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Highlights in this issue:

- Italy continues to record low employment and participation rates
- A high tax burden on labour may help explain Italy's labour market performance
- There appears to be scope for revenue-neutral and efficiency-enhancing tax reforms that help boost employment

Italy's employment gap vis-à-vis the euro area and the EU is due to low participation

Italy's employment gap: the role of taxation

By Laura Bardone*

Summary

Much improvement has been recorded in the Italian labour market over the past decade, resulting in robust employment growth and a steep fall in the unemployment rate. However, employment and participation rates in Italy remain low by international standards, particularly for women, youth and older workers. With an overall unemployment rate that has remained below the EU average since 2003, the employment gap vis-à-vis most other EU countries reflects low participation. After a brief review of how taxation can affect the labour market, the analysis in this Country Focus provides a dynamic picture of taxation in Italy, with a special focus on taxation of labour and its interaction with social transfers. The potentially distortive effects of the Italian tax-benefit system on labour market outcomes are discussed in the light of the available evidence. It is concluded that, while in the medium-term the overall tax burden in Italy is set to remain relatively elevated, given the need to reduce the very high government debt ratio, there may be scope for revenue-neutral and efficiency-enhancing tax reforms that help boost employment. In any case, some difficult policy choices are needed if raising labour market participation and employment, particularly of women, is to become a policy priority in Italy.

The employment gap in Italy

Despite considerable progress over the past decade, the employment rate in Italy continues to be among the lowest in the EU, entailing a loss in terms of both potential growth and social cohesion. In 2008, less than 59% of the working age population had a job, compared with around 66% in the euro area (Figure 1, Panel A) and over 75% in the two best performing EU countries (Denmark and the Netherlands). With the overall unemployment rate having been below the EA and EU average since 2003, also thanks to labour market reforms from the mid-1990s, Italy's employment gap vis-à-vis most other EU countries reflects low participation.

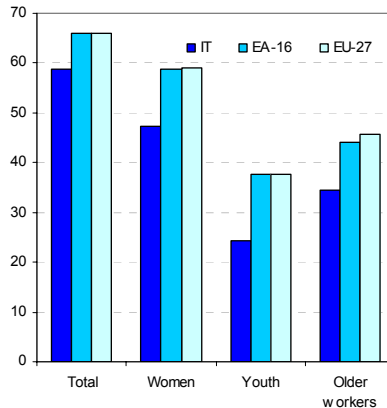
The gap is particularly large – in the order of 10 percentage points or more – at the two ends of the age spectrum. In the case of young adults (aged 15 to 24 years), the low employment rate in Italy is largely due to an unemployment rate that is four times that of adults aged 25 to 54. In the case of older workers (aged 55 to 64 years), it reflects a combination of early exits from the labour force and low participation, especially among women.

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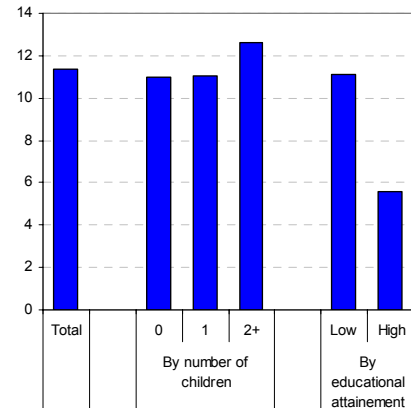
Also among prime-age persons (i.e. aged 25 to 54 years), Italy's employment gap vis-à-vis the euro area is largely driven by women (Figure 1, Panel B): with only six out of ten of them in work, Italy is the worst EU performer after Malta. Again, this is first and foremost the result of extremely low participation, especially among low-skilled women (a larger category in Italy than on average in the euro area): fewer than one in two of them are at work or are seeking a job. Parenthood also reduces the proportion of women in employment, the more the higher the number of children (and the lower their age). Interestingly, however, in Italy the employment rate among childless women of prime working age is by itself already low compared to that for the euro area average.

Figure 1: Italy's employment gap – 2008

Panel A: Employment rates by group¹



Panel B: The employment gap v-à-v the euro area for prime-age women by group²



1) Number of employed persons in each group as a share of the population in the same group
 2) Percentage point difference between the employment rates for the relevant groups in the euro area and in Italy.

Source: Eurostat

Women's labour supply decisions are typically taken from within a household context. Unlike in many other countries in the EU, one-earner households with children in Italy are more common than two-earner couples with children. This poses a policy problem to the extent that these households are exposed to a relatively high risk of poverty.

Another distinctive feature of Italy's employment gap is its distribution across regions. While the northern regions display employment and activity rates in line with, or higher than, the rest of the euro area, the southern regions show stagnating activity and high unemployment rates. This, again, is particularly true for women and young people, and goes hand in hand with a high incidence of irregular work.¹

... and is distributed unevenly across the territory.

Taxation and the labour market: the potential links

Taxes on labour can have an adverse impact on labour utilisation

Taxes on labour such as personal income taxes and employers' and employees' social contributions can have adverse effects on labour utilisation by affecting both labour demand and supply. In particular, to the extent that taxes and social contributions translate into higher labour costs, as wage earners succeed in shifting the tax burden onto employers, they can result in lower labour demand. By contrast, if taxes are reflected in lower take-home pay, they can influence the decision of whether to enter the labour market and/or how much labour to supply by those in employment. This negative effect on labour supply is amplified when the perceived benefit of paying taxes and social contributions is low, like for example when public spending is felt to be inefficient and the social protection system inadequate.² Depending on whether the income or the substitution effect prevails, a change in the combination of taxes and social benefits could result in higher or lower labour supply. Empirical evidence tends to find a negative impact of labour taxes on labour supply, although with different magnitude for different groups of workers, reflecting the elasticity of their labour supply curve (for a review, see Nickell (2006)). The effect seems largest for older workers, potential second earners within households and single parents.

Among prime-age persons, Italy's employment gap is driven by women

... and may encourage resort to the hidden economy

A high tax burden on labour can also create an incentive to resort to the shadow economy. When working in the hidden economy, the market value of the labour services is fully reaped by both the worker and the employer, whereas in the official economy part of that value would be taken up by taxes.

Shifting the tax burden away from labour in a revenue-neutral and efficient way may help increase employment

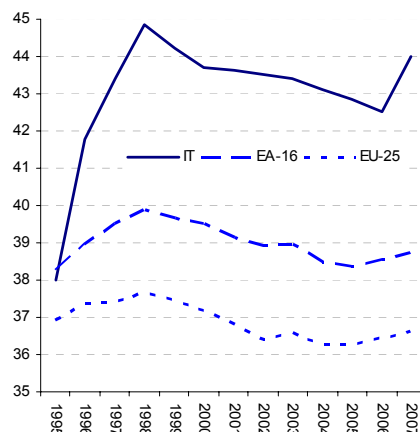
Overall, it can be argued that a relatively high tax burden on labour may have contributed to unsatisfactory employment levels in many EU countries, including Italy. In this context, revenue-neutral tax reforms that shift the tax burden away from labour to other tax bases can be an important element to help improve labour market outcomes and foster growth. European Commission (2008) discusses the potential benefits in terms of employment gains and growth of a tax shift from labour to consumption, typically in the form of a reduction of payroll taxes or social contributions financed by an increase in VAT. The analysis confirms this as a potentially useful instrument for governments to improve the structural conditions for employment growth in Europe. However, with consumption taxes being less progressive than personal income taxes, or even regressive, such a shift would reduce the progressivity of the system and thus imply a trade-off between efficiency and equity. Johansson *et al.* (2008) extend this analysis by considering other tax bases. They conclude that recurrent taxes on residential property are the least distortive tax instrument in terms of long-run GDP per capita. However, switching revenue towards these taxes is politically difficult, as they are particularly unpopular. There may also be gains, both in terms of quantity and quality of labour supply, from reducing the progressivity of the personal income tax schedule, but again entailing a potential trade-off between growth-enhancing strategies and distributional concerns.

The structure of taxation in Italy

Also because of the very high general government debt and related servicing costs, the overall tax burden in Italy is elevated by international standards. In 2008, the total tax-to-GDP ratio (including actual social contributions) stood at 43%, the fourth-highest in the EU and 3 percentage points higher than the euro area average. It has remained above the 40% mark since the early 1990s, with a peak at 43.8% in 1997, reflecting strong public finance consolidation in the run-up to the euro.

The tax burden is high in Italy, particularly on labour

Figure 2: The implicit tax rate on labour



Source: European Commission (2009)

Italy imposes a particularly high tax burden on labour income, in comparison with both the euro area and the EU as a whole. In 2007, the implicit tax rate (ITR) on labour – i.e., the sum of all direct and indirect taxes and social contributions levied on employed labour income³ as a percentage of total compensation of employees from national accounts – stood over 5 percentage points above the euro area average and was the highest within the EU-27 (Figure 2). In contrast to the experience of most Member States, between 1995 and 2007 the ITR on labour has increased markedly in Italy, from around 38% of total labour income to 44%. The increase was concentrated in the years leading to Italy's accession to monetary union,

as a result of the effort to meet the Maastricht criteria on the fiscal front. After decreasing steadily between 1998 and 2006, the ITR on labour increased again in 2007. This was due to a widening of the income tax base as well as an increase in social contributions.

Italy also displays an above-average implicit tax rate on capital – i.e., the ratio between revenue from all capital taxes and aggregate capital and savings income in the economy (Table 1). It should be stressed, however, that the analysis of the ITR on capital is greatly complicated by the fact that taxes on capital include a variety of taxes paid by both enterprises and households on many sources of revenue. In

particular, in these calculations, receipts from taxes and social contributions levied on the self-employed, a relatively large group in Italy, are booked as capital taxes.⁴

Table 1: The implicit tax rate on labour, capital and consumption

	Labour			Capital ¹			Consumption		
	2007	Ranking	p.p. change 1995-2007	2007	Ranking	p.p. change 1995-2007	2007	Ranking	p.p. change 1995-2007
Italy	44.0	1	6.0	36.2	6	8.8	17.1	25	-0.3
EA-16	38.7		0.5	32.1		6.2	19.6		0.2
EU-27	36.5		..	34.2		..	20.0		..

1) Data on the ITR on capital are not available for BG, LU, MT, RO; for EL, HU and PL, they refer to 2006.

Note: Averages for EA-16 and EU-27 are GDP-weighted.

Source: European Commission (2009)

... while it is relatively low on consumption

Finally, despite the 1998 increase in the VAT rate from 18% to 20% and the abolition of the 16% intermediate rate, the implicit tax rate on consumption, at 17% in 2007, is the third-lowest in the euro area after Spain and Greece. Indeed, Italy scores very poorly with respect to a measure of 'VAT reduced rate and base indicator' developed by the European Commission, indicating an erosion of the tax base by exemption, reduced rates, poor compliance and/or poor tax administration.⁵ In Italy, reduced rates to widely consumed goods and services such as food, transport, books and periodicals, pharmaceuticals, public facilities, hotel and restaurant services and residential housing⁶ are applied rather extensively. Tax evasion and avoidance certainly also play a big role: in 2003/2004, the non-declared tax base was estimated to account for more than 30% of the total theoretical tax base and the evaded/avoided VAT was estimated at more than 3% of GDP (Marigliani and Pisani (2007)).

Taxation of labour

The labour tax wedge

Measuring the tax burden on labour from an individual perspective

The implicit tax rate on labour is a summary measure approximating the ex-post average effective tax burden on labour income in the economy. As such, it does not allow disentangling cyclical, structural and policy elements and can hide important variations in effective tax rates across different household types or at different wage levels. At the micro-economic level, a useful measure of the tax burden on labour is the tax wedge, i.e., the difference between the labour costs to the employer and the corresponding net take-home pay of the employee. In Figure 3, Panel A, the tax wedge is measured with respect to the earnings of a single person and a one-earner couple with two children, both at the average wage (AW) in 2008. Also on this measure, Italy scores above the EA and EU average, even though its position in the country ranking is more favourable than for the ITR on labour (within the euro area, it comes after Belgium, Germany, France and Austria).⁷

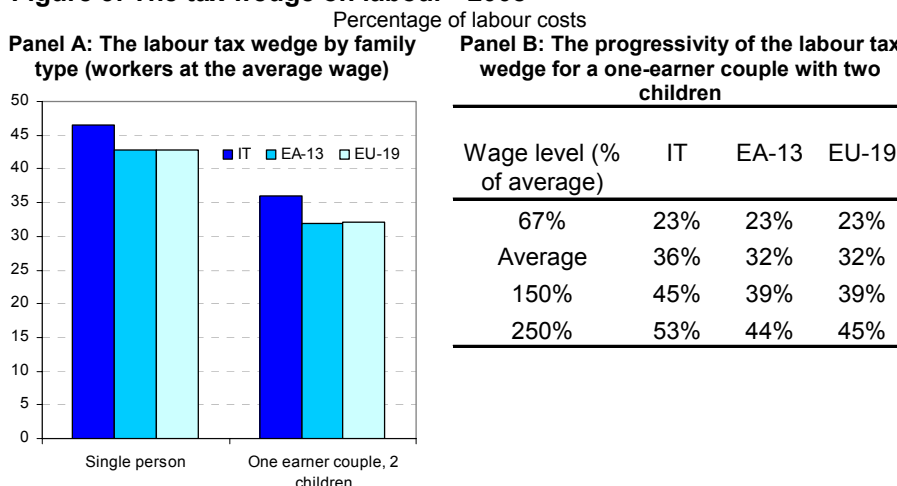
For a one-earner couple with two children, tax credits and cash transfers for family dependants that are calculated as a function of net income and the fact that social contributions are capped at rather high income levels makes the labour tax wedge highly progressive, with rates ranging from below 23% for a wage at 2/3 of the average wage to around 53% for wages that are 2½ times higher than average (Figure 3, Panel B).

Policy action to lower the tax wedge

Econometric analysis by the OECD (2006) confirms that the relatively high tax wedge in Italy is an important factor explaining its low employment rate. Various government actions intended to reduce it over the years prove that this problem is well recognised. As general cuts in social contribution rates and labour taxes are expensive, the Italian government has targeted rate reductions on specific groups – namely, workers in disadvantaged regions, women or young workers. The latest such reductions were introduced with the 2007 and 2008 budget laws, which allowed part of the labour cost borne by employers to be deducted from the tax base of IRAP. The deductions were more generous for companies in poorer regions and targeted at hiring workers on permanent contracts (as well as personnel involved in R&D and apprentices). Given the variation in the amount of these deductions and

the specific rules applying to them, it is difficult to estimate the impact of this provision on the measured tax wedge. The Bank of Italy estimates that between 1999 and 2007, the proportion of the tax wedge (including the IRAP base) borne by employers was reduced by between 2.4 and 2.8 percentage points of total labour cost, depending on the regional location and other characteristics of the productive activity.

Figure 3: The tax wedge on labour - 2008



Note: Unweighted arithmetic averages for EA-13 (data for CY, MT and SI are not available) and EU-19 (CY, EE, LV, LT, MT, SI, BG and RO are not included)
Source: OECD (2009)

Financial incentives to work: marginal effective tax rates

One method commonly used for measuring the potential impact of tax and benefit policies on labour supply is the computation and comparison of tax burdens and benefit entitlements for a number of typical households moving from one labour market situation to another. This is the approach followed in the calculation of Marginal Effective Tax Rates (METRs), measuring the financial gain implied by a given labour market transition within the formal economy.⁸

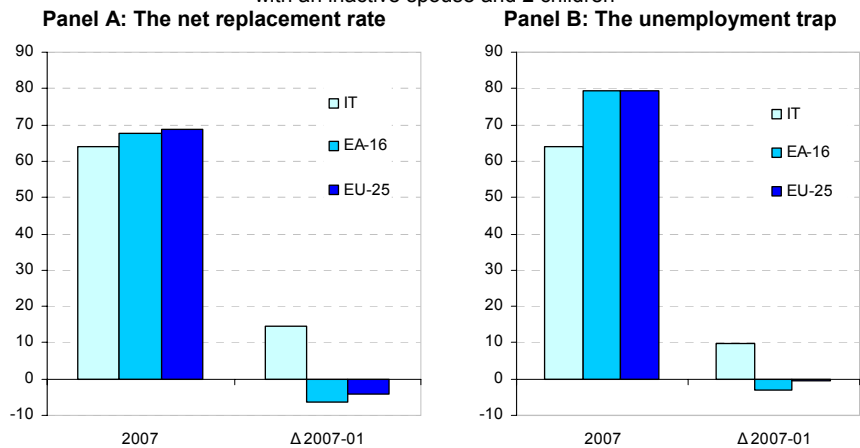
While Italy's overall level of taxation on labour is quite high, changes in the combination of tax and benefits associated with the transition from unemployment to work do not create major traps, given the low benefit protection provided to the unemployed⁹ (Figure 4). If at all, the trap is relevant only for a relatively short period, as ordinary unemployment benefits are paid for a maximum of 8 months (12 months in case of persons aged over 50). While it is true that the unemployment trap faced by persons returning to work in families with an inactive spouse and 2 children increased in Italy between 2001 and 2007 (while it decreased on average in the euro area and the EU), this increase should be seen in the light of the low income security afforded to the unemployed at the beginning of the decade.

Low benefit protection in Italy avoids creating unemployment traps

However, labour supply disincentives for the unemployed are not completely irrelevant in Italy. The Italian unemployment benefit system is patchy in terms of coverage and includes a variety of schemes applying different eligibility conditions, amounts and duration of treatments. The unemployment indicators displayed in Figure 4 relate to the ordinary unemployment benefit, which is much less generous than other existing schemes. In particular, the wage supplementation scheme (CIG)¹⁰ allows eligible workers to maintain the employment relationship in case of reduction of activity. Although this scheme has helped to limit the rise in unemployment in the current adverse cyclical conditions, a re-design of the system of unemployment support to make it less fragmented and extend its coverage is advocated by many observers. In the event of such a move, particular attention will need to be paid to the design of the new benefits in order to limit their budgetary cost and the employment disincentive effects associated with a more generous welfare system, also through appropriate activation and retraining policies.

Figure 4: The interaction of the tax and benefit system during unemployment - 2007

Unemployed persons previously earning 67% of the AW living with an inactive spouse and 2 children



Note: Unweighted arithmetic averages for EA-16 and EU-27

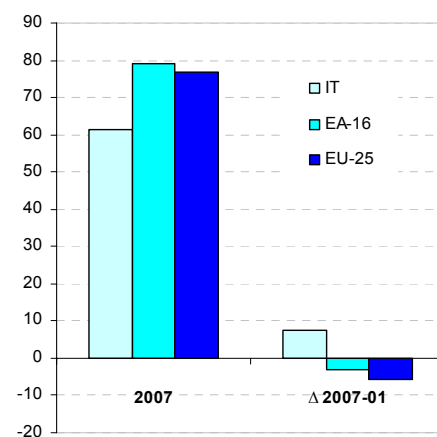
Source: Joint European Commission-OECD project, using OECD Tax-Benefits models

... whereas potential low-wage second earners in a household with children may find paid work unattractive

The Italian tax and benefit system appears more problematic with respect to a potential second earner in a one-earner household, a prevalent household type in the country. Although the tax unit is the individual, there are tax rebates for family dependants, including not only children but also a non-working spouse. These rebates are such that second earners are effectively taxed more heavily than single earners. Thus, paid work for a potential low-wage second earner in a one-earner couple may be unattractive, especially in the presence of young children or elderly dependants to be cared for (Figure 5). The combination of this feature of the tax system with the lack of affordable and good-quality care services most likely helps to explain why Italy has low female employment rates in couples.

Figure 5: The inactivity trap faced by a potential second earner - 2007

Person expecting to earn 67% of AW and living with a working spouse (67% of AW) and 2 children



Note: Unweighted arithmetic averages for EA-16 and EU-27.

Source: Joint European Commission-OECD project, using OECD Tax-Benefits models

Reviewing the tax system to attract more women in the labour market

In this context, reviewing the tax system in order to strengthen the financial support to second earners, and in particular working mothers, while fostering the development of affordable and high-quality care services, would clearly contribute to address the problem of low female participation in Italy. Starting from the assumption that women have a more elastic labour supply than men, Alesina *et al.* (2007) argue that women's labour income should be taxed less to achieve optimal taxation and change the allocation of family chores so as to allow women to work more in the market. The resulting increase in female labour supply and employment could eventually make up for the revenue loss generated by the scheme. Apparently simple, the implementation of such proposal raises some difficult issues, primarily related to its underlying assumption on the elasticity of women's labour

supply: namely, is the elasticity of labour supply of single women comparable to that of married women with children? If not, should gender-based taxation be applied only to the latter? More fundamentally, it has been argued that gender-based taxation violates the principle of equality of treatment and could end up stigmatising the role of women in the labour market.¹¹ An alternative proposal, discussed by Del Boca and Boeri (2007), is the introduction of a tax credit for couples with dependants to cover for part of the sustained care costs, conditional upon both

spouses working and requiring proof of payment. This proposal would pose fewer implementation problems, but would come at the cost of complicating further the tax code.

Increasing efficiency is not the only policy goal in the area of taxation; equity matters as well. In Italy, the change from an individual-based to a family-based taxation system has been proposed several times on distributional grounds. The effect of a reform of the Italian tax system in this direction has the potential to discourage the labour supply of women.¹² Thus, if raising labour market participation and employment, particularly of women, is to become a policy priority in Italy, such a reform would need to be considered with great caution.

Conclusion

Despite considerable progress over the past decade, Italy continues to record low employment and participation rates, particularly among youth, older workers and women. Italy's relatively high taxation of labour may help to explain this unsatisfactory employment and labour market participation performance. Given the need to reduce the elevated government debt ratio, while having to pay for the related servicing costs, the overall tax burden is set to remain relatively high in the medium term. Still, there may be scope for a revenue-neutral and efficiency-enhancing tax reform. Research has shown that shifting the tax burden from labour to consumption and/or immovable property can allow to achieve a long-term improvement of the structural conditions for increasing employment and growth. Obviously, any such shift must be closely scrutinised, because expanding other types of taxes is likely to raise efficiency and/or equity concerns. Looking at the structure and operation of the Italian taxation system, there appears to be some scope for such a move. In particular, the low implicit taxation rate on consumption in Italy suggests that part of the tax burden could be shifted onto this economic function. Priority should be given to increasing the efficiency of VAT collection. Further fighting tax evasion/avoidance on this specific levy would help achieve this goal without increasing tax rates.

Since raising employment and participation rates should be a policy priority in Italy, it is also important to look at the role of taxation in encouraging labour supply. Although in Italy the interaction of tax and benefit policies does not create many of the unemployment and inactivity traps that are observed in other European countries, 'making work pay' must be seen as a policy challenge also for Italy. Notably, in a possible move towards an overhaul of the unemployment benefit system to design it more in line with the flexicurity approach, attention will need to be paid to keeping financial incentives to work high. In addition, tax rebates for dependent spouses create inactivity traps at low work incomes that discourage participation of women, especially in the presence of young children and elderly dependants that need to be cared for. This may have supported the tradition of women staying at home to care for children and ageing parents, which in turn has certainly had a role in the underdevelopment of affordable and quality care facilities. In this context, revenue-neutral tax reforms that strengthen the financial incentives to work for potential second earners, while fostering the development of affordable and high-quality care services, would contribute to addressing the problem of low female participation in Italy.

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¹ The Italian statistical office (ISTAT) estimates that in 2005 the share of irregular workers in total employment amounted to as much as 12% for the country as a whole, but almost 20% in the South, as against around 10% in the Centre and 9% in the North.

² Social contributions could have a smaller impact on labour supply than other taxes because they are directly related to the future benefits people receive. In particular, to the extent that the contributions would not be perceived as a tax. In Italy, the shift from a defined-benefit to a notional defined-contribution system, which establishes a stronger link between contributions paid and benefits received, may contribute to alleviating the perceived tax burden on labour supply.

³ Including the part of the regional business tax - IRAP - related to labour costs. This tax was introduced in 1998 as part of an important tax reform that led to the elimination of employers' compulsory health care contributions and local income taxes. Although not levied on wages and salaries as such, the fact that the tax base of IRAP is calculated as the difference between the value of production and production inputs excluding personnel costs and interest costs means that IRAP falls on both labour and capital. It is therefore allocated to the ITR on labour and capital.

⁴ Except for taxes (and the corresponding income) of 'continuous and co-ordinated collaborations' that are allocated to the labour category.

⁵ The indicator is calculated as the difference between the standard VAT rate and the VAT component of the ITR on consumption. It aims at giving a snapshot of the extent to which a given VAT system approximates a "pure" consumption tax, characterised by a flat rate and the widest possible tax base (i.e. the entire value of private consumption without exemptions). The higher the value of the indicator, the higher the share of private consumption that is spared from taxation at the standard rate. Italy scores the highest value of the indicator among EU-27 countries. See European Commission (2009).

⁶ The favourable treatment of housing is likely to have a significant impact on revenues. However, housing taxation should probably be rather attributed to capital stock taxes.

⁷ Since IRAP is an indirect tax (see Footnote 3), the part of it that falls on labour is not included in the labour tax wedge. By contrast, it is included in the ITR on labour. CNEL (2008) estimates that the inclusion of IRAP would increase the tax wedge for the average worker by as much as 3 percentage points.

⁸ METRs measure the percentage share of any additional gross earnings following a labour market transition that is taxed away by the combined operation of taxes, social contributions and (the withdrawal of) social benefits. See Carone *et al* (2004) and Carone *et al* (2009).

⁹ See also Sestito (2005). The higher the value of the METR, the lower the financial incentive to work.

¹⁰ Workers on permanent contracts in specific, mainly manufacturing, industries incurring an involuntary and temporary reduction of hours worked can access CIG (*Cassa Integrazione Guadagni*) payments, financed by specific contributions. In case of industry- or firm-specific crisis, the government can grant laid-off workers access to the CIGS (or extraordinary CIG) for up to 2 years; CIGS is mainly funded through general tax revenues.

¹¹ For a critique of the proposal in Alesina *et al* (2007), see G. Saint-Paul (2007).

¹² For a discussion, see Aasve *et al* (2007).

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