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Italy's tax-reform challenge: the tax-wedge conundrum in five charts

Italy's tax wedge is high by OECD standards, considering the economy's low labour productivity and modest wage levels, but the country's narrow tax base and budgetary constraints provide little room for the government to reduce it.

The tax wedge is the difference between total labour costs for employers and the corresponding net salaries of employees. There are three main components: i) income taxes paid, ii) the employer's social security contributions (SSC), and iii) the employee's social security contributions. A high tax wedge can distort the labour market by discouraging hiring and encouraging informal employment, in turn weighing down on the economic outlook and public finances.

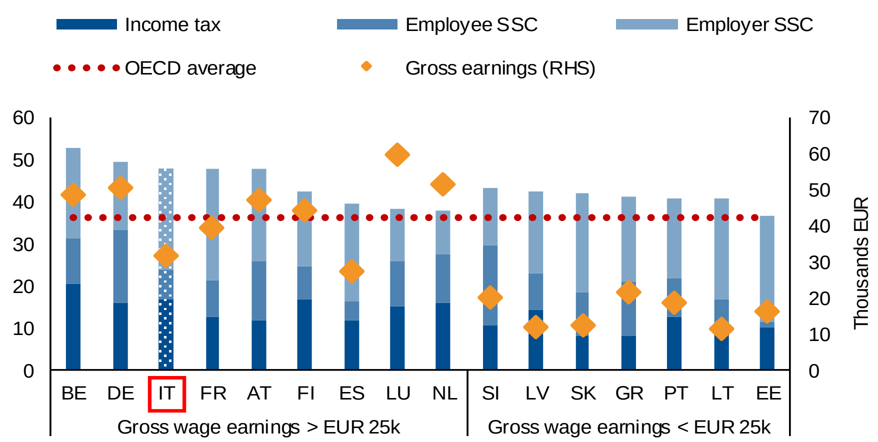
Italy's tax wedge is disproportionately high in the context of the country's moderate average earnings (**Chart 1**), and at odds with Italy's stagnant labour productivity (**Chart 2**). This combination distorts the labour market. The Italian government faces two main obstacles in cutting the tax wedge. The first concerns the tax base, which is narrow considering the number of persons employed, a problem made worse by adverse demographics, namely the ageing population and a shrinking labour force (**Chart 3**). The tax base is also narrow insofar as taxpayer contributions (**Chart 4**) are concentrated on the already highly taxed upper-middle class, another reflection of low average earnings and a high degree of informal sector employment. The second major obstacle is Italy's limited fiscal space, given elevated public debt and sluggish growth. The government took action to reduce the tax wedge in the 2020 budget but allocated only limited resources to the issue (**Chart 5**).

Breaking out of this "*tax wedge trap*" in the context of constrained room for budgetary manoeuvre requires the government to enhance fiscal efficiency by shifting the tax burden away from labour and introducing or increasing more growth-friendly forms of taxation, in addition to refocusing expenditure towards measures with the potential to raise productivity.

Chart #1: Italy's tax wedge is high, especially given low average earnings

Italy has the third highest tax wedge among euro area member states of the OECD. Decomposition reveals above-average burdens in both employer social security contributions and income taxes compared with peer countries. Italy's tax wedge as a share of labour costs is close to that of Germany and France. However, average earnings in Italy are much lower. As such, a high tax wedge may create significant economic bottlenecks, restricting the country's development potential.

Figure 1: Tax wedge decomposition (% of labour costs), 2018



Source: OECD, Scope Ratings GmbH

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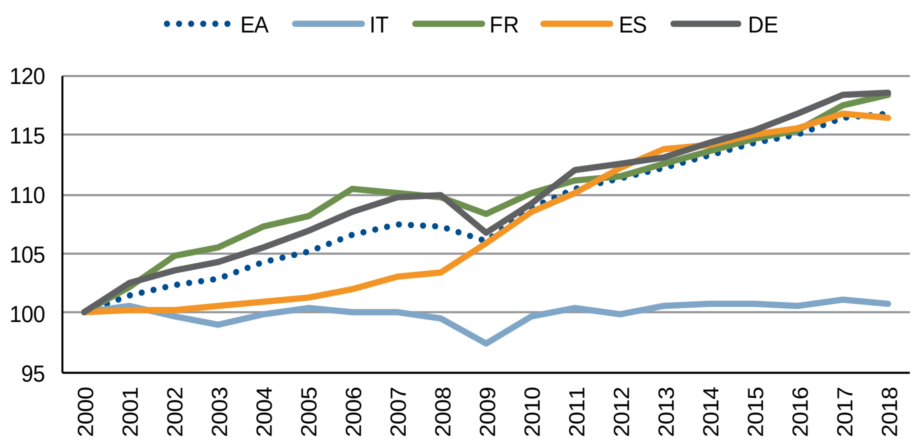
#2: Absence of productivity growth since 2000

Italy's lower wages result from low levels of productivity. While Italy's tax wedge is perhaps in line with that of some other large European economies, it is not in line with labour productivity. Real labour productivity has remained virtually flat over the past 20 years. Consequences of a disproportionately high tax wedge include weaker economic competitiveness, reduced rates of employment and incentivisation of a large informal economy and tax evasion. In turn, the tax wedge itself contributes to constraining efforts to improve productivity: heavy labour costs encourage companies to curtail investment and discourages them from hiring staff on permanent contracts. This works against the improvement of workers' skills, which could otherwise contribute to enhancing productivity.

The OECD's policy priorities (for example, via the OECD's *Going for Growth 2019*) have stressed the importance of enhancing productivity to boost growth. Policy suggestions include, for example, the improvement of the efficiency of public administration; improving the efficiency and equity of the tax structure; upgrading workers' skills; higher public investment; and better management of Italian infrastructure.

Figure 2: Real labour productivity per hour worked, 2000=100



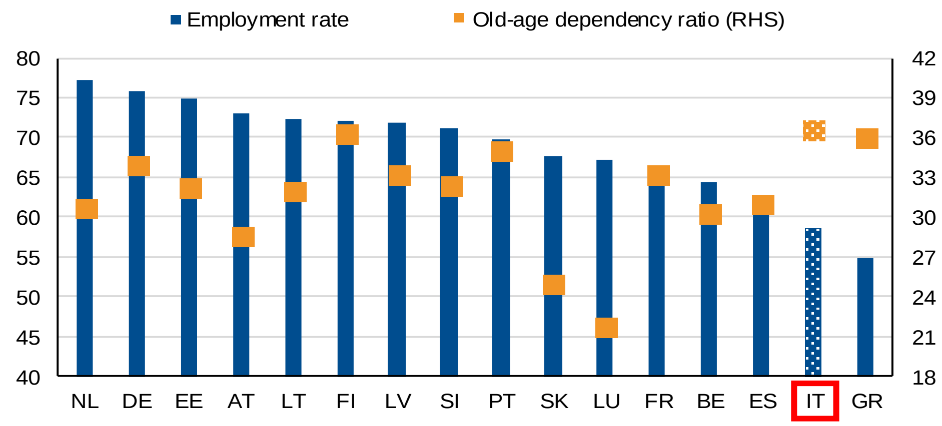
Source: Eurostat, Scope Ratings GmbH

#3: Low employment and adverse demographics

Excessive labour taxation distorts the labour market, discouraging employment in the formal economy. Italy exhibits one of the lowest employment rates and the *highest* old-age dependency ratio (i.e. the population aged over 65 as a share of the working-age population) in the euro area.

An ageing population coupled with continuing emigration, particularly among Italy's youth, have eroded the tax base and weigh on the sustainability of state-provided safety nets. The government finds itself with less financial room to reduce the tax wedge without compromising public finances with the tax burden shared by an increasingly small number of domestic taxpayers.

Figure 3: Employment rate (2018) and old-age dependency ratio (2020F)



Source: Eurostat, European Commission's Ageing Report 2018, Scope Ratings GmbH

#4: Excessive burden on the middle class

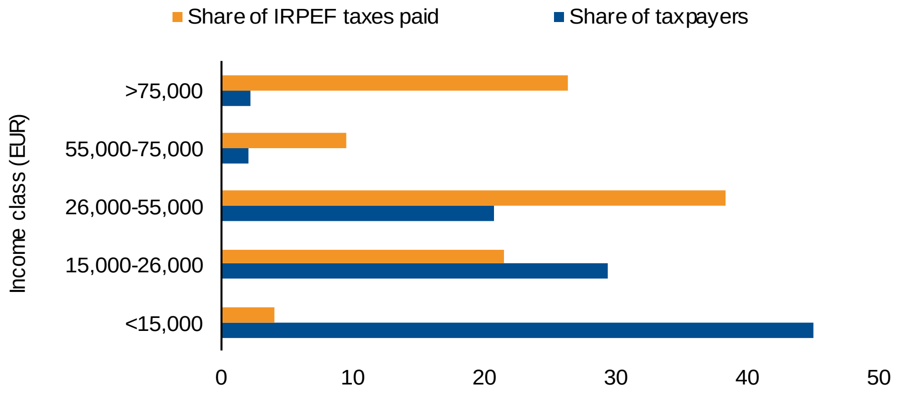
The distribution of personal income tax (*IRPEF*) payments amongst taxpayers shows how Italy's tax burden is disproportionately borne by a small and narrowing upper-middle-class, while a large share of the total Italian population might not be contributing adequately to covering per capita costs of providing public services.

Reported data for IRPEF revenues in 2017 revealed that among the 68% of the Italian population who are registered taxpayers, 45% of these persons claim annual incomes of below EUR 15,000 and pay only 4% of total IRPEF[1]-based revenues. By contrast, around 25% of taxpayers (or 17% of the population), who declare incomes of above EUR 26,000, pay around *75%* of IRPEF, while a narrow segment of only 5.3% of taxpayers (or 3.6% of the population) declare annual incomes of above EUR 50,000 and pay 40% of IRPEF tax collections. While it is inherent in progressive tax systems to have upper income class segments bear a larger share of tax payments, in Italy's case, a disproportionately significant share is paid by the middle class[2]. The large share of taxpayers declaring very low or no income reflects in significant part a high degree of income-tax evasion and informal sector employment.

The comparatively high tax burden of the upper-middle-class suggests measures aimed at reducing the tax wedge should also be directed at providing a degree of relief to this population segment. Absent fairer taxation, Italy runs the risk of incentivising its higher-skilled persons to emigrate, eroding the economy's human capital and longer-run growth potential.

[1] The total revenue from IRPEF in year 2017 amounted to EUR 157.5bn.
[2] NB. The IRPEF tax rate rises from 27% to 38% at a EUR 28,000 income threshold

Figure 4: Personal income tax paid, by income group, 2017



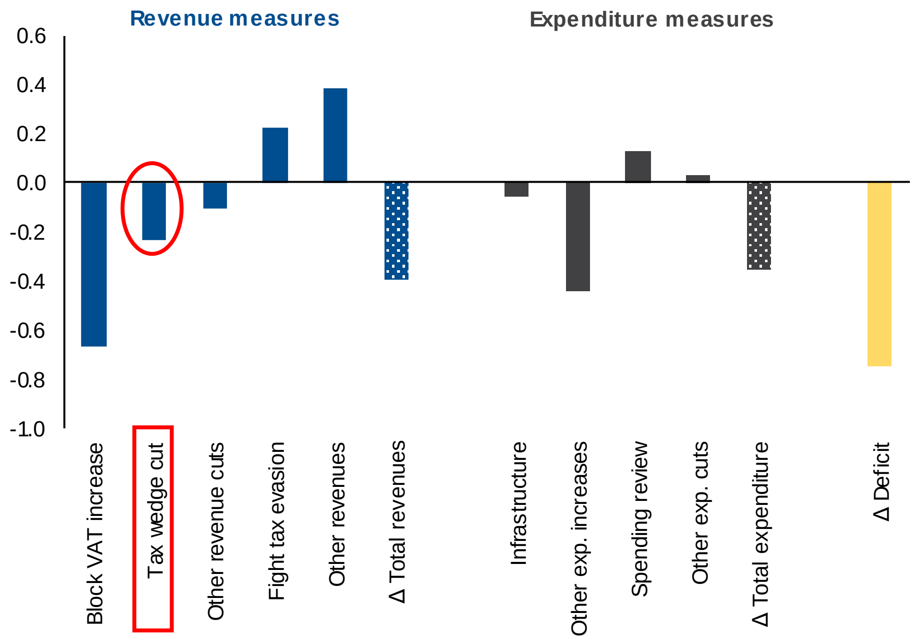
Source: Italian Ministry of Economics and Finance, Scope Ratings GmbH calculations

#5: Limited fiscal space to act

Italy's new government had limited space to immediately act on the tax-wedge issue, as around 80% of additional resources allocated in the 2020 draft budget had to be used to offset lost revenues from a cancellation of a 2020 VAT increase. Nevertheless, the government did include a tax wedge cut into the 2020 budget and medium-term fiscal programme, albeit of a limited amount (EUR 3bn (0.2% of GDP) in 2020, EUR 5bn (0.3% of GDP) programmed for 2021 and 2022). The cut is weighted towards supporting employees, especially low-income-earners and the lower-middle-class.

Additional resources for the reduction of the tax wedge could come from accelerating efforts in the area of cutting less-productive expenditure and better targeting spending on productivity-enhancing measures and investment. On the revenue side, besides further combating tax evasion, supportive reforms could come from further shifting the tax burden away from labour toward more growth-friendly forms of taxation.

Figure 5: 2020 Budget proposals, average budgetary impact for 2020-22, % of GDP



Source: Italy's Draft Budgetary Plan 2020, Scope Ratings GmbH

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