by distinguishing those that can be ascribed to the limitations of the scheme itself from those connected with the profound changes that have occurred in the general economic situation and in the priorities of the objectives of economic policy over the last decade; lastly, it will help us to identify the main problems still hampering the implementation of the tax reform and to explore solutions which may be practicable today.

## II. Variations in the Level and Composition of Revenues from Taxation after the 1973-74 Reform

2. During the nineteen-sixties, when the tax reform was being prepared (until the outline law was issued in 1971), the Italian economy formed part of a relatively stable context of international economic and financial relations. It had a positive and fairly steady income growth rate, a relatively mild inflation rate, a public expenditure level only slightly higher than the average of the OECD countries and still well below that of the EEC, with a public budget current account surplus practically equal, in terms of gross domestic product, to that achieved on average by EEC and OECD countries.

During the seventies, when the tax reform framed in the previous years came into force, the international economic and financial situation was troubled and uncertain, the growth rate of the product slower and unsteadier, the inflation rate very high, public expenditure rapidly increasing so as to overtake the average of EEC countries in terms of GDP, and the public sector budget current account in deficit. Thus, in a

<sup>1</sup> Many of these questions have been formulated, and some answers attempted in E. Gerelli and M. Vitale (eds.), *È fallita la riforma tributaria*, Milano, Angeli, 1979; A. PEDONE, *Evasori e tartassati. I nodi della politica tributaria italiana*, Bologna, Il Mulino, 1979; R. VALIANI, *La tassazione diseguale*, Roma, FNDAL, 1982; E. Gerelli and R. Valiani (eds.), *La crisi dell'imposizione progressiva sul reddito*, Milano, Angeli, 1984, which also contain an abundant bibliography.

<sup>2</sup> C. COSCIANI, *Scritti scelti di finanza pubblica*. Reprinted by his pupils on his 75th birthday, Padova, Cedam, 1983. The present references, unless otherwise indicated, are to the papers reprinted in this volume. For references to other writings not reprinted there, see the "Bibliografia generale degli scritti di Cesare Cosciani" (compiled by A.M. Cavaniglia) included in the same volume, pp. 1063-1076.

<sup>3</sup> J.M. BUCHANAN, "La scienza delle finanze: The Italian Tradition in Fiscal Theory", in *Fiscal Theory and Political Economy*, Chapel Hill, The University of North Carolina Press, 1960: "With rare exceptions, the Italians have not been greatly interested in fiscal reforms (p. 34) ... No reforming spirit has guided the Italians. This has made their arguments seem sterile and devoid of normative content (p. 72)".

far more uncertain and unstable economic situation, with a far lower GDP growth rate and a far higher inflation rate than foreseen, the new tax system introduced by the reform was faced with an extremely high, and still rapidly increasing, level of public expenditure. The requirements of financing public expenditure and containing the deficit became overriding; the previous evolution of budgetary items conditioned their present level and imposed strict constraints on their use for objectives other than those of reducing the imbalances accumulated.

Averaged over the whole 1960-82 period, the proportion of the GDP devoted to total public expenditure is two and a half percent less in Italy than in the EEC countries as a whole and four percent higher than in OECD area countries (Tab. 1). The situation is much the same if

TABLE 1  
PUBLIC EXPENDITURE AND PUBLIC REVENUES IN % OF THE GDP:  
AVERAGES PER PERIOD

|                            | 1960-82 | 1960-67 | 1968-73 | 1974-79 | 1980-82 |
|----------------------------|---------|---------|---------|---------|---------|
| Total Public Expenditure   |         |         |         |         |         |
| A) Italy                   | 38.2    | 31.9    | 36.0    | 42.9    | 50.3    |
| B) EEC                     | 40.7    | 34.9    | 39.0    | 45.7    | 49.7    |
| C) OECD                    | 34.2    | 29.9    | 32.9    | 37.7    | 41.2    |
| D = A - B                  | - 2.5   | - 3.0   | - 3.0   | - 2.8   | + 0.6   |
| E = A - C                  | + 4.0   | + 2.0   | + 3.1   | + 5.2   | + 9.1   |
| Current Public Expenditure |         |         |         |         |         |
| F) Italy                   | 34.3    | 28.2    | 32.4    | 38.7    | 45.4    |
| G) EEC                     | 36.2    | 30.5    | 34.1    | 41.2    | 45.6    |
| H) OECD                    | 30.6    | 26.4    | 29.3    | 34.1    | 37.7    |
| I = F - G                  | - 1.9   | - 2.3   | - 1.7   | - 2.5   | - 0.2   |
| L = F - H                  | + 3.7   | + 1.8   | + 3.1   | + 4.6   | + 7.7   |
| Current Public Revenue     |         |         |         |         |         |
| M) Italy                   | 32.3    | 29.7    | 30.8    | 33.5    | 39.5    |
| N) EEC                     | 38.3    | 34.0    | 37.8    | 41.5    | 44.4    |
| O) OECD                    | 32.1    | 28.8    | 31.8    | 34.5    | 36.9    |
| P = M - N                  | - 6.0   | - 4.3   | - 7.0   | - 8.0   | - 4.9   |
| Q = M - O                  | + 0.1   | + 0.9   | - 1.0   | - 1.0   | + 2.6   |

Source: derived from OECD data in *Historical Statistics, 1960-1982* (Paris, 1984).

only current public expenditure is taken into account. However, what distinguishes the Italian experience most sharply from that of the EEC countries as a whole, and even more so, from that of the OECD area, is its performance during the various sub-periods. Italy's relative "excess" in the public expenditure/GDP ratio as compared with the OECD area has increased in each of the sub-periods, from two percent in the first sub-period (1960-67) to over nine percent at the beginning of the eighties (Tab. 1). Similarly, its relative "inferiority" as compared with the EEC countries has gradually diminished from the three percent of the first two sub-periods until it has completely disappeared in the early eighties.

The difference in Italy's performance from that of the EEC and OECD countries as a whole is confirmed if we look at the annual data on the levels of current public expenditure and current public revenue (Fig. 1) and on the "gaps" between the Italian situation and that of these countries (Fig. 2), as well comparing the data in detail (Tab. 2). The level of total public expenditure as a share of GDP in Italy between 1960 and 1982 has increased by about 24 percentage points compared with the average of about 19 and 14 percentage points for the EEC countries and for the OECD countries.

Not only has the increase in Italy been much greater than in the other European and western countries as a whole, but it has also been largely concentrated in the period after 1973, when the tax reform came into force. From the data shown in Tab. 2, it can be seen that whereas between 1960 and 1974 the growth of the overall public expenditure level in Italy was comparable with the OECD average and lower than that of the EEC, the situation in 1982 compared with that in 1974 reveals an increase in Italy that is more than twice that found in the OECD countries (15.8 percent as against 7.2) and almost twice that of the EEC countries.

Obviously the results of these comparisons need interpreting with caution, since they depend on different initial levels in the individual countries, on the relative dynamics of public expenditure and Gross Domestic Product and on the changing importance of the various countries within the EEC as a whole and within the OECD area. Allowance must also be made for the limitations of comparisons based on a notion of public expenditure derived from national economic accounts (which nevertheless is the only commensurable one for the purposes of international comparisons), thereby neglecting some items of public expenditure of a strictly financial nature, which, if they were

FIGURE 1  
TOTAL PUBLIC EXPENDITURE (—) AND CURRENT PUBLIC REVENUES (-----)  
IN % OF THE GDP

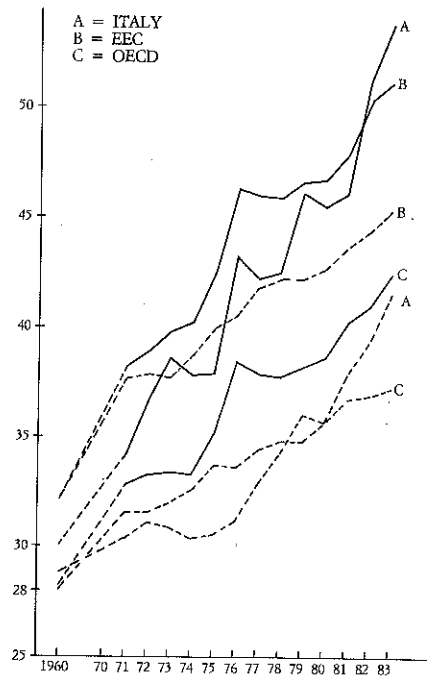


FIGURE 2  
GAP BETWEEN THE LEVEL OF PUBLIC EXPENDITURE AND REVENUE  
(IN % OF THE GDP) IN ITALY AND THE AVERAGE OF EEC AND OECD COUNTRIES

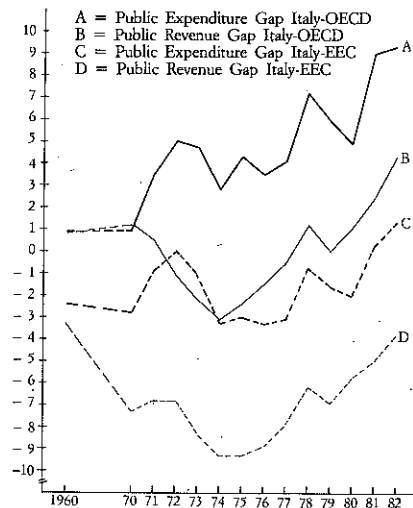


TABLE 2  
LEVEL (IN % OF THE GDP) AND CHANGE IN THE LEVEL OF EXPENDITURE AND  
REVENUES OF THE GENERAL GOVERNMENT

|                            | Level (in % of the GDP)<br>during the years considered |      |      | Change of the level between<br>the years considered |           |           |
|----------------------------|--|------|------|---|-----------|-----------|
|                            | 1960   | 1974 | 1982 | (1982-60)   | (1974-60) | (1982-74) |
| Total Public Expenditure   |  |      |      |   |           |           |
| Italy                      | 30.1   | 37.9 | 53.7 | 23.6  | 7.8       | 15.8      |
| EEC                        | 32.2   | 42.5 | 51.1 | 18.9  | 10.3      | 8.6       |
| OECD                       | 28.2   | 35.2 | 42.4 | 14.2  | 7.0       | 7.2       |
| Current Public Expenditure |  |      |      |   |           |           |
| Italy                      | 26.2   | 34.4 | 48.5 | 22.3  | 8.2       | 14.1      |
| EEC                        | 28.6   | 37.7 | 47.2 | 18.6  | 9.1       | 9.5       |
| OECD                       | 25.3   | 31.6 | 39.2 | 13.9  | 6.3       | 7.6       |
| Current Public Revenues    |  |      |      |   |           |           |
| Italy                      | 28.8   | 30.6 | 41.5 | 12.7  | 1.8       | 10.9      |
| EEC                        | 32.1   | 39.9 | 45.3 | 13.2  | 7.8       | 5.4       |
| OECD                       | 28.0   | 33.7 | 37.2 | 9.2   | 5.7       | 3.5       |
| Current Balance            |  |      |      |   |           |           |
| Italy                      | 2.6  | -3.8 | -7.0 | -9.6  | -6.4      | -3.2      |
| EEC                        | 3.5  | 2.2  | -1.9 | -5.4  | -1.3      | -4.1      |
| OECD                       | 2.7  | 2.1  | -2.0 | -4.7  | -0.6      | -4.1      |

Source: derived from OECD data in *Historical Statistics, 1960-1982* (Paris, 1984).

taken into account would very likely accentuate the differentiating features of the Italian situation. Moreover, the ratios calculated here, if used for other purposes than the present ones, would need to be adjusted to allow for the cyclic element and the different degrees of automatic flexibility of public expenditure and revenue from taxation, for the influence of inflation, and for the different degree of development of per capita income achieved in single countries or groups of countries. For our purposes, however, the data available is sufficient to point to what appears an indisputable fact: *the boom in public expenditure coincides with the implementation of the tax reform.*

To recognize this fact does not, of course, solve the problem of causal relationships: was it the sharp expansion of public expenditure that gave rise to a large increase in taxation, or was it the rapid growth of the latter which facilitated the boom in public expenditure? The issue is further complicated in the Italian situation by the fact that the marked expansion of public expenditure and taxation was accompanied by an increase in the public deficit. Was it the fact that deficit financing of public expenditure was felt to be less burdensome that gave rise to the public expenditure expansion, and would that expansion have been contained had it to be financed by greater revenues deriving from increased taxes? Or was it the rise in revenue from taxation that provided the initial impulse which led to the budgeting of public expenditure consistently in excess of the increased revenues?

The relative explosion of public expenditure during the last decade, however, has been offset by an unprecedented increase in revenue from taxation, even though this has not been sufficient to absorb the growth in public expenditure entirely. Over the 1960-82 period as a whole, the level of current public revenue in Italy has been more or less the same as that of the OECD area countries and no less than 6 percent below the EEC average (Tab. 1; for the trends in the annual differential, see Fig. 2).

Here too, the "inferiority" of the Italian level of taxation, which was extremely limited in the early sixties, grew rapidly, and only in the last few years has been reduced drastically. The detailed comparison given in Tab. 2 shows this tendency clearly. Between the beginning (1960) and the end (1982) of the period considered, the rise in the level of current public revenue in Italy has been only slightly below the EEC average and much higher than that of OECD countries. However, whereas the increase in the EEC and OECD countries took place mainly between 1960 and 1974, when in Italy it was negligible (less than two percent as against about eight percent in EEC countries: see Tab. 2), between 1974 and 1982 we find in Italy an increase in the level of current public revenue of nearly 11 percent, which is more than twice that of EEC countries and more than three times that of the OECD area countries. During the last decade, in Italy, the great expansion in public expenditure goes hand in hand with an exceptional growth in current revenue, especially that from taxation, though this is not large enough to offset the public deficit.

3. The sharp rise in taxation following the 1973-74 reform can be considered as "insufficient" compared to the financing required by the

high level of public expenditure, "excessive" compared to the degree of development or to the cyclic situation of the economy, and being imposed by what is held to be too high a level of public expenditure, or again, as "too low" to represent an effective check on further expansion of public expenditure financed to a large extent in deficit.

Above and beyond possible contrasting evaluations as to whether taxation in Italy is adequate, it cannot be denied that there has been a steep increase in the tax yield in the post-reform years, an increase with few precedents in the past experience of Italy or other industrialized countries. It should also be remembered that, paradoxically, at the time when the outline law containing the draft of the tax reform was passed, it was widely feared that there might be a drop in the tax yield.<sup>4</sup> The fact that this did not happen, and that there was an unprecedented expansion of revenue from taxation, does not prove that these fears were unfounded but shows, rather, the extent to which the unforeseen result was affected by the change in the economic situation (above all by high inflation), and by the distortion of the original reform bill and the numerous technical expedients adopted for collecting the taxes in advance.

During the pre-reform years, the level of taxation had been relatively diminishing as compared with that of the other industrialized countries. The decline in the value of the ratio between revenue from taxation and GDP had begun in the early sixties,<sup>5</sup> and it continued to all intents and purposes until about half way through the seventies — at least, as far as revenue from taxes in the strict sense is concerned (*i.e.* overall taxation minus social security contributions). Unlike what was happening in many industrialized countries, in Italy the level of taxation in relation to the GDP seemed incapable of rising, in spite of the sharp

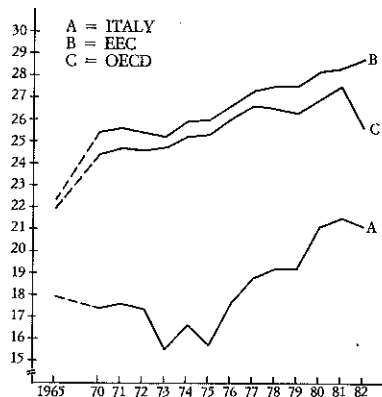
<sup>4</sup> In an article which appeared in *Moneta e Credito* in 1971, No. 96, pp. 381-406, with the title "Considerazioni sulle aliquote delle imposte dirette nel quadro della riforma tributaria", C. COSCIANI, while declaring that the lack of sufficiently exact data made a quantitative estimate of the consequences of the tax reform impossible, expressed the view that "apart from the temporary effects deriving from the initial application of the reform, the drop in tax yield might turn out to be alarming" (p. 909 of the *Scritti*).

<sup>5</sup> According to the data contained in an OECD report (*Tendances à long terme des recettes fiscales des pays membres de l'OCDE 1955-1980*, Paris, 1981), in 1960 Italy apparently was the country with the highest overall taxation level in relation to its GDP. It was thus ahead of countries generally held to be more severe fiscally, such as the United Kingdom (in sixth position) or Sweden (in ninth position), being no less than eight percent above the average of the eighteen countries considered. Even if these data seem surprising and unexpected, and are certainly open to question, it must be remarked that this is the only broad international comparison to have been made over a long period of time by an organization in which the Italian government participates officially supplying basic information, and whose statistics are usually held to be wholly reliable.

expansion of public expenditure. The tax system in force before the reform seemed to have exhausted its potential for obtaining a flow of tax revenues sufficient to offset the expansion of current public expenditure. The result was a series of deficits which, due to the increasing burden of nominal interests on the national debt and the slow growth of the GDP, began to be self-fuelling and helped to distinguish the Italian situation ever more sharply from that of the other leading industrialized countries. This "incapacity" of the pre-reform tax system to produce a yield sufficient to finance to a large extent a sharp expansion of public expenditure needs to be taken into account in evaluating some of the options made when the reform was framed and during its first period of implementation.

The relative drop in the "productivity" of the Italian tax system up to the middle of the seventies is clearly shown by the data given in Fig. 3, which also reveals, on the other hand, the more regular trend towards a moderate, constant increase to be found in the average of the EEC countries and of the OECD area.<sup>6</sup> The negative differential between the taxation level in Italy and the average in EEC and OECD

FIGURE 3  
LEVEL OF REVENUES FROM TAXATION IN THE STRICT SENSE (IN % OF THE GDP)

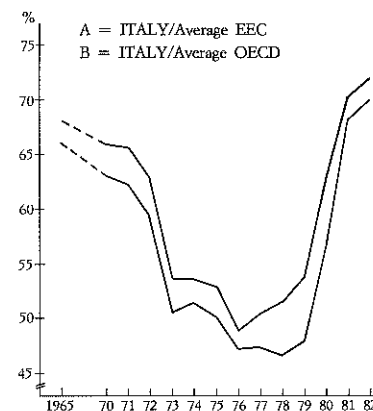


<sup>6</sup> When evaluating these different performances, we must not overlook the limitations of any comparison of taxation levels between different countries, especially between groups of countries that are not entirely homogenous. These derive in particular from the varying range of tax expenditures in individual countries, from the varying degrees of accuracy of the estimates of national accounts, and from the varying impact of recurrent or occasional taxation. For an international comparison of the level and structure of taxation, see A. PEDONE, "Tendenze del prelievo tributario in alcuni paesi industrializzati", in *Aspetti del sistema tributario italiano*, Roma, Camera dei Deputati, 1980, pp. 1-38.

countries, which was around four percent half way through the sixties, gradually rose until it reached 10 percent in 1975, and then shrank again after the second half of the seventies due to the steep increase in the taxation level that followed the introduction of the 1973-74 reform.

The sharply differentiated performance of the taxation/GDP ratio during the first and second half of the seventies is confirmed also by Fig. 4, where the overall per capita taxation in Italy and in the average of EEC and OECD countries is expressed in comparable units of purchasing-power. It shows that whereas half way through the sixties each Italian paid the State two-thirds of what, on average, a member of the EEC and OECD countries paid, this percentage diminished constantly during the first half of the seventies. It then began to grow very rapidly once more during the late seventies, and at the beginning of the eighties it outstripped any value previously attained (whilst nevertheless remaining around 70% of the taxation, expressed in dollars, borne on average by members of EEC and OECD countries).

FIGURE 4  
PER CAPITA TAXATION IN DOLLARS: ITALY COMPARED WITH THE AVERAGE OF EEC AND OECD COUNTRIES



It is precisely because of its success in rapidly gathering vast revenues that our tax system is faced with such serious problems today. The way in which the unforeseen and exceptional expansion of the tax yield has taken place during the last few years has brought to light and accentuated problems present right from the beginning of the tax reform. Corrections have thus become necessary today, if for no other

reason than to maintain the system's capacity to produce tax yield without imposing too many sacrifices on the other objectives usually set for the tax system. The objective of collecting an increasingly high yield has, in fact, made it harder to use the tax system effectively for other important purposes of economic policy (from a not-too-unequal and possibly progressive distribution of the actual tax load, to manoeuvring-capacity for controlling the economy in the short term, to the reduction of disincentives to investments). It has led to increasing resistance to further expansion and even made it difficult simply to keep up the level of taxation reached today, without radical innovations in the present tax system.

4. The drawbacks that have accompanied the success in increasing the tax yield derive mainly from three features that have marked the growth of taxation in Italy in recent years: it has occurred in a very brief span of time, it has varied greatly from year to year, and it has affected a very small number of taxes, producing a very strong swing from indirect taxation to direct taxes. These three features are linked up with the way taxation has varied with the passage of time and with changes in its composition; their role is confirmed by all the data available.

The extreme concentration in a brief time-span of the increase in taxation is shown clearly by the data given in Tab. 3. Between 1960 and 1983 overall taxation increased, in terms of the GDP, by more than 16 percentage points, but of this little over 1 point was realized between 1960 and 1974, as opposed to 15 percentage points in the shorter interval between 1974 and 1983. The increase in the level of taxes in the strict sense over the whole 1960-83 period (just under 10 percentage points) is actually the resultant of a reduction in the first sub-period, and of an exceptional increase (over 11 points) in the years 1974-83, 8 of which concentrated in the last years between 1979 and 1983, four-fifths of this being due to the increased incidence of direct taxation.

This steep rise in taxation concentrated in the last few years has been also accompanied by an extreme variability in growth rates which does not appear in any way systematically correlated (whether in a pro-cyclic or anti-cyclic sense) with the rates of change of the GDP or of public expenditure. It is clear from Fig. 5 that in spite of the increased range of oscillation of the rates of change of the nominal GDP during the last decade, the value and range of oscillation of the growth rates of the current public expenditure are greater. Even greater, with exceptionally high peaks, are the oscillations in the growth rates of revenue from taxation in the strict sense.

TABLE 3  
CHANGES IN THE RATIO OF TAX REVENUES TO THE GDP

|                                     | (1983-60) | (1974-60) | (1983-74) | (1983-79) |
|-------------------------------------|-----------|-----------|-----------|-----------|
| Total Tax Revenues                  | +16.4     | + 1.4     | +15.0     | + 9.9     |
| Social Security Contributions       | + 6.6     | + 3.0     | + 3.6     | + 1.9     |
| Tax Revenues in the<br>Strict Sense | + 9.8     | - 1.6     | +11.4     | + 8.0     |
| Direct Taxation                     | +10.4     | + 0.7     | + 9.7     | + 5.9     |
| Indirect Taxation                   | - 0.6     | - 2.3     | + 1.7     | + 2.1     |
| IRPEF                               | —         | —         | + 6.5     | + 3.4     |
| VAT                                 | —         | —         | + 0.9     | + 1.2     |

Source: derived from data in the *Relazione Generale sulla situazione economica del paese*, various years.

Apart from the increase in volume, the concentration in a narrow time-span and the high degree of variability, taxation since the reform has shown profound changes in its composition. At the level of the overall revenues of the general government (Fig. 6), such are the dimensions of the changes in composition between the main revenue categories that they make irrelevant the normal reservations about using these aggregate categories because of their composite nature and because of the limited and variable correspondence between the formal definition and the actual character of the individual kinds of taxes.

Indirect taxation, which amounted to 44% of the overall taxation at the beginning of the sixties, has almost halved its percentage, dropping rapidly to about 25% of the total at the beginning of the eighties. Social welfare contributions, which have always been a substantial portion of overall taxation, increased in percentage until half way through the seventies (nearing 48% of the total in 1975), only to lose about ten percent in the following years. They were, in fact, compressed by the steep rise in direct taxation, which increased from less than 20% in the early sixties to 36% in 1983 (13 out of the 16% increase being concentrated in the 1975-1983 period). The dramatic inversion of roles between direct and indirect taxation during the seventies is also confirmed in terms of its incidence on the GDP (Fig. 7). Here there is clearly a trend towards increase for all three categories of revenue during the last few years; however, direct taxation reveals a far

FIGURE 5

ANNUAL RATES OF CHANGE OF THE GDP (.....), OF CURRENT EXPENDITURE (—) AND OF TAX REVENUES IN THE STRICT SENSE (---) OF THE GENERAL GOVERNMENT

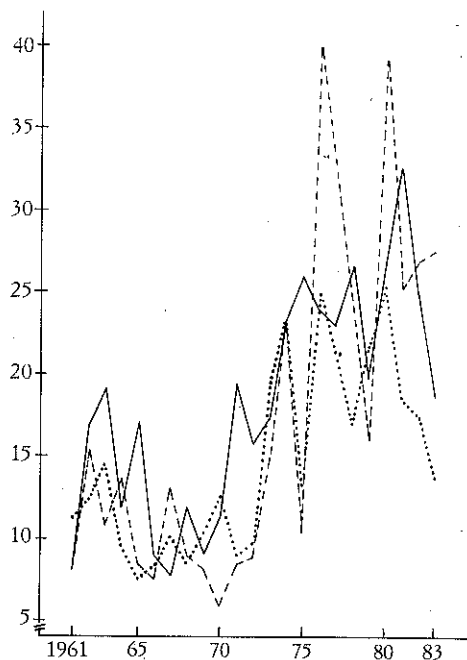


FIGURE 6

% COMPOSITION OF THE TAX REVENUES OF THE GENERAL GOVERNMENT

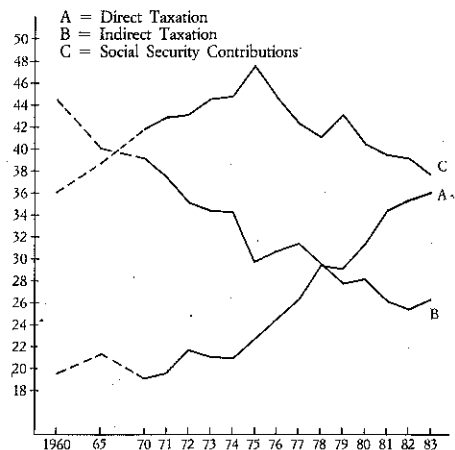
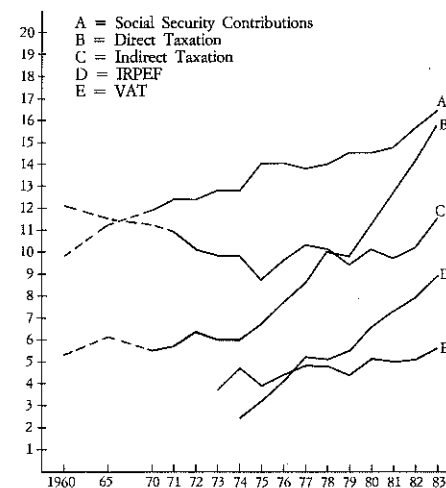


FIGURE 7

TAX REVENUES OF THE GENERAL GOVERNMENT IN % OF THE GDP IN ITALY



sharper acceleration, driven as it is by the progressively growing incidence of the IRPEF (Imposta sul Reddito delle Persone Fisiche, i.e. Individual Income Tax), which accounts for over two-thirds of the growth in direct taxes.

Among the Central Government revenues from taxation, the IRPEF took up the leading position in the period immediately after the introduction of the reform. This position has been further accentuated with the passage of time, the original 21% of the total in 1975 increasing to 35% in 1983 (Tab. 4). It has thus become quantitatively by far the most important single form of taxation in our system. The Value-Added Tax (VAT) has not got off to such a good start, its proportion of the total Central Government revenues from taxation remaining just over 20%. In terms of the GDP too (Fig. 7), it has shown only a marginal increase.<sup>7</sup> As a whole, IRPEF and VAT have accounted for over half of Central Government taxation since the tax reform was introduced. The extreme concentration of Central Government tax revenues in these two particular forms of taxation has further increased in the last few

<sup>7</sup> For an analysis of the reasons for the relative failure of VAT in terms of the yield expected, see A. PEDONE, "Italy", in H.J. Aaron (ed.), *The Value-Added Tax. Lessons from Europe*, Washington, The Brookings Institution, 1981, pp. 31-42.



years, and even if we include a wider range of taxes in our comparison it still remains very high (Tab. 4). The success of the 1973-74 tax reform, in terms of increased yield, is thus mainly due to the IRPEF and, to a much lesser extent, to the VAT.

TABLE 4

CENTRAL GOVERNMENT TAX REVENUE: PERCENTAGE SHARE OF THE MAIN TAXES

|                          | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|--------------------------|------|------|------|------|------|------|------|------|------|
| A) IRPEF                 | 21.2 | 24.5 | 28.2 | 26.0 | 29.0 | 32.6 | 34.7 | 33.4 | 34.9 |
| B) VAT                   | 11.9 | 25.5 | 26.0 | 24.3 | 22.8 | 24.2 | 23.0 | 21.4 | 21.4 |
| A + B                    | 33.1 | 50.0 | 54.2 | 50.3 | 51.8 | 56.8 | 57.7 | 54.8 | 56.3 |
| C) Taxes on Oil Products | 4.7  | 13.1 | 12.6 | 11.1 | 11.1 | 9.2  | 7.9  | 7.4  | 7.8  |
| A + B + C                | 47.8 | 63.1 | 66.8 | 61.4 | 62.9 | 66.0 | 65.6 | 62.2 | 64.1 |
| D) Tax on interest       | 5.2  | 7.8  | 7.6  | 9.3  | 7.4  | 8.4  | 9.3  | 9.7  | 7.6  |
| A + B + C + D            | 53.0 | 70.9 | 74.4 | 70.7 | 70.3 | 74.4 | 74.9 | 71.9 | 71.7 |
| E) ILOR                  | 1.4  | 1.7  | 1.1  | 7.5  | 6.7  | 6.1  | 6.1  | 6.0  | 5.8  |
| A + B + C + D + E        | 54.4 | 72.6 | 75.5 | 78.2 | 77.0 | 80.5 | 81.0 | 77.9 | 77.5 |

Source: derived from data of the *Ministero delle Finanze* (Ministry of Finance).

The rapid growth of tax revenue, with the exceptional expansion of the IRPEF, was quite unforeseen and largely due to external factors, like high inflation, to a number of occasional and unrepeatabe measures (such as the "condono", a conditional tax amnesty), and to some administrated measures (such as an extention of deductions at the source and payment in advance). Though unforeseen and mainly due to external and occasional factors, this success in terms of a sharp spontaneous increase in yield caused a certain neglect of problems of the distribution of the tax burden and of unequal application of individual taxes consequent on and heightened by the growth in yield. Now that the external factors inducing yield increase have diminished their impact, these problems have come once more to the forefront.

### III. The Problems Deriving from the Implementation of the 1973-74 Tax Reform

5. The problems of spreading the tax burden and of applying taxes uniformly were discussed at length by the Commission for the reform of taxation in the sixties. It clearly pointed out the dangers of an excessive concentration on the progressive taxation of income, especially when this might not be uniformly applied either because of legislative delimitations or administrative shortcomings.

The limits that progressive taxation of incomes comes up against when it is assigned tasks too vast and varied and when it is not applied in a sufficiently uniform fashion have been revealed by the experience of many countries and have been frequently analysed. Hence when the bill was being drafted the tax on income was intended to be accompanied by a widespread taxation of consumption and a property tax. What hampered a wider use of taxes on consumption was a reaction against what was felt to be their excessive incidence until half way through the seventies (Figs. 6 and 7) and the related appearance of contraband and evasion phenomena, together with the assumption that these taxes are regressive, and a reluctance to increase them owing to the presence of wage-indexation mechanisms which would have amplified their impact on prices in a period in which inflation was already high. These reasons for opposing a wider use of taxes on consumption should by now have decreased, both because of the lower incidence this form of taxation now has in the overall revenue from taxation and on the gross domestic product, and because their regressivity is less certain given the highly differentiated consumption patterns, as well as because of the drop in inflation and the possibility of isolating wage-indexation mechanisms from the variations of indirect taxation.

During the drafting of the reform it was also urged that, together with maintaining taxes on consumption in a more significant role, there should also be introduced an ordinary property tax with a proportional and uniform rate, and a real and general character. In Cosciani's opinion,<sup>8</sup> the decision not to introduce one "was a serious error" and

<sup>8</sup> C. COSCIANI, "La riforma tributaria: speranze e preoccupazioni", in *Moneta e Credito*, 1967, No. 79, pp. 243-264, repr. in *Scritti scelti*, p. 868; for a fuller analysis of the reasons for the adoption of a property tax, see *L'imposta ordinaria sul patrimonio nella teoria finanziaria*, 1940, in *Scritti scelti*, pp. 111-191.

“seriously distorted the original scheme of the tax reform”. This was not only because “it would have been convenient not to concentrate the whole burden of direct taxation on a single tax base — income — but to shift at least part of this onto another base, such as property, partly to avoid an excessive tendency towards evasion”, but also because it would have had a positive effect on production and have permitted a qualitative distinction between incomes — results which, as it turned out, income tax was intended to achieve, thereby complicating this form of taxation enormously.

In this way income tax was deprived of the support of a widespread taxation of consumption and of a property tax, with which it could have been combined to relieve the pressure on a particular tax base as well as to make possible cross checks that would have made evasion harder and less advantageous. But the IRPEF was not only deprived of these two important supports foreseen in the reform project. Its implementation, too, turned out to be distorted and unequal with regard to the various types of income, in spite of the intentions outlined in the draft reform. Thus, although it was conceived as a general tax on overall income, its actual field of application was limited or distorted, first during its drafting into legislation and later by the way the administration applied it.

During the drafting of the law, interest on government securities was completely exempted, while other interests (on bank deposits, on fixed-interest securities other than those of the national debt, etc.) were subjected to a schedular tax with differentiated rates; taxes on land and on part of housing income (imputed income of owner-occupied houses and of unused houses) continued to be determined on the basis of the cadastre, without this being updated, while other incomes from rented houses were to have been determined on the basis of the gross income reduced by a certain percentage; for incomes deriving from the running of a business or from arts or professions, the tax base was defined as the difference between sales proceeds and costs determined on the basis of accounts, while so-called “minor” taxpayers (*i.e.* those with annual sales proceeds below 480 million Lire, raised to 780 million in 1983) were allowed to use a “simplified” form of book-keeping.

In practice, the IRPEF has thus come to be not a general tax, but a special tax on certain incomes, in particular on incomes from employed labour and from self-employment subject to tax deductions at the

source, on pensions and dividends from shares.<sup>9</sup> Thus taxes on wages and salaries amount to over 70% of the total yield of the IRPEF (Tab. 5), in spite of the measures frequently taken to increase tax allowances for this kind of income-earner, which have further complicated the structure of this tax. Taken together with tax collected at the source on self-employed workers' income, they amount to 80% of the total yield of the IRPEF.

The exemption of a number of incomes and different procedures for determining and assessing the various types of income may appear acceptable (and to some extent inevitable) sacrifices of the principle of generality of the individual income tax when this tax is quantitatively modest and largely proportional in structure. They come, however, to be felt as unacceptable distortions when income tax produces an extremely high and increasing yield and is steeply progressive, as has been the case in recent years with the IRPEF.

TABLE 5  
CENTRAL GOVERNMENT TAX REVENUE (A), DIRECT TAXATION (B), IRPEF (C), DEDUCTIONS AT SOURCE ON EMPLOYED LABOUR (D) AND SELF-EMPLOYED LABOUR INCOME (E)

|           | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|-----------|------|------|------|------|------|------|------|------|------|
| C/A       | 21.2 | 24.5 | 28.2 | 26.0 | 29.0 | 32.6 | 34.7 | 33.4 | 34.9 |
| C/B       | 52.8 | 58.5 | 63.0 | 53.2 | 58.0 | 62.3 | 63.2 | 58.4 | 60.8 |
| D/A       | 19.9 | 16.0 | 16.4 | 17.4 | 20.8 | 22.5 | 23.8 | 23.8 | 25.2 |
| (D + E)/A | 21.2 | 17.2 | 17.5 | 18.5 | 22.1 | 23.8 | 25.3 | 25.4 | 27.2 |
| D/B       | 49.5 | 38.3 | 36.8 | 35.5 | 41.6 | 43.0 | 43.4 | 41.6 | 44.0 |
| (D + E)/B | 52.7 | 41.0 | 39.3 | 37.8 | 44.2 | 45.5 | 46.0 | 44.4 | 47.4 |
| D/C       | 93.8 | 65.4 | 58.4 | 66.8 | 71.8 | 69.0 | 68.8 | 71.2 | 72.3 |
| (D + E)/C | 99.9 | 70.1 | 62.3 | 71.2 | 76.3 | 73.1 | 72.8 | 75.9 | 78.0 |

Source: derived from data of the *Ministero delle Finanze*.

<sup>9</sup> For a detailed quantitative analysis of the various forms of erosion linked to the different models of exemption and determination of the individual sources of income, see V. VISCO, “Disfunzioni ed iniquità dell’IRPEF e possibili alternative: un’analisi del funzionamento dell’imposta sul reddito in Italia nel periodo 1977-83”, in E. Gerelli and R. Valiani (eds.) *La crisi, cit.* pp. 75-195; G. VITALETTI, “La struttura e la dinamica dell’imposizione diretta”, in E. Gerelli and A. Majocchi (eds.), *Il deficit pubblico: origini e problemi*, Milano, Angeli, 1984, pp. 307-359. On the features which a general tax on income ought to have included, see C. COSCIANI, “I problemi fondamentali della riforma tributaria” (1948), in *Scritti scelti*, pp. 626f.

The principle of generality of the taxation on income was first violated, as Cosciani noted<sup>10</sup> "by excluding from the overall income those incomes from government securities, private bonds and bank deposits, thereby creating a situation far worse than that obtaining before income surtax was abolished". Of course, a preferential treatment for some types of income could be maintained, but there should at least be "an obligation to declare the interests exempt from personal taxation or taxed definitively at the source, for the sole purpose of calculating the average tax-rate of the overall income in order to apply it to that portion which is not exempt", or the taxable income should be limited only as regards that portion of the interest earned during the year that is to be calculated on the basis of the inflation rate.

The second violation of the principle of generality and homogeneity in the determination of income derives from the incomes assessed through the land register (landed property and real estate). Apart from the traditional justification that this kind of assessment is an incentive to productivity (*i.e.* determining the ordinary average income on the basis of the land register would reward those who succeed better in exploiting their resources and punish those who use them less effectively), it also seems to be functional when agricultural activity is broken up into a large number of small farms.<sup>11</sup> However, it is clear that — especially in a period of profound and frequent transformations in production and of sharp variations in the general level of prices and in relative prices — the determination on the basis of the land register of a large portion of incomes from landed property and real estate can only be satisfactory if the land register is functioning properly and is continually updated, as it could be (though at present is not) if the technology available today were made use of.

<sup>10</sup> C. COSCIANI, "I principi informativi della riforma tributaria nei lavori preparatori: validità e limiti nella situazione attuale", in E. Gerelli and R. Valiani (eds.), *La crisi, cit.*, pp. 41-2. As early as 1971 (in "Considerazioni sulle aliquote delle imposte dirette nel quadro della riforma tributaria", in *Scritti scelti*, pp. 911-2), Cosciani warned that "this modification at the legal level could acquire considerable importance if it is necessary, and to the degree it is necessary, to resort to the inductive assessment of the overall income. In fact this exemption will enable tax-evaders to prefabricate valid evidence by doing the opposite of what a certain number of shareholders do using the technique of contango, whereby the banks' portfolios swell temporarily in correspondence with the dates dividends fall due. With the new regulations, it will suffice for the taxpayer to buy government securities the day before the interest coupons fall due, to cash them and have this operation documented by the bank, and to resell the government securities the following day without the coupons. In this way he can demonstrate to the tax authorities that he possesses a (fictitious) income exempt from the personal tax."

<sup>11</sup> Here, "analytical assessment and inspection would be impossible and would inevitably lead to flat-rate payments, which would be neither more nor less than a worse version of the land register system" (C. COSCIANI, "I principi informativi...", *cit.*, pp. 43-4).

Lastly, the determination of incomes derived from the running of a business or from professional activities can only be carried out by calculating the difference between costs and sales proceeds on the basis of a complete and verifiable system of accounting. Thus, in principle, the tax reform of 1973-74 extended the obligation to keep account records to members of professions and to businesses run by individual persons and by partnerships, reaffirming the concept that the IRPEF's object is the actual income and that what is to be taxed should be determined by analytical procedures. In practice, however, the majority of "minor" taxpayers (95% of businesses, excluding corporations) were allowed to use the so-called simplified book-keeping, that prevents any reliable and verifiable assessment of the tax base for the purposes either of the IRPEF or the VAT.

With the extension of the IRPEF and, to a lesser extent, of the VAT to a great number of taxpayers after the tax reform, the basic principle of assessment laid down in this same law (namely that the analytical method based on documentation is to be used, and may only be replaced by the synthetic-inductive method if strictly defined circumstances or presuppositions obtain) seemed inapplicable to most taxpayers in the arts and professions and to businesses other than corporations, partly because of the high cost for many minor taxpayers of adopting a system of ordinary and verifiable book-keeping. However, allowing the majority of small businesses and members of the arts and professions to make use of simplified book-keeping has meant accepting, in the words of the Finance Minister Visentini, an "arbitrary, subjective and unverifiable assessment of taxable incomes by the taxpayers themselves". The right of minor taxpayers to determine their own taxable incomes has so far been granted for nothing. The recent proposal to determine the taxable income of minor taxpayers who opt for the system of simplified book-keeping by applying forfait coefficients to their gross sales proceeds should make this option relatively costly, redistribute the IRPEF burden more evenly over the various types of income, and drive a larger number of taxpayers towards forms of analytical and verifiable assessment of taxable income.

6. Apart from the almost "solitary" role that the IRPEF has come to play in collecting the greater part of the increased revenue from taxation in the post-reform period, and apart from the lack of generality and homogeneity in the incomes that form the tax base of the IRPEF, the current problems of our taxation system can also be blamed on the failure to adapt the organization, procedures and methods of the financial administration to the new circumstances.

During the drafting of the reform, this problem was frequently stressed. It was in fact constantly pointed out how the success of the reform would depend on the capacity to meet the demands of the new tax system shown by "the structures of the financial administration, both as regards the number, professional training and territorial distribution of its personnel, especially those in charge of tax assessment, and as regards its equipment procedures and working techniques".<sup>12</sup> The administration failed to adapt adequately, despite the wide use of technically advanced computers. This confirmed Cosciani's opinion<sup>13</sup> that "the two experiences of tax reform in Italy (1951-56 and 1973-74) clearly show that any reform which lacks a satisfactory administrative structure in its services and is not preceded by a sufficient reorganization of these cannot fulfil the hopes placed in it. Moreover, under the circumstances, the introduction of severer administrative and penal sanctions against evaders proves entirely useless as a corrective as long as the administrative machinery is incapable of functioning". This being the case, the ineffectiveness of the financial administration's activity shows up clearly when one considers that the chance that someone who fills in the annual income tax form will be subjected to an inspection is about one in a hundred, and that in the unfortunate event that he finds himself in that one percent, the higher tax ascertained is, in the vast majority of cases, only moderate in amount. If we also bear in mind the loopholes and delays in payments made possible by a prolix and practically free litigation procedure, then only if we imagined Italian taxpayers to have a profound aversion to risk could we expect a widespread voluntary compliance of the IRPEF.

The failure of the reform to pay sufficient attention to the problems of administering a mass taxation, as the IRPEF became, was made more serious by a simultaneous tendency of assessment activities to become less flexible, the tax offices tending to stress the limitations to which these were subject. The use of selective criteria in planning the work of the tax offices was not introduced until 1980 and is still in an experimental phase. Many problems have still to be solved in fact as regards the choice inspections and as regards the actual use of these

<sup>12</sup> C. COSCIANI, "I principi informativi della riforma tributaria...", *cit.*, p. 25. A detailed analysis of the changes required, and not introduced, in the organization of the financial administration and in its working methods is to be found in "Stato dei lavori della Commissione per lo studio della riforma tributaria" (1964), in *Scritti scelti*, pp. 745-834, and in "La riforma tributaria: speranze e preoccupazioni" (1967), in *Scritti scelti*, pp. 851-873.

<sup>13</sup> C. COSCIANI, "Struttura dei sistemi tributari e loro riforma", *Bancaria*, Oct. 1978, p. 24.

criteria by the offices. It is easy to see how important it is for the taxpayer control that criteria chosen and applied are good ones if we consider that a very small percentage (between 1 and 5%) of taxpayers subjected to inspections must be capable of guaranteeing that the IRPEF is applied as broadly and uniformly as possible to many millions of taxpayers. A low percentage of ascertainties may be "sufficient" for administering a personal income tax involving a very large number of taxpayers if the direct method of assessment is also accompanied by indirect methods, whether these are complementary or alternative.<sup>14</sup> In any case, even the use of indirect methods, if it is to be efficient, requires a thoroughgoing reorganization and reinforcing of the financial administration.

In conclusion, a more uniform application of the IRPEF and, secondarily, of the VAT would be possible if the measures outlined here were put into practice. A more uniform application of taxes, together with the restoration of a greater degree of generality to the IRPEF, a cutting-back of its role as main source of revenue along with a greater expansion of other forms of taxation, and a slowing down of the growth rate of overall taxation as a result of a real check to the expansion of public expenditure — these are the conditions which must be fulfilled if the success of the Italian tax reform of 1973-74 is to amount to something more than a temporary huge increase of tax revenues.

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<sup>14</sup> When indirect methods of control are best resorted to, what constitutes them, and the problems that their use poses to our system, is discussed in A. PEDONE, "I problemi di gestione di un'imposta personale progressiva sul reddito estesa ad un elevato numero di contribuenti", in E. Gerelli and R. Valiani (eds.), *La crisi...*, *cit.*, pp. 52-74.