The Italian Economy and Recession: from France, Germany and UK New Ideas for an Adequate Fiscal Exit Strategy

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During 2012 the downturn has hit the Italian economy to a greater extent than the rest of Europe. In fact, following a slight recovery in the years 2010-2011, there has been a new drastic drop in the GDP, producing the most severe effects in the southern regions of the country, and numerous proposals have been presented to overcome this critical period in the Italian economy. One of them provides for the full abolition of IRAP, to be offset by eventual VAT remodulations. However, this proposal has aroused many criticisms for its possible effects on consumption households and, in general, on the Italian economic system. After a comparative analysis of the local business taxation systems applied in Italy, Germany, France and UK, this article contains a first rough evaluation of these effects, showing that the above mentioned abolition of IRAP may instead produce a clear benefit, which could widely offset the effect of the increased taxation on consumption and could be decisive for the resumption of the economic growth and employment in Italy. Finally, it contains a proposal for the implementation of new models of governance analogous to those used in the UK in order to incentivize the local economic growth.

I. Introduction

More than any of other European countries, Italy has severely felt the ending of the brief recovery phase of the previous two years, returning more quickly to a recession. The GDP has diminished by 2.4% in 2012 and the previsions unanimously foresee a continued fall in production for 2013, even if it is less than that of 2012. Moreover, they predict the possibility of a cyclical reversal only for 2014.

The worsening of the Italian economy is caused by external and internal cyclical factors. Among these, the principal exogenous factors are the abrupt reduction of the growth perspectives both in and out of Europe and the financial stress tied to the sovereign debt crisis. However, it also has structural causes, such as the competitiveness crisis which for more than a decade is a feature of the Italian economy. In fact, in the period from 2001 to 2012 the gap in the growth rates compared with the major European countries was equal to more than 11%, as the Italian economy
had grown only by 1.6% compared to 14% of France, 14.3% of Germany, 21.2% of Spain. Also in this case the causes for this difference are manifold, both structural (the small average size of enterprises, the international specialization, the low investment in research and innovation) and institutional (the inefficient market regulation, administration and management of public services, such as education and civil justice, and finally the lack of adequate infrastructures and human capital).

Numerous proposals have been made to overcome this moment of clear difficulty in the Italian economy. One of them provides for the full abolition of IRAP, to be offset by the eventual VAT remodulations. However, it has aroused many criticisms for its possible effects on consumption households and, in general, on the Italian economic system. This article – after an accurate analysis of the Italian system of local business taxation (see Sections 2, 3 and 5) and a careful comparison (provided in Section 4) to the ones used by three countries (Germany, France and UK) which appear more relevant in respect to the Italian situation – evaluates some alternative proposals to get rid of IRAP (see Section 6) and contains a first rough analysis of these effects (see Sections 7, 8 and 9), showing that the above mentioned abolition of IRAP may instead produce a clear benefit, which could widely offset the effect of the increased taxation on consumption and could be decisive for the resumption of the economic growth and employment in Italy. Finally, it contains a proposal (see Sections 10 and 11) for the implementation of new models of governance analogous to those used in the UK in order to incentivize the local economic growth.

II. Nature, rationale and taxable base of IRAP

Since 1st January 1998 the Italian Regions apply a “derivative own tax”, which is levied on those who habitually carry out an activity (economic or otherwise), independently organized, aimed at the production of goods and services1. This tax is called “Regional Tax on Productive Activities” (Imposta Regionale sulle Attività Produttive, IRAP) and it was established by the Italian State with the Legislative Decree dated 15th December 1997, No. 446 (henceforth, “Decree”); the State

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1 According to the approach adopted in recent years by the Italian Constitutional Court, IRAP was considered a “derivative own tax” (Cf. Const. Court, sent. 22nd April 1999, No. 138). However, since 2010 the process to regionalise the tax has began based on Art. 1, Para. 43, of the Law No. 244/2007 (Financial Act 2008). This normative has foreseen the power to establish this tax with a Regional Law from 1st January 2010 on.
maintains, therefore, pursuant to Art. 117, Para. 2, Lett. e), of the Italian Constitution, every right to change its features, or even to abolish it altogether; the denomination of this tax (“Regional Tax”) means merely that the Region obtains its revenue (Art. 15 of the Decree) and is able to exercise some minor powers, granted by the State, concerning the measure of the tax and its application procedures (see Articles 16 and 24 of the Decree).2

The IRAP taxable base is calculated annually as the difference between gross receipts (sales revenues) and the cost of intermediate goods and services (purchases from other firms plus depreciation)3. Its rationale is to tax the entire wealth produced from the business carried out “at the source”, before the entrepreneurs distributes to the suppliers of the productive factors their return/remuneration.

The basic rate of IRAP is 3.9% (Art. 16, Para. 1, of the Decree), except for certain special cases regulated by the Decree which establishes the tax (Art. 16, Para. 1 b, 16, Para. 2, and 45, Para. 1, of the Decree); Regions are allowed to “modify the basic rate of up to one percentage point”, but the established tax rate can be differentiated by business sectors and categories of taxable people (Art. 16, Para. 1, of the Decree); the normative in force provides for tax benefits linked to the territory, to the membership in certain categories of subjects and to new production initiatives (see Articles 17 and 18 of the Decree).

III. The shortcomings of IRAP and the debate on its abolition

In Italy, the possibility to abolish or reform IRAP has been at the center of a heated debate for a long period of time. However, in recent years, proposals to totally or partially abolish the tax have

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2 Even after the normative changes introduced by the Financial Act 2008, the Italian Regions still don’t have the power to modify the IRAP taxable base; they can only modify its rate, deductions and introduce special tax reliefs, within the legal State limits.

3 The initial criteria for the determination of the taxable base have been revised over time especially in order to reduce the penalization of labor-intensive enterprises. Lump-sum deductions applicable to employees, deductions relative to costs sustained for apprentices, for disabled people and for staff hired under a job training contract were introduced. Currently both the cost for research and development staff (since 2005) and the amount of social security contributions are fully deductible.
been increasingly set forth. These proposals were motivated by the following principal observations:

1. IRAP, since the beginning, has raised serious doubts regarding its conformity to the principle of tax-paying capacity, provided by Art. 53, Para. 1, of the Italian Constitution; the doctrinal debate has calm down, but it hasn’t ceased: notwithstanding the diverse opinions by jurists and economists on how to approach the fair taxation theory, there is an almost unanimous tendency to recognize the difficulty to justify the tax in light of the traditional and still prevalent interpretation of this principle;

2. this levy is a value added tax implemented through the subtraction method and levied on basically all business, both in the production of goods and services and in the financial sector; however, from a technical point of view, it is totally inferior to the value added tax currently applied (VAT);

3. even if the European Court of Justice has stated that IRAP doesn’t perfectly coincides with a “business turnover tax”, as specified by Art. 33 of the Sixth VAT Directive (Directive No. 77/388/CEE) and by its decisions, we cannot exclude the possibility that this panel of judges reconsider its thinking extensive reinterpreting the afore mentioned normative, in particular relying on the possibility that this tax is transferred on the final consumer and on its suitability to perturb the functioning mechanism of VAT; if this happened, the Court should once again face the issue of the possibility of limiting the effects of a judgment that recognizes the violation of art. 33 of the Sixth VAT Directive on the past juridical relationships;

4. IRAP produces an increase in the labour cost (the so-called tax wedge) and a disincentive for enterprises which make new investments;

5. the assignment to the Regions of this tax did not take into account of the more plausible hypothesis on its impact, according to which IRAP is shifted downstream, thus allowing that the richest Italian Regions to put the burden of their expenditures on the rest of Italy.

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On this basis, several proposals to abolish the tax have been put forth. One of these aroused many criticisms for its possible effects on the Italian economy. This proposal provides for the abolishment of IRAP charged to manufacturing firms, but increasing the VAT rate to ensure the financial coverage of this operation. In regard to this, it was noted that the increase in VAT reduces consumption, but since the abolition of the IRAP increases them, we tried to make a first assessment. The analysis relates to the direct impact of the hypothesis put forward here (the percussion): others, better equipped, will be able to evaluate the pertinent multipliers, having the possibility to dispose of an aggregate consumption function properly specified with respect to variables concerning the distribution of wealth (intended in real terms, i.e. discounted for the pertinent prices) among income levels and among territories.

### IV. The local business taxes in the European context

The hypothesis of exchange IRAP-IVA, which is proposed in § 1, falls within the framework of the debate which is taking place in various European countries on the business taxation methods, at the local government levels. We have found it useful in this paper, to make an analysis of the taxation system of three countries which appear the most relevant, compared to the Italian situation, Germany, France and United Kingdom.

1. **The German case**

In Germany, the system of business taxation is mainly based on four taxes: the Federal Corporate Income Tax (Körperschaftsteuer); the Federal Personal Income Tax (Einkommensteuer), to which are subject the income of unincorporated enterprises and corporate dividends received by individuals; the Solidarity Surcharge (Solidaritätszuschlag), which is applied both to the corporate income tax revenue and the one from personal income tax; the Municipal Trade Tax (Gewerbesteuer).

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The Gewerbesteuer was instituted in the late Nineteenth Century, along with the personal and progressive income tax. However, over the years, this tax has been modified several times and has been challenged, especially for the numerous subjective exemptions provided for in its regulations. Nevertheless, it still represents the most important source of financing for the German Municipalities (Gemeinden), which are funded for a major part by their own revenue – such as the Trade Tax (which represents, at the present, ¾ of the Municipalities’ tax revenues), the Property Tax (which account for over 20% of municipal tax revenues) and other minor taxes (which provide a minimum contribution to the finances of the Municipalities, accounting for barely 2% of their tax revenues) – assigned exclusively to them, according to Art. 106, co. 6, of the Fundamental Law (Grundgesetz).

In contrast to the income taxes, the Gewerbesteuer is not a personal levy (it applies, in fact, to the company itself, and not to its owner nor its manager) and is considered, despite the considerable size of its revenue, an appendix of the (personal and corporate) income tax. Its taxable base was originally tridimensional (it comprised, in fact, the wage bill, the profits and the company capital, including the indebtedness), but since 1980 it has undergone a progressive narrowing, almost an “emptying”, which has made this levy more and more similar to “a skeleton tax”.

In particular, the most significant changes in the original regulations of this tax were made with a series of measures by the Federal Government, which have established:

a) the reduction of the tax liability for taxpayers, through the repeated increase of the exemptions related to the profits (1975, 1978, and 1980) and the capital of enterprises (1978 and 1981);

b) the lowering of the deduction level originally planned for the interest on long-term debt and for the same quota of the long-term debt (by 40%, since 1983, and by 50%, since 1984);

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6 The Gewerbesteuer is the oldest among the turnover taxes, as they are considered in their present form: it was introduced in 1810 with the vonStein/Hardenberg reforms and already in 1820 received a setup very similar to the one which it has today. Cf. D. Birk, Steuerrecht, C.F. Muller, Heidelberg, 2012, p. 372.


c) the exclusion (from 1980 onwards) of the wage bill from the tax base;

d) the reduction (also in 1980) of the share of revenue which the Municipalities, originally, had to pay to the Bund and the Länder in exchange for the assignation of 15% of the income tax;

e) the abolition (in 1998) of the capital from the taxable base (because of the inability of the Financial Administration to carry out an assessment of the real assets of the new Länder) and, in return, the transfer of a share of the VAT to the Municipalities.

However, these changes led to a drastic drop in the revenue deriving from the tax, which in turn gave rise to further amendments (in December 2003), mainly directed at increasing the revenue of local governments. Among these, we think it is important to mention:

a) the further reduction of the revenue share which the Municipalities, by law, must pay to the Bund and the Länder;

b) the setting of a limit on the carry forward of losses;

c) the coordination of the local business tax’s regulations with the federal corporate income tax.

As a result of these reforms, the German local business tax has gradually degenerated into a profit tax\(^9\) and it is no longer deductible (with effect from 1\(^{st}\) January 1998) from the income tax. Only industrial enterprises managed as sole proprietorship or as a partnership are entitled to deduct the German local business tax, in forfaitaire way, from the personal income tax. Therefore, it is possible to assume that this tax is still paid mainly by large corporate firms\(^{10}\), while agricultural entrepreneurs, self-employed workers and banks are exempt.

2. The French case

\(^9\) Its taxable base is, in fact, only the operating profit, plus or minus some modifications and adaptations. Then, through these latter it is possible to get a fictitious element, which instead of the actual income of the firm identifies its available profitability (i.e. after tax).

\(^{10}\) Cf. S. Bach, *Has German Business Income Taxation Raised too Little Revenue over the Last Decades?*, Discussion Papers of DIW Berlin1303, DIW Berlin, German Institute for Economic Research, 2013, p. 4.
Until 2010, in France the enterprises were subjected to two types of local taxes: the Property Tax (Taxe Foncière)\(^{11}\), which was by far the oldest, but also the least burdensome, and the Local Business Tax (Taxe Professionnelle, TP), which strike anyone (natural or legal person) who habitually carried out self-employed or enterprise activities. This latter levy had “a very troubled debut and a very precarious childhood”, but until 2009 it was the most important source of finance for the French local governments, and the third most expensive fiscal task for firms, after the Corporate Income Tax (Impôts sur les Sociétés) and the Value Added Tax (Taxe sur la Valeur Ajoutée). Nevertheless, from the moment of its establishment (with Law 19\(^{th}\) July 1975, No. 678), this tax had to undergo an interminable series of modifications which led, on the one hand, to the forecast of several exemptions and subsidies in favor of particular categories of economic operators (primarily, artisans and new enterprises)\(^{12}\) and, on the other hand, to the progressive elimination (starting in 1999 and finishing in 2003) of the wage component from the taxable base of the charge\(^{13}\). In particular, the most relevant modifications to the original regulations of the TP led gradually to:

a) the extension of the voluntary deductions;

b) the narrowing of the taxable base (in particular, of the wage component);

c) the enforced reduction of the rates, i.e. their containment within the limits laid down by national law;

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\(^{11}\) We must remember that in France there are two different types of property tax: one is the building land tax (taxe sur le foncier bâti) and the not building land tax (taxe sur le foncier non bâti), payable by their owners; the other is the tax on revenue from buildings (taxe d’habitation), payable by the lessees.

\(^{12}\) According to Grosclaude and Marchessou (J. Grosclaude, P. Marchessou, Droit fiscal général, Dalloz, Paris, 2003), the enumeration of the numerous exemptions which restricted considerably the scope of the tax “challenge the consistency, because they reflect the breadth of legislative interventions aimed at meeting the needs of different socio-professional categories” (the translation is ours).

\(^{13}\) The wage component of the taxable base has been gradually suppressed, over a period of five years, as provided by Art. 44 of the Financial Act of 1999. Initially, instead, the taxable base was composed by the sum of the annual returns from the instrumental buildings, of 16\% of the market value of other means of production and of 18\% of the wages and emoluments paid by the firm during the given fiscal period (see Art. 1467 of the Code Général des Impôts). This method of determining the taxable base was applied to almost all enterprises. However, a special scheme of exception was provided for some service providers.
d) special regimes for groups of local governments considered taxable subjects (such as the Établissement Public de Cooperation Intercommunale, EPCI\textsuperscript{14}), designed specifically to encourage the associationism of Communes;

e) various tax benefits for enterprises investing.

However, all these changes and the various reform attempts which took place over the years were not able to make the above mentioned tax more tolerable. Its main criticisms had as their target its taxable base, particularly its excessive sensitivity to the economic cycle and its lack of neutrality with regard to the choice of inputs. In early 2004, a committee chaired by the Prime Minister M.O. Fouquet (\textit{Commission de réforme de la taxe professionnelle}) received the task to study the feasibility of a Local Business Tax reform, to encourage corporate investment and reduce the tax burden on business activities\textsuperscript{15}. The best known of the reform proposals made by the Commission concerned the taxable base which should have replaced the TP: an accounting taxable base which included, in one part, the added value produced by the firm (an element more stable, less variable and therefore more appropriate to the needs of local communities) and, in another, the rental value of real estate used for business undertakings (a factor which guarantees the existence of a direct fiscal link between the enterprise and the territory in which it carries out its activities).

The Commission Fouquet had found, therefore, a solution which seemed to keep everyone happy firstly politicians, who had granted exemptions and benefits of all kinds, in order to increase their electoral consensus, secondly entrepreneurs, according to whom the old tax had shown to have a negative impact on investments and on the choice of production factors, thirdly local governments, who asked to be able to count on a less variable funding source, or at least less reliant on the economic cycle. This solution, nevertheless, was not exempt from criticisms. Many pointed out, for example, that the need to combine a new taxable base of an accounting nature with the preexisting one, which is identified in the rental value of the property, would have resulted in an

\textsuperscript{14} As most of the French Communes are small, they are allowed to create jointly many different Inter-communal Entities which can exercise part of communal responsibilities for its more efficient execution. The most important are Inter-communal Cooperations (\textit{Établissement Public de Coopération Intercommunale}, EPCI) which have their own Councils and resources.

\textsuperscript{15} Meanwhile, tax cuts for enterprises which invest were also introduced, but this measure did not have any impact on the resources of local governments, because it was fully funded by the State.
increased number of fiscal tasks on operators (likely, increasing their incentives to evade or avoid the tax) and penalized investment in fixed capital. Others, however, were afraid of the possible repercussions on the balance sheets of households\textsuperscript{16} and firms which carried out their activities in the areas of trade and services\textsuperscript{17}. Finally, other critics, but especially the Municipalities, called for the preservation of the fiscal link between the territory and firms and a real review of the financial equalization system.

Afterwards, the Syndicat National Unifié des Impôts presented a counterproposal, aimed at anchoring the TP to a taxable base which would be “un-delocalisable” and, at the same time, a reliable indicator of the enterprise’s ability to pay tax. This proposal foresaw, in fact, the preservation of the real estate component in the taxable base, but with values updated or completely redefined, and the application the EBITDA (\textit{Earnings Before Interest, Taxes, Depreciation and Amortization}) as a measure of the enterprise’s ability to pay tax. This had already been used by financial analysts as a reliable indicator of the profitability of firms (i.e. of their ability to generate wealth through operational management\textsuperscript{18}).

None of these proposals, however, had a great following, and shortly afterwards (in 2008), a new committee (Comité pour la réforme des collectivités locales), presided by Edouard Balladur, was formed with the task of making a wider and more ambitious proposal to reform the whole system of local government in France. The aforementioned committee concluded that it was necessary to:

\begin{itemize}
  \item[a)] revise the bases of the direct local taxes and update these latter every six years;
  \item[b)] fully compensate the abolition of the French business tax with another kind of business taxation, linked mainly to the rental values of business properties reevaluated and to the added value produced by the firm;
\end{itemize}

\textsuperscript{16} According to the Syndicat National Unifié des Impôts, in fact, it is necessary to begin a reform of the entire funding system of the Local governments. A reform of only the TP would have been unfair and damage to households.

\textsuperscript{17} At that time, in fact, it was argued that the structure of the French Business Tax produced serious discrimination among productive sectors, having a greater effect on the industrial one and advantaging the enterprises which were operating in the sectors of trade and services.

\textsuperscript{18} Thus excluding the operations made by the managers of firms (such as the amortizations and the accruals, but also the financial management), which do not always provide correct information about the enterprise’s performance.
c) limit the overcrowding of many fiscal burdens on the same taxable base.

This led to the abolition of the local business tax and to its replacement by a new type of levy, which affects the same taxable people, although based on different presuppositions, and the revenue from which is shared by the same local governments. This levy is called “Local Economic Contribution” (Contribution Économique Territoriale, CET) and consists, pursuant to the new Art. 1447 of the Code Général des Impôts, of two parts: the Contribution for Enterprise Land Value (Cotisation Foncière des Entreprises, CFE), calculated on the cadastral values of properties owned by the firm and the Contribution for Enterprise Added Value (Cotisation sur la Valeur Ajoutée des Entreprises, CVAE), based on the value added generated by the annual business activity carried out. The overall amount of the two taxes cannot exceed a maximum ceiling provided by law, i.e. 3% of the added value calculated according to the methods established for the CVAE.

3. The British case

In the United Kingdom, the system of business taxation is mainly based on four different kinds of taxes:

the Corporation Tax (CT), which is charged on the global profits of UK-resident companies, public corporations and unincorporated associations and on the UK profits of non resident firms; the Income Tax (IT), to which are subject the income of unincorporated enterprises and corporate dividends received by individuals; the Capital Gains Tax (CGT), which is levied on gains arising from the disposal of assets by individuals and trustees (while capital gains made by companies are subject to CT); the National Non-Domestic Rates, or Business Rates (BR), which are local property taxes applied to those occupy non-residential properties (including shops, offices, warehouses and factories) and normally amounts to approximately 45% of the annual rent. As such, these latter represent one of the largest overheads for businesses and have a substantially impact on their profits.

The aim of the BR is to contribute towards the cost of services provided by the Local Authorities. The primary legislation on non-domestic rating in England and Wales is the Local Government Finance Act 1988 (LGFA 1988). The implementation of this system is further regulated by statutory instruments and case-laws.
The taxable base of the BR is the property unit which is used for rating purposes and it is called the “rateable hereditament” (land, buildings and rateable plants and machineries). Liability for the rates falls on the person who occupies the rateable hereditament, i.e. the person who is in “paramount control” of the assets, defined by case-law as the actual, exclusive and non-transient occupier of the hereditament, who receives a commercial benefit from it.

A uniform tax rate (Uniform Business Rate, UBR) is determined annually by the Central Government (or the Devolved Administrations in Scotland and Wales) and is applied equally to all business properties and to all operators. The base of this tax, the so-called “rateable value”, is the hypothetical annual rent which the hereditament might reasonably be expected to be let at from year to year in an open market transaction at a specific valuation date\(^{19}\). The full statutory definition is contained in Schedule 6 of the LGFA 1988.

The BRs are calculated by multiplying the aforementioned rateable value of a business property by the UBR. The BR revenues must be split between local and central government and from 2013-14 on under a new system of local authority financing. Previously, revenues were paid into a central pool, consequently the net income that local authorities received had little bearing on the rate revenues raised. However, under the new system established by the Local Government Finance Act (2012), local authorities will keep about half of the rate revenues raised from the new developments, for a period of up to 10 years.

Business rates were transferred from local to national control in 1990 and this caused the downgrading of the Local Government fiscal autonomy to the lowest levels in Europe, after Holland. For the past ten years we can note, however, a partial “resurrection” of the local autonomy along with the experimentation of new models of local governance aimed at improving the quality of public services and incentivizing the local economic growth.

In this way, for example, the so-called Business Improvement Districts (BIDs) were born. These are the result of a collaboration among local authorities and enterprises for the creation and

\(^{19}\) The valuation of this hypothetical annual rent is carried out by the Valuation Office Agency (VOA), an executive agency of the Inland Revenue, part of the Central Government. Revaluations are carried out every five years. The VOA has a choice of four methods for calculating the “rateable value” of assets, with an accepted hierarchy between the possible methods depending on the individual circumstances and the evidence available. For further information, see A. Lymer, L. Oats, *Taxation: Policy and Practice*, Fiscal Publications, August 2013, 20th Edition (2013/14).
strengthening of the industrial districts. By this operation the British Government has given to the local authorities the possibility to collect as additional local tax on the business rates (Business Rate Supplements), definitely aimed at improving the quality of local services and to promote the development of a given territorial area, but also bound by the implementation of a partnership with the private sector. Nowadays, the BIDs are considered “an increasingly popular form of local service provision and urban revitalization and their impacts are documented empirically and anecdotally”.

Another recent development in this direction is the start (from 2005) of the official experimentation and the subsequent entry in force (from April 2013) of the LABGI (Local Authority Business Growth) scheme, directed essentially to confer significant tax benefits to the local authorities adopting policies aimed at promoting local economic growth. According to this new model of local governance, local authorities have the right to retain 70% of the tax revenue generated by the growth of the local economy, if this growth is superior to the difference between the specific territorial growth trend and a “correction factor” determined by the Government (the factor will initially be equal to 1.4%). For example, with a trend of 3.4% the benefits will be triggered only if the growth exceeds 2% (3.4% – 1.4%). It has been estimated that, immediately after it is applied, the LABGI scheme should generate additional resources for the local authorities to the extent of about 1.5 billion Euros. The mechanism is therefore neither equalizing nor distortionary: all territories, rich and poor, have the same possibilities to benefit from it and they could share additional resources with the Central Government.

V. The Italian case: IRAP and its taxable object

The tax in question here is called “imposta sulle attività produttive”: this name should indicate the object of the tax obligation, as occurs, for example, in the case of the Personal Income Tax or

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20 The Business Rate Supplements Act 2009 empowers upper-tier local authorities to levy a supplement on the business rate in their area in order to fund economic development projects. The most significant example of this is the business rate supplement levied by the Mayor of London in order to part-finance Crossrail. BIDs, moreover, involve an additional levy on the business rate, but there are important differences between this and the rate supplements. For more detailed information, see M. Sandford, Business Improvement Districts, House of Commons Standard Note SN/PC/04591, 9th September 2013.

the Municipal Property Tax. The taxable object is the element to which, essentially, the tax is related to and therefore the “reason” for it: the income or the rental value of real estate. However, there are particular cases. For example, the object of the tax obligation of the Value Added Tax, through the special regime of investment and exports, is identified in the amount of consumption.

It is clear (and quite obvious) that the taxable object of IRAP is not the “productive activities”, which, however, may help to identify the person liable (the firm). The tax is applied, as it is established in Art. 5, Para. 1 of Legislative Decree No. 446/1997, which in this regard refers to Art. 2425 of the Italian Civil Code, on the production value, as determined for statutory purposes. However, the costs related to raw materials and consumable supplies, goods and other costs of the same nature, as indicated in Art. 2425, Para.1, sub B, Para.6, 7 and 8, must be first deducted from the production value. From the value determined in this way, which is called “value-added”, are deducted the cost of depreciation of tangible and intangible assets. IRAP, therefore, requires a direct determination, from the Income Statement of enterprises, of the above mentioned difference between the production value and the costs. The seller of goods (or services) is identified as the liable subject.

If we consider only the production in the private sector, IRAP hits the value of goods and services produced in a country by firms (Gross Domestic Product: GDP), net of amortization (Net Domestic Product: NDP)\(^2\). This value, on the supply side, includes consumption goods (C), investments (I) and exports (E). Assuming the existence of a price system able to equal the three addenda indicated by the analogous variables resulting on the demand side, the taxable object of IRAP, for macroeconomic equivalence, will be equal to the sum of consumption plus investments plus exports.

If we take into account the fact that, on the demand side, part of consumptions, investments and exports derives from goods and services in turn imported (and IRAP-free), and we neglect the amount of amortization, the relevant variables of the national accounting, calling M the imports, will be

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\(^2\) In regard to this, cf. R.M. Bird, *Below the Salt: Decentralizing Value-Added Taxes*, International Center for Public Policy Working Paper 13-02, Andrew Young School of Policy Studies, Georgia State University, February, 2013, p. 35: “The IRAP is essentially a net income-type VAT on an origin basis”. 

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So, since the taxable object of VAT is the consumption,

\[ IRAP - IVA \rightarrow C + I + E - M - C = I + E - M \]  \[2\]

Therefore, IRAP, if compared with VAT, hits for a second time consumptions and then investments and exports. Imported goods have a greater advantage than those produced within the country.

Again for macroeconomic equivalence we can state, simplifying and, in all likelihood, leading to an error, that IRAP hits the remuneration of production factors. In this way, however, we neglect the issue of tax shifting and the one of the “personality” of direct taxation (the ability to pay tax).

VI. Some alternative hypotheses to get rid of the IRAP

In this paper we present, in the sense that will be specified in § 8, the most radical hypothesis, which is that of the total abolition of IRAP hitting the private sector (hereafter “private-IRAP”). We believe that, even in terms of an “announcement effect”, this decision is the most effective one, relating to the objective of the resumption of growth and employment in Italy: we must remember, in this case, that IRAP, unlike VAT, discriminates against investments and exports. The (partial) replacement of IRAP with two points of the VAT rate can have a positive effect at national and international levels. In principle, however, we believe that we must apply those measures which have the greatest impact, rather than marginal adjustments, in favor of more or less extensive groups of beneficiaries. Moreover, the pure and simple abolition of the private-IRAP presents a lot of complications, for example in relation to issues of the vertical integration of enterprises and issues of more or less appropriate specification of business sectors (eg. industry, agriculture).

The alternative solution, which is preferred by the legislators, provides for facilitation measures for the part of the added value which includes the cost of labour. First of all, it is necessary to clarify that IRAP does not have as its object the wage bill. IRAP, as we have explained, is a business turnover tax, which for macroeconomic equivalence has as its object the

\[ IRAP \rightarrow C + I + E - M \]  \[1\]

23 The Stability Act for 2014, approved by the Italian Government convened at the Council of Ministers, reduces both the obligations of the worker, by changing the deductions for employment income, both those charged to the employer, by lowering no-social-security contributions and increasing indefinitely the deduction from the tax base of IRAP for new employees. Overall, the reductions would be approximately 2.6 billion Euros in 2014, 2.9 in 2015 and 3.1 in 2016.
NDP. Since the value added is distributed to production factors, for macroeconomic equivalence, the latter can be expressed as follows:

\[ PIL = C + I + E - M = W + OF + P + R \]  \[3\]

Where the terms \( W \), \( OF \), \( P \) and \( R \) are, respectively, wages, financial charges (interests), profits and rents. In this context, a tax concession offered to firms and commensurate to the total amount of wages (which corresponds, according to the computation proposed in § 8, to 1.6% of the wage bill – a concession which, however, it must be self financed) is a measure whose effectiveness is quite dubious. The idea that this tax relief can shift to the price of goods is extravagant, given the variability of productive combinations and tax rates among business sectors and among enterprises. Mainly, the measure in question would favour more labor-intensive enterprises and produce regressive distributional effects\(^{24}\); moreover, it would not be a useful tool aimed at increasing the labour demand, because the resources used by the state are distributed on the whole wage bill, instead of working only on the marginal changes in labour demand. The most radical solution proposed in this paper, which is that of a pure and simple abolition of IRAP applied to private production and distribution enterprises, does not certainly have a minor effects then the previous mentioned. In addition, if this solution produced a real definite effect, firms would not be induced to prefer labour-intensive productive combinations, which are not necessarily the most efficient ones.

VII. The taxable object of VAT and IRAP: a comparison

From the beginning\(^ {25}\) it was recognized that VAT is, in reality, a consumption tax. We want to point out that the VAT base does not consist of the sums destined by households to consumption:

\(^{24}\) Recent studies show, in fact, that the deduction of labor compensation could principally favor larger enterprises and, if foreseen within a CBIT-type taxation system (that is a system of business taxation modeled on the Comprehensive Business Income Tax principle), could produce more regressive distributional effects, compared to IRAP, by including the tax allowances in force (deductions, tax reliefs, tax wedge reductions). Cf. M. Manzo, M.T. Monteduro, From IRAP to CBIT: tax distortions and redistributive effects, MPRA Paper No. 28070, 2010.

\(^{25}\) Cf. R.W. Lindholm, The Value Added Tax: A Short Review of the Literature, “Journal of Economic Literature”, vol. 8, n. 4, December 1970, pgs. 1178-1189. Lindholm, in his review of the literature on the Value Added Tax, explained very well (see p. 1180) that we should reason on the differences, for example, as related to the comparison between VAT and alternative definitions of the taxable object of the Income Tax. We have tried to make use of this criterion in comparing VAT (defined as in the Italian case) and IRAP.
VAT is applied, in fact, to all trade through which goods and services are transferred among enterprises or among enterprises and consumers, with the exception of sales or transfers made by those who regularly do not have a similar business activity. Since this tax is imposed on all the steps within the chain of production and distribution of goods, or services, and it is commensurate to the full price of these, prior to the deduction entitled, the tax takes the form of a particular species of general tax whose taxable base is related to the business turnover and the object of which is, as a result of its internal mechanisms, the aggregate of consumptions. Therefore, both VAT and IRAP are different forms of the same family of taxes, which is that of general taxes, non-cumulative, and are commensurate to the gross business receipts.

The same reasoning applies to IRAP: at every stage of the production and distribution process of goods or services, this tax hits the difference between their sale value and their production cost, consisting of raw, auxiliary or semi-processed materials. IRAP is a business turnover tax just as VAT. Rules for applying the two taxes are such that each of them is equivalent to a monophase tax charged on the full value in the last step of the distribution of the goods, or services. These rules, as we have shown so far and still will show hereinafter, are such that IRAP, unlike VAT, hits exports and investments and exempts imports.

Suppose, now, that an enterprise makes only one operation: it buys a commodity at 100, and resells it at 200 without additional costs. In the purchase, this enterprise pays 100 plus VAT, that is 122 (VAT at 22%); in the sale of commodity, it (the enterprise) obtains from the seller 200 plus VAT, namely 244; the first seller, who has sold at 100 plus VAT, is bound to pay to the Treasury, as a taxpayer, 22; the second seller, who sells at 200 and collects 44 of VAT, pays only on its added value, determined by the mechanism of deduction of tax from tax, which is equal to 100, 22%, that is still 22. The total burden (44) weighs entirely on the final purchaser, who is the liable subject.

We now refer to the same example, but applying it to IRAP. The first firm has production costs, including products, gross of any relevant variable, equal to 100, as in the case which we have already proposed. Suppose this company is not entitled to any fiscal deduction. IRAP is added to these costs in the amount of 4. We assume that the firm sells the product at 104. The second firm
buys at 104, adds the relevant variables (100) and also adds IRAP, which is an additional specific cost component. The IRAP is applied, at the rate of 3.9%, to the difference between gross amount resulting from the sale and the amount of raw materials purchased (103.9). On the basis of the same data used so far and adopting the same assumptions, we can assume that the business turnover required by the seller is 207.8 (i.e. 100 plus 100 plus 3.9 plus 3.9).

In the proposed example, the following things have happened:

- for IRAP, as in the case of VAT, an amount equal to the product between the rate of tax and the final value of goods was shifted to the final purchaser: in the case of IRAP, 3.9% of 200, i.e. 7.8; in the case of VAT, 22% of 200, i.e. 44;
- the particular mechanism for the application of the tax hides its equivalence to a monophase tax; the reason for the choice of a particular mechanism based in both cases on the notion of added value, rather than on a monophase tax on the final value of the goods or service, could lie in the following consideration: the evasion of the levying of a tax on a single act of exchange can be easier than to that related to the whole chain of production and distribution. Consequently, a value-added tax (VAT or IRAP) could produce serious difficulties in the evasion of a single step.

Someone might object that in the case of VAT the seller must recover the tax, while in the case of IRAP he may recover. This observation concerns the question of the tax incidence. In the case of VAT, the liable subject is the buyer (the seller is only the taxpayer under obligation); he who will be able to shift, or not shift, upstream – from the buyer to the final seller – the tax, obtaining a lower price. In the case of IRAP, the liable subject is the seller, who can shift the tax into the price, on the final buyer.

In the calculations which we present in the following paragraphs we have assumed, for both taxes, however, that the tax is fully shifted downstream, which in practice we believe is the more plausible case. Of course, this result could not occur: it may happen that the buyer, in the case of VAT, get a lower price and, in the case of IRAP, the seller is not able to shift in full, downstream, the tax. This simply depends on the elasticity of the demand and supply of goods: there is a theorem, in financial economics, which shows that the moment of the tax impact (namely the fact
that there is, or there is not, the recovery of the tax) is irrelevant with respect to the question of who actually bears the burden of the tax, namely the question of the tax incidence (Dalton’s theorem\textsuperscript{26}).

In any case, the issue of the shifting of the tax arises for the two taxes in the same way: the recovery of the tax can make this shifting easier, but it is neither necessary nor sufficient for it to happen. The most plausible hypothesis that we consider is that the cost element of the tax is fully shifted on the purchaser in the case of IRAP\textsuperscript{27} and remains fully on him in the case of VAT; the latter hypothesis is needed to make sure that the tax takes the form of a consumption tax.

\section*{VIII. VAT. Its taxable base and the object of the tax}

It should be reiterated once again that consumption is not the taxable base of VAT: VAT is a general tax on business turnover, which is applied to all exchanges, including investments and exports. Since the mechanism to determine its taxable base is based on the value-added, VAT has as a tax base, including deductions, all the variables making up the GDP, namely consumption, investments and exports.

*Thus, for macro-economic equivalence, the VAT appears to be, in effect, a tax whose object consists in the sums paid by consumers for the purchases of consumer goods.*

In fact, what happens is that, through the mechanism of deduction of the tax from tax, the VAT paid on investments and exports is recuperated by the operators, while the “final consumption” is lastly charged to the consumer, who do not “recover” the tax from other people.

*Based on the same assumptions, since for IRAP the particular mechanism of the deduction of the tax from tax is not applied (but, instead, the one of the base from base is applied), this tax is commensurate to the Net Domestic Product (NDP). Some argue that this tax is applied to the...

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“production”, because obviously the measure of the domestic production, net of amortization, is not different from the NDP. For the macroeconomic equivalence, the taxable object of VAT consists of the consumption, while the taxable object of IRAP is equal to the sum of consumption plus investments plus exports net of the value of imported goods.

IX. VAT and IRAP: effects on consumption

The indications proposed so far are a first attempt to “account” for the greater burden produced by an increase of one percentage point of VAT. The “account” is made on the basis of macroeconomic data included in the *Rapporto SVIMEZ 2012 sull'economia del Mezzogiorno* and the revenue data published by the Ministry of Economy and Finance, both being expressed in billions of Euro and refer to 2010.

Let us, first, indicate with the expression $t_1$ the effective (average) tax rate, in 2010, of VAT, defined as the ratio between revenue $T_1$ and consumption $C$. It will be, therefore, at the national level

$$t_1 = \frac{T_1}{C} = 110.1 \quad 945.1 = 11.6\%$$

[4]

Starting from these data and reasoning in a proportional way, the increase of one percentage point VAT (from 20% to 21%) is worth approximately 5.5 billion Euros.

If the same line of reasoning, referring to the expression [5], is followed in the case of IRAP, the question becomes much more complicated.

Let us assume that, indeed, on the basis of criteria completely analogous to those followed for VAT, namely for macroeconomic equivalence, the taxable object of the private IRAP (which we denote by $B_2$) consists in the sum of household consumption, plus investments plus exports, minus imports, minus depreciation; if we refer to the account of IRAP paid by private production and distribution enterprises (liable subject) – excluding public administrations, banks and insurance companies –, given the targets of this account and the specific regulations concerning IRAP, we get:

$$B_2 = C + I + E - M - A = C + I + (E - M) - A = 9.451 + 300.0 - 40.6 - 31.3 = 1173.2$$

[5]

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The indicated value allows us to obtain the effective average tax rate, at the national level, of IRAP:

$$t_2 = \frac{T_2}{B_2} = \frac{19.2}{1173.2} = 1.6\%$$  \[6\]

If we apply this tax rate to consumption, we must deduct a part of it which is composed of imports and are exempt of IRAP. Assuming an average propensity to import by 24.1%, the part of IRAP referring to consumption will be equal to

$$T_2 = t_2(C - mC) = 0.016(945.1 - 0.241 \cdot 945.1) = 11.5 \text{ miliardi di euro}$$  \[7\]

*There are now innumerable problems related to an “accurate account”, and there is also a problem of funding, which is serious but not irresolvable. The solution we propose, however, requires a strong involvement of all the social partners, to who is necessary to offer a real advantage of the tax abolition, because it discriminates against investments and exports, and even is also detrimental to workers and consumers.*

**X. The reasons for the proposal**

The fundamental reason on which rests the proposal included in this paper concerns the enterprise system. VAT affects, in our opinion, not businesses, but consumers: the issue, therefore, arises from the side of demand. In our opinion, and as we have so far shown, the observation made concerning the strong negative impact on consumption, which could occur if the Italian Government applies the proposal we have set forth, is the result of a largely inadequate knowledge concerning the taxable object on which would weigh IRAP.

For the two other variables which are relevant, namely investments and exports, a benefit would result for enterprises with the abolition of IRAP which would not be compensated, as in the case of consumption, by a greater tax burden. However, assessing the magnitude of this benefit, for the different regions and districts, is difficult. We would need to know the extent to which the investment cost (or the export cost to other regions or other countries) depends not only on the tax rate applied in the region, which may be different from region to region, but definitely on the load, which is also different, of imported IRAP (IRAP imported along with the goods used to produce the investment goods or the exports). Moreover, it is important to consider the issue of tax
incidence (tax shifting), which may be crucial when the same good is subjected at different tax rates within and outside of a region.

Surely, it might be argued that a properly articulated model can allow an useful management of these problems. However, we think that, taking in the consideration the present situation, no model is fully trustworthy and, in any case, what we have explained so far could solve the problem, as it is a substantially satisfactory justification for the proposal.

XI. Concluding remarks

The conclusion reached by us is the following: on the one hand, the exchange IRAP-IVA for businesses produces an obvious (although not quantified) advantage, being related to critical variables, such as investments and exports; on the other hand, the cost of this advantage materializes in a greater weight on consumption, but is widely overrated. It follows that, in the current situation, the benefits which could be obtained on the side of investments and exports could be decisive for the purposes of a resumption of growth and employment in Italy.

The German case and the French one should teach us, moreover, that “to hook up to the train of recovery” and to exit from the recession is more than ever appropriate to lighten the local tax burdens on enterprises. In this two countries we have been witnessing, in fact, as we have already shown (see § 2), a radical reform of the structure of the Local Business Tax, with the narrowing of the taxable base and its transformation into a special tax on profits (Germany) or with its “unpackaging” into more taxes, based on the rental values of reassessed business properties and the value added produced by the enterprise (France). However, it seems paradoxical what happened in Germany where, in addition to the wage bill, the “capital” component has been excluded from

29 This advantage cannot be absolutely underestimated. The Italian National Audit Court itself, during the oral hearing in the Senate on the Stability Act for 2014, argued that “to reverse the decline of the production system is now a national emergency which the Central Government has to focus on and dedicate itself” (the translation is ours). Cf. National Audit Court, Joint Sections with Audit functions, Oral hearing on the Stability Act for 2014, 29 October 2013, p. 29.

30 The most recent data on the economic trend in the Eurozone countries seem to show, in fact, that in Italy “the stage of exit from the most serious economic crisis since the postwar period has proved difficult and incomplete. (...) These difficulties appear even more pronounced when compared with the performance of the principal EU partners, who had already gone back during 2010 (Germany) and 2011 (France) to the levels seen prior to the recession of 2008-2009.” (the translation is ours). So ISTAT, Rapporto sulla competitività dei settori produttivi, Roma, 2013, pgs. 13 ss., but see also OECD, OECD Economic Outlook, Vol. 2013/1, OECD Publishing, 2013.
the taxable base of the Local Business Tax also, although one of the main criticisms to this tribute is its excessive sensitivity to the economic cycle.

With regard to the Italian case and the proposal which was presented today, it should be noted that the effectiveness of tax benefits related to labour costs, for the reasons given in § 5, is yet to be demonstrated. In addition, in the event that the Italian government decides to make the tribute fully deductible from the income tax, it is highly likely that this benefit (the tax deductibility) is not immediately usable, because the income of many firms, for example those which invest in riskier sectors, may not be fairly consistent.

For these reasons, we argue that the simple abolition of IRAP is not sufficient to create the conditions most appropriate to put Italy back on the path of development and economic growth. It is necessary to do much more. It is appropriate to recognize the need to create economic development and engage seriously in achieving the necessary conditions in order to make it possible. If we want to proceed in this direction, there are plenty of successful models to which Italy could inspire to. In regard to this, the British case (see Section 4.3) seems very interesting. In the UK, the economic crisis has led to a strengthening of tax policies in favour of enterprises and the realization of a more active industrial policy, especially aimed at supporting the industrial sector. From this case, the Italian Government could borrow the BIDs model and the LABGI scheme. Such tools, if properly adapted to the Italian economic and institutional framework, may in fact provide, from our point of view, the right incentives to promote the emergence and development of forms of collaboration between the public and private sectors (thereby taking advantage of the recent expansion of the non-profit sector, which in Italy plays more and more often a key role of replacing PA in the delivery of some important social services). Moreover, they could allow the adoption of growth policies aimed at increasing the competitiveness of the local economic systems and the enterprises operating within them.

31 The British Government has planned, among other things, a progressive reduction in the Corporate Income Tax, which should decline from 24% to 20% in 2015. Cf. Institute for Fiscal Studies, A Survey of the UK Tax System, IFS Briefing Note BN09, 2012.

32 This phenomenon has been well highlighted in the Rapporto SVIMEZ 2012 sull’economia del Mezzogiorno, which shows that the so-called Third Sector had a real boom in the regions of Northern Italy, increasing its workforce by 50%, from nearly 3 million in 2001 to nearly 4.6 million in 2011; in the South, its presence has been, instead, much less significant; in fact, there was an increase of only 200,000 units, accounting for 13% of all employees in the same period (from 932,000 to 1,138,000).