

Case Study

Topic 1.1 International priority

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The Maastricht Treaty has bound the European Union States (EU) to a precise and irrevocable agenda for their full participation in the final stage of the economic and monetary Union. Only the States complying with the convergence criteria fixed by the Treaty will be admitted to the decisive appointment for the creation of the single currency which will mark the completion of the integration process started with the institution of the European Monetary System. A concise account of such criteria includes - in addition to the compliance with the normal fluctuation bands provided for by the European exchange-rate agreements - the achievement of a high degree of stability in prices and long-term interest rates and the implementation of sustainable financial policies. The criteria set for public finance, like those concerning prices, exchange rates and interest rates, are extremely strict and also apply to the phase following the entry into the Union.

The 1992-1993 monetary crises inevitably slowed down the process of European construction. Nevertheless, there is an ever-increasing awareness that the economic and monetary union is an irrevocable choice for all States and the creation of an area of monetary stability in Europe is a prerequisite for its economic development. Obviously, given the state of public finances in most European countries, eventually it will turn out to be a political decision. Nevertheless, it is essential that the governments wishing to join the monetary Union officially commit themselves

to comply with the Maastricht parameters: "*on s'engage et après on voit*" ("*commit yourself and then wait to see what happens*"), as the French say.

The 1997 Finance Act passed by the Italian Government and currently under debate before Parliament provides for numerous and varied measures: related with taxation on individuals (IRPEF), an increase in social security contributions, new taxes and contributions. The financial measures - estimated at 62,500 billion lire - are necessary for our country to join the monetary Union.

But, behind and beyond the Finance Act, this has been the first attempt for the past 25 years to reform and update our taxation system. In short, the fiscal reform tries to plan a long-term economic and industrial policy instead of being overwhelmed, as occurred following the 1973 reform, by the need for constant, sometimes marginal, changes in tax rates.

In fact, when reporting on the government's guidelines in the tax field, current Minister of Finance Hon. Vincenzo Visco, announced the fiscal and tax administration reform and the radical simplification of the taxation system, given the very unsatisfactory condition of our fiscal regime, as far as both its general legal aspects and actual working are concerned.

This reform is due to be implemented in a reasonably short time, considering the present different economic, social and political circumstances in Italy. In mid '90s, the evolution of the European tax systems towards a stricter convergence could not conceal substantial differences in both pressure and structure of taxation. In fact, if on the one hand there is a common objective of financial reconstruction resorting to the decisive fiscal instrument, on the other, the harmonization process is at a standstill confronted with the specific features and ties of the various countries.

Besides the need for harmonization, great consideration has thus been given to the requests not to diminish the States' taxation autonomy and financial flexibility. Two different phenomena are to be interpreted in the light of what has just been mentioned: the

growing difficulties for the European Union to take decisions by unanimous vote in the tax field and the likewise increasing fiscal competition between tax systems which seems to affect the way in which each country treats the most mobile and reallocation-prone income classes.

In this panorama, the Italian situation appears among the most significant ones. Actually, the tax effort which has been characteristic of the level and evolution of total collection has counterbalanced the bonds that strongly condition the adaptation of the national system to the community parameters. The battle for European fiscal harmonization dates back at least to the battle for the creation of the single market. Since then, it has become ever more difficult due to increase in number of EU Member States. Nevertheless, it is equally necessary because it has increased mobility of all production factors.

The tax system has always reflected the model of society and development of each State. According to Mr. Monti Internal Market and Taxation Commissioner, the States still believe they can impose their own model of society through their fiscal policy. However, they are ever less capable of doing so, because they are ever less in a position to exercise their fiscal sovereignty. This conclusion which is commonly accepted in the monetary debate, is not quite so in the fiscal field. Paradoxically, greater fiscal coordination may help the States to regain their tax autonomy.

Commissioner Monti reiterates that the progressive rate of a tax and the public-expenditure-to-GDP ratio should remain the object of the national decisions. Nevertheless, since we do want the single market, the harmonization of both, direct and indirect taxes, as for mobile factors is a prerequisite. If we really want to increase the employment rate, any cause of distortion must be removed.

During the celebration of the Finance Ministers' Meeting held in Verona, during the Italian six-month Chairmanship, it has been maintained that at least the fiscal discriminations between residents of a member State and EU non-residents should be removed since the distinction has already disappeared in some areas, such as

those concerning contracts, elections, consular representations, which are even closer than taxation to the State's core.

As this is not a zero-sum game, the fiscal competition between States should be reduced to achieve a single monetary leverage. With the single currency in force, the existing fiscal distortions would be ever more evident and harmful.

For instance, today the capital market meets with various obstacles: costs of currency transactions, exchange rate risks and fiscal distortions. The single currency will remove the first two and only the fiscal distortions will be left. But not only the single market strengthened by Europe will increase the mobility of all factors, including the fiscal one. If then we look at the opportunities offered by new technologies and telecommunications (allowing us to choose not only where to carry out our service operations, but also where to elect our fiscal domicile), the lack of co-ordination would result in the gradual imposition of a single model, that is the model of a minimum or void State.

The fiscal competition between tax systems, with minimum standards in the various fields, has some unquestionable merits. The freedom of movement of capital, in fact, has eliminated in Europe the hidden taxation due to inflation and financial ties. The same may be applied to the so-called "*explicit taxation*", which is established in a transparent way to finance public expenditure and avoid budget deficits.

Things are quite different in the USA where the State's essential functions are guaranteed by federal taxes and therefore tax competition among States does not necessarily undermine the basis of necessary and sufficient resources for the Government's minimum operation. In Europe, circumstances are different, and inadequate and uncontrolled competition may jeopardize the essential public financial basis.

In short, it can be affirmed that the weakest point in the European taxation framework is the lacking simplification; the second most critic point is the shift from a transitional to the definitive VAT

regime, since it is important for the enterprises to remove the distinction between national and intracommunitary operations. Third, company taxation to prevent both double and zero taxation.

The European average tax burden (EU 15 States) reached 42.1% in 1993 with a 50% increase over 1965. Such trend is the result of a non-homogeneous temporal distribution and different contributions from each State. The increase, in fact, took place mostly in the 1970-1985 period. Moreover, the taxation burdens in the various States differ greatly, ranging from a 50% ceiling in Denmark to a minimum of 33.6% in the United Kingdom.

In addition to variations in the level of collection, there are also changes in the composition of tax revenues. On average, in the EU, direct taxes increased slightly and became the most significant item of tax revenues. On the contrary, indirect taxes show a more or less lowering trend. This upturn in the tendency of the '90s refers only to some isolated national situation for example, that of Spain.

The situation is different in relation with social security contributions, whose incidence on the overall receipts have recently undergone a marked revaluation, in view of the crisis of the public social security systems.

Italy shows a significant convergence in relation to the overall fiscal burden. The 43.8% in 1993 is slightly above the EU average, and well above the figures of some major European partners (Germany, United Kingdom and Spain). With respect to the structure, however, in the Italian tax system there is a predominance of direct taxes over indirect taxes. The direct taxes represent over 42% of the overall revenue, that is, 6 points above the EU average. On the contrary, the indirect taxes account for 26.2%, and show a reverse ratio with respect to the rest of the European countries.

Both cases are the result of the deep changes that have taken place in the past 20 years, in an economic and productive inflation-ridden panorama that has significantly increased direct taxation of

income. Similarly, the fear of an upsurge in inflation accounts for cautious use of indirect taxation, due to the immediate negative effects on consumer prices and accordingly, the cost of living and the level of compensations.

In fact, up to now the only tentative steps taken towards fiscal harmonization in the European Union concern essentially the indirect taxation (VAT and Excise duties) but, despite some precise deadlines and strategies, it has not been possible to establish a "*definitive regime*" in line with the creation of a single market, not undermined by competitive distortions.

The VAT harmonization is awaiting completion: the transition from the current provisional regime to a definitive one is due to take place in 1997. In actual fact, the introduction of the "*origin principle*" still poses a few problems, also owing to the entry into the EU of new member States that resulted in exacerbating the difficulties to reach a complete harmonization of tax systems. The first obstacle is the need to achieve a strict alignment of rates to avoid competitive distortions. To this end, as expected, it would be advisable to introduce two possible rates and define tight brackets. This would imply an exacting restructuring of taxation and a loss of fiscal autonomy for a number of States.

In particular, Italy should first of all increase the reduced rate from the current 4% to the expected minimum 5% and remove the intermediate 10% rate and the so-called 'ferry' 16% rate with a consequent re-allocation of items in the two remaining rates. Nevertheless, this could not be enough if there were differences in tax rates causing distortions in the flows of trade with the other EU countries.

The second obstacle is due to the need to establish a compensation mechanism aimed at matching the domestic consumption in each State with the receipts achieved through the relevant tax system.

The VAT collected by the seller's State, as a result of the introduction of taxation in the country of origin, will be assigned to the tax system of the buyer's State. From this point of view as well, the EU

enlargement and the required unanimous vote complicate the convergence on one of the mechanisms which were originally envisaged, and represented by the detailed record of all transactions and by the lump-sum methods based on macroeconomic data of intracommunitary trade. Tax harmonization remains an open issue as far as direct taxation is concerned. In fact, the problem is even more difficult and urgent than in the past.

The taxation of capital and business income, in particular, must face a growing market liberalization and mobility of capital, in a context in which competition between tax systems inevitably results in a slump in revenues. Hence the need for the harmonization of tax regulations and parameters that, by minimizing the fiscal motivations, can prevent distortions for businesses and markets, re-allocation of revenue among other countries and fiscal competition between tax systems. The taxation of business income shows a complex structure, in the various countries, as reflected in the combination of rates and rules determining the taxable base.

The EEC Commission recently dwelled upon the importance of the latter when stressing the need to eliminate certain forms of international double taxation on international capital flows. And a specific form of distortion peculiar to the Italian tax system is related to the rules defining the taxable base: the significant tax benefits granted in case of debt capital in comparison with financing with equity capital.

In this respect it must be said that the mentioned 1997 Finance-Act-related bills of law - which the Italian Government intend to use to bring about the fiscal revolution - provide for a proxy to issue, within 9 months from the entry into force of the 1997 Finance Act, one or more decree laws which will thoroughly re-organize the tax treatment of enterprises. It will actually reward to a larger extent the business-concerns in good conditions, making a profit and filing their earnings in their tax returns, which have a low debt financing and high equity capital, as well as a high number of employees. It would be like saying: *"Blessed are the first that shall be last...to be taxed"*.

Apart from the joke taken from a newspaper, a harsher treatment will be given by the Treasury to the companies that, to avoid taxation by taking advantage of the deficiencies of the existing rules and regulations, are constantly thinly capitalized and always highly-indebted with the banks, as well those under-staffed or with no staff at all, such as many self-employed workers.

This will be possible with the introduction of a new tax, the IREP (regional tax on production activities), whose receipts will be assigned to the regions and will hit the production added value.

In other words, the fiscal system is structured not only to increase the tax revenue and make it more efficient, but also - and above all - to produce structural changes in the world of enterprises, and correct some historical distortions due to the existing tax system.

Up to now, the entrepreneurs have found it more profitable, while acting within the law, to adopt financial and budgetary policies that keep profits down, resorting to massive bank loans. The reason is a simple one: the interest paid is deductible as operating costs. However, in the future the above interest will no longer be deductible. The entrepreneurs therefore will have to search for risk capital. They will either use their own reserve funds or look for capital on the market.

But there are a few more surprises related to the fiscal revolution promised by the government and wanted by Minister of Finance Vincenzo Visco. The changes are many and affect all economic agents, altering their advantages and the way they compete on the market. The introduction of the "*Dual income tax*" is particularly significant. It is in force in North-European countries and is due to create two IRPEG rates (12.5% and normal 37%), while today the IRPEG rate is 37%, coupled with the ILOR (that the government intend to remove) 16.2% rate, totalling 53.2%, in addition to the net worth tax.

The highest rate would be applied to profits exceeding the normal financial yield (interest rate) for equity capital. This would guarantee that taxation is fully neutral with respect to entrepreneurial decisions. At present, in fact, taxation is strongly

unequal and distorting: profits are taxed more heavily than interest, so that enterprises find it fiscally convenient to run into debt. The lack of fiscal neutrality is an extraordinary incentive to avoid taxation and causes a loss of revenue for the State and a loss of earnings for the economic system since the available resources are not utilized according to real economic advantages, but their allocation is affected and distorted by the tax system.

Another proxy requested by the government concerns the taxation of investment income, *"by agents and intermediaries on the annual operating profit, with the adequate incentives for invested savings"*. This aims at unifying the existing taxation methods and, at the same time, hitting all earnings that still dodge taxation. Reference is made to the so-called derived financial products and persons *"directly holding securities"*.

As far as indirect taxes are concerned, in addition to the reduction of the number of taxpayers, a standardization of VAT rates has been planned, taking into account both the overall financial reconstruction and the need not to hinder the downward inflation tendency.

Simplifications represent another important chapter of the reform wanted by the Minister of Finance. In fact, it has been already decided to introduce a number of simplified administrative requirements as for taxes and tax obligations, including a lump-sum regime intended to exempt small businesses from many accounting obligations.

Therefore, minor taxpayers subject to VAT, whose earnings are less than 20 million lire, will no longer be obliged to keep the books for tax purposes and to draw up the accounts of VAT payments. In our country there is a very high number of VAT taxpayers: 5.2 million and 1.5 million of them have a turnover of less than 18 million lire. In many EU countries, a lump-sum taxation has already been envisaged for these taxpayers.

If a taxpayer earns profits ranging between 20 and 50 million lire, he will only have to keep records and enter the most significant purchases, that is those used for *"sector surveys"*.

Another proxy is represented by the introduction of the regional tax on production activities (IREP), as already mentioned above, with the simultaneous removal of ILOR (local income tax), ICIAP (municipal tax on production activities), net worth tax on enterprises, concession tax on VAT registration number, health contributions and "*health tax*". This proxy is also intended to strengthen the taxation autonomy of Municipalities and Provinces.

Moreover, the same proxy includes a comprehensive reorganization of IRPEF (personal income tax) implying new significant rebates for families. Such rebates are aimed, above all, at relieving the tax burden with respect to the number of children and meet the requirements underlined in the Government programme to encourage a policy of support to families.

Finally, it is worth mentioning another proxy concerning the reorganization of both its system of penalty taxes and verification criteria, which will include special procedures so as to allow for a timely payment of assessed taxes.

In consideration of the above, it is possible to state that the fiscal part of the financial measures consists of a number of provisions with an anti-avoidance and rationalizing character as well as a package of bills of law enacted under delegated power, envisaging deep changes in the taxation system. The principle stated in the Government programme as to the maintenance of the fiscal burden is strictly complied, as a result it is expected an extra revenue of 12,500 billion lire in 1997.

I have previously mentioned the introduction of a new tax (IREP) and the simultaneous removal of the health contributions and the "*health tax*", among others. We all know too well that the excessive burden of social contributions makes the cost of labour prohibitive and contributes to the current high unemployment rate in Italy and in other EU Countries, as underlined in many surveys and also recalled by Italian EU Commissioner Professor Monti.

As a matter of fact, in both Italy and Europe, the problem of unemployment has a fiscal cause, and not in the sense that the fiscal reform imposed by the standards set by the Maastricht Treaty is threatening to increase unemployment.

The real reason why unemployment is now a fiscal problem, in both Italy and Europe, lies in the fact that employment taxes are really too high. Economic theory teaches us that taxing employment causes unemployment, and this is what we are experiencing in practice.

If we really want to reduce unemployment in Italy, so the experts, it is above all necessary to do one thing: cut down employment taxes. And, in the long run, there is only one effective way to do this: reduce current expenses, which mostly consist of social transfers.

The abolition of the health contributions and the so-called "*health tax*" and their replacement with taxes adjusted to broader taxable bases of total wages and contributions was first proposed quite a long time ago and remains an integral part of any fiscal reform, as pointed out also by the present Minister of Finance. Thus, also considering the forthcoming end of the current tax-regime treatment, the labour cost would decrease by approximately five to six points and, in the absence of adjustments, a slight increase of the gross wages could also be achieved.

Nevertheless, in a broader view, something more should be done at least in two directions: state subsidies for contributions - in part also social security contributions - relating to works marked by low wages and poor technological contents, which otherwise would run the risk of disappearing altogether; and state subsidies for contributions relating to new entrepreneurial activities to be added to the fiscal support already provided for by recent laws that, however, did not produce the results expected.

So the Government is getting ready to do its part in order to make the "*system Italy*" more competitive through the above measures and the adoption of the 'dual income tax' intended to relieve the

fiscal burden of enterprises and therefore also foster the allotment of new production activities, both national and international.

Finally, I would like to mention another problem, which seems to be important, that is refunds. This is a most serious issue and a source of legitimate protests and mistrust of the taxpayers towards Tax Administration. A few problems are on the way to solution thanks to the adoption - though partial - of the 'fiscal account' and others will be solved by virtue of the proposed reforms.

Nevertheless, the problem of working off a considerable bulk of outstanding refunds still has to be solved and there are delays and hindrances in the automatic procedures, which have been recently introduced.

However, an in-house working group has already started work on these problems on the instructions of the Minister of Finance so as to supply concrete solutions in a very short time.

Also as far as the question of refunds is concerned - and this is a problem which is particularly felt by taxpayers for obvious reasons - the tax administration has vigorously chosen the way of simplification and is undertaking many initiatives for supporting citizens. We know that the tax systems in France, Germany, United Kingdom, United States and Japan guarantee efficient services, although there are still some problems. In those countries, refunds are carried out in a short time, ranging from three weeks in the United Kingdom and United States (as for returns drawn up by telephone) to a maximum of one year (but with a few months' average) in France.

The above remarks point to an ambitious programme implying an at least five-year long temporal horizon and a corpus of formal and substantial innovations.

It is true that the reduction of the fiscal burden - *"a significant reduction which will make it possible to reward the taxpayers for their considerable contribution in these years of financial reconstruction"*, as the Minister of Finance stated, will be accomplished only after at

least a two-year course, but it is likewise true that only very recently the problem of reducing the fiscal burden in Italy has been actually tackled, a burden that - as previously mentioned - is one of the highest in Europe.

The possibility of moving towards greater convergence of the European tax systems depends on the ability of making supranational choices, which are not qualified by the need of fiscal autonomy of each country and by the 'temptation' - if I may say so - of solutions characterised by competitive fiscal systems rather than harmonising systems.

Even if there are international obligations of a binding nature, it cannot be yet ignored that each country may be facing, from time to time, trade-off situations, which cannot be easily solved. Particularly, in the case of Italy, fiscal revenue represents an extremely binding element, because of both, the high public debt and the need to meet, with an appropriate fiscal coverage, the high expenses due to interests.

As the Minister of Finance rightly stated, the proposed tax reform represents in itself a very valuable opportunity of simplification, since a number of taxes, tax obligations, tax rates, etc. would be removed. Nonetheless, the Government commitment and the actual possibilities of simplification and rationalization go far beyond this and imply a transformation of organizational structures, obligations and procedures.

The crucial issue is that today the tax system is not structured as if the taxpayer were a unitary point of reference, but rather considering single taxes, contributions and obligations. Therefore, all procedures are being reorganized so as to place taxpayers in the centre of the system, making it possible to standardize procedures and obligations both at a central and local level, as well as those deriving from the relations with social security institutions, the latter process being already under way.

To this end, it is necessary to standardize and co-ordinate the central and local tax legislation with rules and regulations concerning social security, accidents, insurance and health, to adjust the taxable bases and unify obligations and procedures.

Consequently, the system of fiscal inspections in our country is at present marked by a sort of vicious circle: high number of taxpayers, each of them having to file a high number of tax returns and to fulfill a great number of different obligations. Offices inundated with documents, on which it is possible to carry out mainly formal verifications, which result in tax sanctions causing the rejection of the taxpayers. Increasing backlog of work, which is more and more difficult to work off. On top of this comes the high cost of the present system for taxpayers, and in particular for small enterprises, which are obliged to spend huge sums each year for often-incomprehensible activities and obligations.

Such situation, completely unacceptable, as also recognized by the Minister of Finance, can be modified both by reducing, as far as possible, the number of tax returns and unifying them, and by promoting the utilization of intermediate structures between taxpayers and tax administration.

Moreover, the prerequisites to achieve the telematic data transmission of tax returns should be arranged as soon as possible so as to significantly improve the quality and timeliness of information and reduce both the cost of data collection and the number of employees involved.

Thus, the new developed system would be able to acquire all relevant information within three to six months after the filing of returns, grant refunds and carry out automatic controls in a short time in order to settle possible formal irregularities with taxpayers by mutual agreement, as in many other countries.