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Italy

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I. POSTWAR ECONOMIC GROWTH

The postwar economic growth of Italy has been remarkable compared with that of other industrialized countries, as well as with that of most previous periods in Italian economic history. Between 1951 and 1962, Italy's national income increased at a rate of about 6 per cent per annum in current lire, and the country's growth rate both in real and in per capita terms was almost as high. Prices were relatively stable through 1961; wholesale prices did not change, while retail prices rose only moderately. Population rose by only 6.5 per cent from 1951 to 1961, mainly as a result of a continuous reduction in the mortality rate, owing to better sanitary conditions, to social assistance, and to an improved standard of living.

This high and steady growth rate combined with reasonably stable prices may suggest that the growth process has been essentially sound and that it has been supported by a good tax system and favorable tax policies. This is not so. It is our thesis that the Italian tax system has not been, and still is not, favorable to economic growth. Past growth has occurred not because but in spite of the tax system. Continued growth may well require tax reforms.

After 1961 the growth process began to falter. The beginning of inflation was followed by wage increases that exceeded increases in productivity. The subsequent balance-of-payments crisis in 1963 was ameliorated only at the cost of sharp deflationary measures that resulted in industrial production marking time in the last quarter of 1963 and even slightly falling in the first quarter of 1964. It seemed that the postwar "Italian miracle" was faced with some very real problems, of which tax policy and reform were of considerable importance.

NOTE: For conversion purposes, 1 lira = 0.16 U.S. cents, or 625 L = \$1.

Structural Features of the Italian Growth Process

What have been some of the key features of the Italian growth process? If the tax structure has been a drag on economic growth, what distinctive forces made the remarkable growth in the 1950's possible?

First, this growth process has been fed continuously by the increase in the labor force. While population increased by only about 0.5 per cent per year, employment increased by nearly 2 per cent per year. Employment has been fed from two sources: absorption of the unemployed and the movement of disguised unemployment from agriculture to industry, primarily from the south to the industrial north. Thus, until 1960, the increase in total wages paid was the result of higher employment, not of higher wage rates. This increase in total wages, therefore, did not put pressure on costs; in fact, productivity rose much faster than labor unit costs. However, the increase in employment and purchasing power throughout the economy did provide buoyant demand conditions.

As the Italian economy approaches a position of full employment —or at least one of full employment for those persons who are capable of being gainfully employed—the possibility of further "extensive" increases in employment have been reduced. Certain industries, such as construction and agriculture, have begun to turn to more capital-intensive methods of increasing output, although they have had no preparation for this. Moreover, it is now becoming evident that it is mainly through rising per capita wages that an expansion of total demand can be continued. But such wage increases create problems of business costs and therefore of price stability. Although, up to now, increases in productivity have preceded increases in per capita wages by several years, Italy is currently confronted by the possibility of having to choose between a continued high growth rate and stable prices.

In recent years, wage increases have tended to exceed productivity increases in some sectors of the economy. Increases in productivity have varied among the agricultural, industrial, and tertiary sectors. Before the war the agricultural sector was the principal contributor to Italian economic development, but during the fifties industry

TABLE 1

Value Added in Private Sector, 1951–62

(billion 1960 lire)

	Agriculture	Industry	Tertiary Sector	Total
1951	2,167	3,458	1,948	7,573
1952	2,315	3,825	2,302	8,442
1953	2,646	4,186	2,498	9,330
1954	2,658	4,573	2,717	9,948
1955	2,786	5,007	2,950	10,743
1956	2,658	5,288	3,223	11,169
1957	2,729	5,687	3,492	11,908
1958	2,949	6,128	3,830	12,907
1959	3,121	6,853	4,638	13,612
1960	2,993	7,634	5,133	15,760
1961	3,390	8,456	5,589	17,435
1962	3,544	9,266	6,120	18,930

played the dominant role. The tertiary sector also developed rapidly during this period, but here the productivity gains were somewhat questionable, especially in distribution and public administration.

Italian growth has also had an uneven geographic impact. The industrial development of the past twelve years has been concentrated mainly in the so-called Milan-Turin-Genoa triangle and in some of the surrounding regions, such as Veneto and Emilia, while it has been modest in other sections. This concentration, and the fact that agriculture has not been expanding as fast as industry, has resulted in regional as well as sectoral unbalance. Attempts have been made to correct the former by the policy of granting aids for the economic development of the *Mezzogiorno* in a broad area which also includes a part of central Italy. But the meagerness of industrial development in the south casts some doubts concerning the potency of the fiscal and monetary measures that were intended to stimulate growth in these regions.

Table 1 gives value added in each of the three major segments of the private sector from 1951 to 1962, and Table 2 the value added

TABLE 2

Value Added in Major Industry Groups, 1951–62

(billion 1960 lire)

	Mining	Manu-facturing	Electricity and Gas	Building	Total
1951	90	2,909	190	269	3,458
1952	110	3,090	227	398	3,825
1953	114	3,235	252	525	4,186
1954	132	3,492	319	630	4,573
1955	152	3,770	338	747	5,007
1956	176	3,948	351	813	5,288
1957	187	4,196	363	941	5,687
1958	180	4,507	391	1,050	6,128
1959	190	5,033	442	1,188	6,853
1960	195	5,668	495	1,276	7,634
1961	199	6,287	543	1,427	8,456
1962	196	6,822	586	1,664	9,266

in the four major industrial classes. The manufacturing industries which led the Italian economic development in the 1950's were generally the "heavy" industries and those using advanced technology such as steel, automobiles, chemicals, oils and engineering. Other more labor intensive industries, such as textiles, tobacco, foods, drinks and leather, and those processing agricultural products, have had a smaller expansion.

A feature of Italian growth which explains the absence of any marked rise in the general price level up to 1961 is the fact that those industrial sectors where most of the economic growth was experienced were able to reduce their prices relative to those of the less rapidly growing sectors. This can be seen in Table 3, which shows the ratios between sectoral prices and general prices for agriculture and the four major industrial classes for the years 1951-61.

The great increase in productivity in the so-called "modern" industries was characterized by sharp increases in wages and profits accompanied by a relative decline in prices. In these industries it was possible for internal growth to be self-financing. At the same time, the other sectors that were less well supplied with internal

TABLE 3

Ratio Between Sectoral and General Prices in Agriculture and Major Industry Groups, 1951–61

	Agriculture and Forestry	Mining	Manu-facturing	Building	Electricity and Gas	Total
1951	100	100	100	100	100	100
1952	98.29	91.27	96.91	101.40	110.64	97.59
1953	99.12	79.09	92.67	108.85	114.87	94.69
1954	103.80	78.56	87.06	111.61	114.66	90.52
1955	101.56	75.17	85.44	118.34	113.56	89.81
1956	97.44	65.88	83.12	121.98	111.29	87.81
1957	100.14	62.55	82.46	125.26	110.80	87.55
1958	92.85	56.77	82.75	126.28	106.47	87.48
1959	92.25	55.31	81.19	127.92	110.08	86.58
1960	94.08	53.07	79.33	130.19	108.48	85.03
1961	95.17	52.08	79.35	131.38	106.52	84.99

SOURCE: ILSES study of Regional Italian Economic Growth by F. Forte and F. Indovina.

funds had smaller possibilities of growth. Within these sectors there were cases where, because of rising productivity, the possibilities of profitable long-term investment were quite considerable.

Another feature of the Italian growth process during the years 1951-61 has been the fact that investment has risen at a faster rate than consumption; higher profits and their use in self-financing aided this development, but a high rate of public investment was also a contributing factor. During the past two years, however, wage increases have reduced the ability of Italy's expanding industries to finance their growth from internal sources. Furthermore, rising rents and retail prices have tended to push money wages even higher, so that these industries have had to face the necessity of doing their financing in the open market. On the other hand, the *rentiers* who seem to have benefited most from capital gains in the recent boom do not seem too anxious to employ their money in financing industrial investments. The seriousness of this situation is only partly mitigated by the presence of a larger number of public industrial enterprises which can secure funds through public financing. These enterprises, like the private industries, do their financing in the organized security markets.[1]

Italy's recent economic development has also been marked by a great expansion in the demand for such consumer durable goods as automobiles and domestic electric appliances. During the period 1951-62, the number of cars in circulation is estimated to have increased from 425,000 to over 3 million, or from one car for every 112 persons in the country to one for every 17. The consumption of nondurable goods also increased greatly, with households spending much more on higher-quality agricultural products, such as meat, and on housing. The demand for more and better housing has been particularly strong, partly because of rising incomes, but also as a result of internal migrations from the south and from rural areas to the industrial cities of the north. The progressive decontrol of house rents has raised living costs, but has also encouraged housing construction.

Italy has always had a balance-of-payments problem, but it has recently become more acute as a result of the country's economic development and rising income. Exports traditionally have been smaller than imports. During the postwar years up to the beginning of the 1950's, these difficulties were overcome mainly due to foreign aid. Later on, the balance-of-payments problem was eased by several favorable developments, including the discovery, in Italy, of large reserves of natural gas, the recovery and considerable development of foreign tourism, increased remittances from Italian emigrants to Western European countries, and large foreign investments in Italy. Even so, in 1954, when the ten-year Vanoni plan for growth and employment was launched, the problem of the balance of payments was considered to be one of the major issues of the immediate future. This did not turn out to be the case during the fifties, but more recently the situation has worsened.

Among the factors which have contributed to the re-emergence of a balance-of-payments problem, the following may be mentioned: (1) emigrant remittances have slowed down their pace as more at-

[1] Public enterprises are financed only to a minor extent with funds supplied directly by taxation.

tractive job opportunities and higher wages in Italy have made jobs in other countries relatively less attractive; (2) a growing shortage of labor for seasonal work and increasing congestion in the traditional tourist centers have placed limits on the further expansion of tourism; (3) the attempt to enforce progressive income tax measures has driven Italian capital abroad (especially to Switzerland); and (4) imports of cars, of crude oil, and of certain food products have risen sharply.

In summary, the principal weaknesses which underlie postwar economic development may be restated as follows: agriculture has been lagging too far behind industry; commercial distribution has clung to traditional methods of operation characterized by disorganization and low productivity; the great concentration of industry in the north has intensified the demand for housing and public services in the growing centers and left underutilized resources and facilities in other areas; industrial development has had to be financed internally in the absence of a parallel growth in the open market for capital funds; consumer affluence has placed an increasing strain on the balance of payments; and the emigration of capital to avoid taxes on dividends has been difficult to control.

Underlying Determinants of Growth

The history of Italian economic growth poses some interesting questions. For many countries the relevant question may be why growth begins after decades or centuries of stagnation. For Italy it seems more relevant to ask why growth did *not* occur before or concurrently with that of the European countries to the north.

For centuries Italy was one of the most advanced countries of Europe, not only culturally but also in the financial, technical, and commercial fields. Cities like Genoa, Milan, Florence, and Venice were famous during the Renaissance for their economic and financial power. What happened? First, of course, there was a succession of wars, bad government, and foreign domination that divided the country. Later on, there was a slowness to adapt to the necessities of a modern economy. National unification and a nationwide market were slow in arriving. A feudal agricultural system persisted, and even today remains in some parts of the south. Good government, especially at the local level, was slow to develop. Colonial wars and two world wars drained state finances and increased the public debt. The interlude with Fascism brought with it innumerable economic, political, and social blunders. All these factors, and others, can be pointed to in capsule form as drags on economic growth.

Why, then, could Italy so rapidly catch up in this postwar era? Other underlying factors existed that made rapid growth possible over the past decade. A great reservoir of unemployed and underemployed labor existed. Technical skills were available; indeed, a tradition of craftsmanship was a foundation for the development of small and medium-sized industrial enterprises. Universities were able to produce engineers and scientists at high levels of competence.

Other ingredients for growth were also present. The propensity to save was high, both through habit and the sharp inequality in income distribution. There was also easy access to the fast-growing markets of Europe and North America after the war. Nearby financial centers, such as Zurich, were willing to finance profitable ventures. Above all, Italy became more integrated within the broader European economy. This also made available a vast pool of technological knowledge.

Politically, nationalism and imperialism were replaced by concentration on increasing economic welfare. Italians became increasingly willing to "act economically." Unions, local groups, and the forces of self-government revived while feudalism and paternalism wilted.

Even though Fascism had earlier maintained that Italy had a "natural" condition of economic inferiority due to a meager resource base, this no longer seems to be true. As was stated, large natural-gas fields have been discovered. Italy's mountains provide much hydroelectric power. The climate is ideal for many vegetables and fruits. Italian history has filled the country with antiquities to entice the tourist. Geography has made Italy a link between the Middle East and Northern Europe and the United States. Since many of these advantages had always existed, the question was essentially one of putting them to use.

Financial and economic policies also played an important role.

The credit and fiscal systems financed heavy public expenditures without inflation. The tax system—despite its weaknesses and inequities—did raise important revenues. Unions were strong, but did not push for excessive wage increases; of course, much of this is explained by the restraint of high unemployment.

Although the development of entrepreneurship was limited by a *rentier* group brought up in a paternalistic and feudal environment, a solution was found in creating large public enterprises in steel, petrol, petrochemical, and other industries as well as in relevant parts of the public utility and banking sectors. Entrepreneurship (except in agriculture) also became more "socially acceptable," whereas previously the army and white collar work had been the chief attractors of talent.

Unfortunately, agriculture has not participated fully in Italian growth. Agrarian reform insisted on promoting the small family farm. This might well have been the proper course fifty or one hundred years ago in breaking the spell of feudalism, but today such a policy absorbs great financial resources while hindering modernization and productivity increases. This lag in agriculture is becoming more keenly felt as growing food imports bear on the balance of payments. Finally, American aid was an important stimulant in the postwar period. This was especially helpful in the liberalization of foreign exchange and trade.

II. TAX STRUCTURE

The Over-All Tax Burden

The over-all tax burden at all levels of government was considerable in Italy even before the Second World War, reaching nearly 20 per cent of national income in 1938. By 1952 it had regained this level and by 1961 had risen to 24 per cent of national income (see Table 4).

If social security contributions are added, this ratio rose to nearly 36 per cent in 1961. In relation to gross national products, the tax burden is 31 per cent, with almost one-third of this being attributable to the demands of the social security system.

TABLE 4

National and Local Tax Revenues, 1938 and 1949–61

	Revenue (million 1960 lire)			Percentage of National Income		
	National	Local	Total	National	Local	Total
1938	1,158,830	276,260	1,435,090	16.0	3.8	19.8
1949	1,045,149	181,648	1,226,797	15.0	2.6	17.6
1950	1,268,433	218,865	1,487,298	15.5	2.7	18.2
1951	1,296,990	220,285	1,517,275	15.8	2.7	18.5
1952	1,548,151	262,106	1,810,257	16.9	2.9	19.8
1953	1,735,547	300,319	2,035,866	17.2	3.0	20.2
1954	1,969,615	352,371	2,321,986	18.2	3.3	21.5
1955	2,189,389	374,452	2,563,841	18.7	3.2	21.9
1956	2,412,583	391,611	2,804,194	19.4	3.2	22.6
1957	2,609,465	426,254	3,035,719	19.8	3.2	23.0
1958	2,853,890	461,521	3,315,411	19.8	3.2	23.0
1959	3,212,267	506,777	3,719,044	20.2	3.2	23.4
1960	3,521,376	526,162	4,047,538	20.5	3.1	23.5
1961	3,963,675	533,545	4,497,220	21.0	2.8	23.8

This growth of revenues has been remarkable, making it possible to finance the government's need for funds without recourse to excessive increases in public debt. Most of the rapid growth in tax revenues has occurred at the national level and in the social security contributions. Local tax receipts, as shown in Table 4, have continued to represent only about 3 per cent of national income—less than before the war. Indeed, this has been one of the reasons why local governments have found it difficult to meet demands for better public services, urban decongestion, and cheap housing, especially in areas of expanding industry and tourism. National government revenues, on the other hand, have risen in relation to national income by about 35 per cent in the last decade. Social security taxes, in constant lire, increased tenfold during the fifteen years after 1947, and have proved to be one of the most income-elastic revenue sources in the fiscal system.

This sharp increase in social security contributions was caused by

TABLE 5

Direct Taxes as a Percentage of Indirect Taxes, 1938 and 1949–61

	Local Taxes	National Taxes	Total Taxes
1938	124.23	42.34	53.12
1949	114.40	27.63	35.76
1950	116.76	25.72	34.00
1951	111.28	27.67	35.46
1952	90.33	28.85	35.18
1953	88.97	28.03	34.43
1954	98.94	27.65	34.99
1955	101.52	27.87	35.08
1956	103.81	29.12	36.09
1957	110.77	29.77	37.18
1958	112.98	30.84	38.26
1959	110.26	31.04	38.12
1960	115.55	30.68	37.73
1961	114.16	32.13	38.42

a number of factors: (1) a gradual extension of coverage from industry to agriculture and services, (2) an increase in the number of employees, (3) a sharp reduction in underreporting owing to more modern accounting methods and the increased bargaining power of labor, and (4) the increase in wages (to which the contributions are roughly proportional). However, reforms are needed in the social security system to curb excessive bureaucratic costs, to reorganize the social security services within a unitary framework, and, perhaps, to bring social security within the general tax-expenditure system.

A distinctive feature of Italian public finance is the emphasis given to indirect taxes over direct taxes. Table 5 shows that while direct taxes have become slightly more important since 1950, they are still below their prewar level, when they accounted for about one-third of total tax revenues. Direct taxes have a slight advantage at the local level, but only account for about one-fourth of central government revenues. However, if social security collections are included as direct taxes, then over-all direct taxes nearly equal indirect taxes.

TABLE 6

National and Local Direct Taxes, 1938 and 1949–61

(million 1960 lire)

	Personal Taxes	Land and Buildings Taxes	Property and Succession Taxes	Corporation Taxes	Other Schedular Taxes on Income (RM etc.)
1938	42,649	124,213	63,074		239,692
1949	51,034	41,237	68,254		149,826
1950	61,400	46,469	59,939		193,543
1951	61,174	49,739	64,306		202,162
1952	61,494	59,025	102,070		224,208
1953	69,353	64,683	120,110		230,628
1954	86,359	79,125	98,680	40,164	270,391
1955	88,930	88,301	79,470	47,862	311,018
1956	97,094	96,523	81,995	62,064	349,729
1957	108,020	103,980	77,259	77,370	399,049
1958	125,980	110,070	73,252	93,448	451,692
1959	149,437	115,110	70,657	112,777	508,544
1960	157,926	121,022	67,011	128,141	559,797
1961	169,697	130,523	69,440	144,059	619,126

Direct Taxes

Personal income taxes play only a minor role in Italian direct taxation. Most revenue of this type comes from schedular taxes on various sources of income: labor, enterprise, building, land, and other capital assets (see Table 6). Taxes on wealth are modest; there is no such thing as an ordinary property tax (except for corporations), and death taxes yield very little.

The tax on moveable wealth (*imposta di ricchezza mobile*), or the "RM" tax, has trebled its revenue yield in the past decade. The RM tax is a schedular tax on wages (RM-C_2), self-employed income (RM-C_1), enterprises (RM-B), and interest income (RM-A). Table 7 shows the rates applied in 1963.

Broadly speaking, direct taxation in Italy weighs more heavily on

TABLE 7

1963 Rates of Schedular Income Taxes[a]

(per cent)

RM Tax	Rate
I. Category A (interest)[b]	30.8
II. Category B (profits of enterprises)[c]	
Under 960,000 lire	17.3
960,000–4,000,000 lire	28.0
4,000,000–10,000,000 lire	30.4
10,000,000–50,000,000 lire	32.8
50,000,000–100,000,000 lire	34.0
100,000,000 lire and over	35.0
III. Category C_1 (professional income; income from handicrafts; and income of small traders)[c]	
Under 960,000 lire	10.2
960,000 lire and over	14.9
IV. Category C_2 (employment income)[b]	
Under 960,000 lire	4.5
960,000 lire and over	9.5
Tax on income from buildings[d]	29.7
Land tax[e]	20.4

[a] The rates are all rounded to the first decimal place; the local government rates are those for Turin.

[b] No local government rates.

[c] The local government rates (communes, provinces, chambers of commerce) are included; they come to a total of about 5–6 per cent.

[d] The local government rates are the major part of the total: The rate due to the national government is 8.9, to the provinces 11.0, to the communes 9.7 per cent.

[e] Here also the local government rates are the major part of the total: national government—5.8, provinces—10.0, and communes—4.5 per cent. Since the official rates are calculated in current lire on each hundred lire of prewar cadastral values, we had to deflate them to take account of the average change in cadastral values as expressed in current lire.

NOTE: For RM C_2, C_1, and B (individuals), the first 240,000 lire earned by each taxpayer are exempted. This benefit may be obtained only once by each taxpayer, who computes it first on his C_2 income (if he has any), then on his C_1 income, and then on his B income.

The same rule applies in paying the lower rate on incomes up to 960,000 lire: each taxpayer applies the C_2 rate (if he has any income in this category after taking the 240,000 lire exemption), then the C_1 rate, and then the B rate.

wages and profits than it does on interest and rent. This feature of the tax system hardly seems conducive to economic development if we accept the thesis—which seems particularly significant for Italy today—that the *rentier* is less important in the growth process than the entrepreneur and the wage earner.

TAX ON LAND (*imposta sui terreni*)

The tax on agricultural land is imposed on the owner as shown by the cadastral rolls and is based on the imputed income attributed to the land. However, the Italian cadastral values have not been updated since 1939 except by rough average coefficients applied uniformly throughout the country. Thus, the present reliability of the tax is highly suspect; often marginal lands face a high burden as rich lands pay low rates. The tax tends to exert its weight inversely to the liquidity of the farmers affected. In poor localities with few tax bases other than agriculture, land tax rates have been pushed higher than in rich agricultural areas with broader tax bases.

There are no general exemptions for incomes below a set minimum, nor are there personal family allowances, because the land tax is a "real" tax. To reduce the burden of taxation on marginal agriculture areas, a considerable part of the national agriculture territories has been declared nontaxable: for example, all the territories of the communes located even partially at an altitude of 600 meters and over. There has, therefore, been some erosion of the tax base, which does not always correspond to a real necessity, and a considerable part of the land tax is still imposed on individuals who do not have ability to pay.

TAX ON BUILDINGS (*imposta sui fabbricati*)

The tax on income from buildings has been a poor revenue producer for a number of reasons: (1) old houses are still mostly under rent controls; (2) new "nonluxury" housing (which includes most because of loopholes in the law) is tax-free for twenty-five years; (3) assessment practices are inadequate.

In general the exemption of new buildings has seriously aggravated the financial problems of local governments without significantly aiding low-income families. Rents have become expensive for these families and thus exert pressure for wage increases, especially in the more developed industrial areas. If such broad exemptions had been avoided, local governments might have had more funds to finance low-cost housing and better public services. This might also have permitted lower and more equitable tax rates and an earlier liberalization of rent control.

Assessment has been poor and evasion high. Until 1961, assessments were made on the basis of rent officially declared by the taxpayers or on the market value of rents for similar buildings in the neighborhood. The assessor is the state tax authority, although it gets the smallest share of the tax revenue. Often the parties to a lease sign two contracts, a "true" one and one used for tax purposes with rents 30 to 60 per cent less.

The assessment system has been recently reinforced by a "new" urban cadastre. This, however, is based on the presumed value of estates in 1938 revalued with national average coefficients, and generally provides unrealistic values today, thus inducing tax authorities to adopt low revaluation coefficients to avoid excessive taxation in certain cases. Since this assessment serves also as a basis for personal taxes, the erosion and evasion in the assessments are spread elsewhere.

THE RM TAX (*imposta di ricchezza mobile*)

In the fiscal reforms initiated by Etio Vanoni in 1951, the schedular tax on income from capital, capital and labor, and professions and employment was "personalized" by the introduction of personal and family allowances, and of reduced rates for lower-income families. The intent was to shift to a system of direct taxes and to use modern methods of assessment rather than outdated presumptive measures. The differences in the rates applicable to the different categories of income reflect, however, a continuing recognition of the fact that it is easier to evade taxes on some types of personal income than on others. Tax evasion is believed to be particularly high among self-employed craftsmen, shopkeepers, and professional people (category C_1), partly because the income of these individuals is difficult to assess accurately, and partly because of the traditional reluctance of the government to press for strict enforcement of the income tax statutes applicable to these particular groups of taxpayers. The rates applicable to this category of income have, accordingly, been set higher than those applicable to wages (category C_2).

The situation with respect to C_1 income is open to criticism for several reasons. First, a good deal of income on which heavy taxes could be levied without adversely affecting investment or the balance of payments goes unreported. Second, the reduction in the effective rate on middle-income taxes has contributed both directly and (by example) indirectly to increased consumption by all social classes. And third, small family concerns are favored in comparison with medium and large-scale enterprises (which are taxed at higher rates, and with less chance of evasion in category B). This may be one reason why the Italian distribution system suffers from an excessive number of small establishments, and why some small shopowners hesitate to modernize or expand their businesses.

On the other hand, it is hard to see why commercial enterprises should not bear the same tax burdens as industrial enterprises of comparable earning power, nor does it seem reasonable that the income from garages, tailor shops, and shoe repair shops should be taxed at lower rates (under category C_1) than the income from small manufacturing establishments (under category B). Furthermore, the RM tax on business profits which fall into the latter category is not imposed uniformly. While corporations and other collective entities *must* be assessed on the basis of their accounts, partnerships and sole proprietorships may choose whether to be taxed on this basis or not. Although it would seem that enterprises taxed on their accounts would have less opportunity to evade taxes than those not so taxed, the penalties for failure to exhibit accounts, or for exhibiting unreliable ones, are quite modest. The major consequence of such "errors" of omission or commission is that the tax administrators will make a presumptive assessment of the corporation's profits based on the average earnings of corporations exhibiting reliable accounts. Thus a corporation that earns more than the average has an incentive to exhibit to the Tax Administration a patently inaccurate statement of its true earnings. Since the extent of tax evasion by business enterprises varies considerably, the competitive position of these firms is frequently badly distorted by the inequality of their effective tax burdens.

It should be recognized, however, that some progress has been made since 1951 in regard to the assessment of enterprises, even though the country still has a long way to go if it is to achieve the objectives of the reforms introduced in that year. Besides improving assessment procedures, the reforms have introduced new rules for depreciation.

The "personalization" of the RM tax through the introduction of personal exemptions and rate graduation for individuals subject to tax under categories B, C_1, and C_2 has lessened the severity of this tax on the lower-income classes. This is an improvement in the tax structure that might well be extended to income in the form of interest on the public debt, which is now excluded from the tax base, and dividend income, which is taxed separately at a flat rate.

PERSONAL INCOME TAXES

Italy's direct tax system also includes both state and local personal income taxes and a state "corporation" tax. The starting rate of the personal income taxes is 2 per cent, with the rates of the state tax reaching 50 per cent at 500 million lire. The maximum rate of the local tax is 12 per cent on income in excess of 10 million lire. For persons in the upper-middle income class, with income between 5 and 10 million lire, the combined burden of the RM tax and the personal income tax would be higher than the taxes on comparable U.S. incomes ($8,000-$16,000), especially for married persons, if there were no evasion. But there is considerable evasion in Italy, and it tends to increase with income. One indication of this is found in the fact that the local personal income tax, with much lower rates on large incomes, yields about the same total revenue as the national personal income tax.

There are many reasons for the weakness of personal income taxation in Italy, some of which go back to the early 1920's, when Mussolini effectively eliminated the progressivity of the national personal income tax and abolished the local taxes. In any case, at the present time, income from agriculture, and especially that from the most productive land, is greatly underassessed. There is massive underreporting of rent and interest income, as there is of professional income. Thus far no efficient system has been found for the assessment of dividend income, and capital gains derived from the sale of land, buildings, and securities are legally exempt from tax unless they are received by "professional" dealers or traders. Finally, the profits distributed by closely held companies often escape personal income taxes because of the difficulties encountered in making assessments of their profits.

Although most of these weaknesses have yet to be corrected, some steps have been taken since 1951 to improve the situation. Under the Vanoni tax reforms of that year, individuals for the first time were required to report income annually for tax purposes. In 1954, a "corporation" tax was introduced; and two years later the first serious attempt was made to secure information concerning the ownership of corporate shares.[2] The effect of this was to bring about a sharp decline in the prices of shares and a massive outflow of capital to foreign countries. Although much of this capital subsequently came back to Italy, because it came back seemingly as foreign capital, it continued to escape taxation.

In 1962, a new method of collecting income tax on dividends and related income was introduced. This required the recipients of dividends to give their names to the institutions making such payments, and these institutions in turn were required to report to the Tax Administration the names of the persons to whom they were paying dividends. At the same time, corporations and similar entities were required to make a provisional withholding of personal income tax with respect to all dividends paid by them. Shareholders were given the right to ask for reimbursement if the tax withheld exceeded the amount due from them, and were obligated to pay the difference if

[2] During the war years, Italy required the owners of corporation shares to register them in a central file, but this was done more for the purpose of getting better enforcement of the general property tax, which had been introduced as a wartime measure, than of preventing personal income tax evasion. Sales of shares by "temporary" contracts, with the possibility of deferred-payment purchase were not, however, subject to registration. Since these contracts could be automatically prorogated from month to month, even though the purchaser might have paid for the shares in full, anyone could become a permanent owner of shares without this becoming known to the tax authorities. The 1956 law changed this by making it compulsory to report to the Tax Administration these so-called temporary contracts. But not for long, since the next government tolerated the introduction on the Stock Market of a new kind of sale contract which relieved purchasers of shares from the obligation to report their holdings.

the amount due exceeded the amount withheld. In the cases of foreign and corporate stockholders, the 15 per cent withholding rate was the final tax.

As might have been expected, this new regulation had a severe psychological impact on shareholders, and again there was a heavy outflow of capital. Even though a substantial part of these funds may have come back to Italy under the guise of foreign capital, they generally did so in the form of short-term investments, or as investments in land or in buildings, thereby contributing to an inflation in land and building values. The banks were ready to assist their customers in carrying out both capital exports and imports while protecting their identity. Neither they nor the government apparently realized how dangerous these developments were for the continued growth and sound expansion of the Italian economy.[3]

One result was a sharp deterioration in the Italian balance of payments, which brought the government to the realization that something had to be done. But what to do? The government does not want sharp restriction on international capital movements, nor, under well-established principles of Italian law, can it tax its own citizens on income that is neither produced nor disposed of in Italy. The problem is one of making it attractive for Italians to bring their capital back to Italy without sacrificing the principle of uniformity, or horizontal equity, in the taxation of dividend income. This problem has not yet been resolved, nor have any really satisfactory proposals yet been advanced for its resolution.

Indirect Taxes

Indirect taxation constitutes the most important part of the Italian tax system. In a country which has suffered much from wars, foreign occupation, and dictatorships, and in which little reliance could be placed on voluntary compliance with direct taxes, the easiest and surest way to raise the revenues needed to finance large

[3] The situation was further aggravated by the circumstance that the nationalization of electricity occurred at about the same time the new regulations regarding corporate shares went into effect. The fact that the government was paying out large cash indemnities at the same time it was discouraging investment in corporate shares contributed to the outflow of capital funds and to speculation in real estate.

public expenditure has been through a multiplicity of relatively small levies imposed on virtually all transactions.

The major indirect tax is a general turnover tax on sales of goods and services imposed at every level of economic activity from production to consumption (IGE: *Imposta Generale Milla Entiota*). The only classes of sales excluded from the base of this tax are real estate, securities or interests therein, services of the Post Office and of the State Railways, and (as of three years ago) sales of retailers and small craftsmen. IGE's revenue yield is about equal to that of all the direct taxes of the state.

The general rate of this "queen" of the indirect taxes is 3.3 per cent. There are, however, a variety of higher and lower rates, some of which are intended to introduce an element of discrimination into the structure of this tax, while others are used to lessen some of the distortions that inevitably arise from the "cumulative" effects of this type of sales tax. It is recognized that a product "incorporates" as much sales tax into its own price as the number of stages through which its various components pass.

Differences in the effect of the multistage tax may arise, not only as between one product and another but also in the case of the same product when it is produced by firms with different degrees of vertical integration either at the manufacturing or at the distribution level of production. A series of measures have been adopted to take care of the most striking cases of this sort. Among them, the most common is the so-called system of *una tantum,* or "condensed rates." Instead of taxing all the possible stages through which a certain product may pass, only one typical stage for that product is subject to tax, but with a higher than normal rate. This higher rate is called a condensed rate, and it is calculated so as to include the average tax burden presumed to be saved at the other stages by a "representative" firm in the industry. As a result, there are a wide variety of these condensed rates, which are based, not on tax policy considerations, but on the more or less accidental fact that certain products do *on the average* pass through more hands before they reach the consumer than others do. IGE is an effective revenue producer, but it cannot be considered a good instrument of "qualitative" tax policy.

Other indirect taxes imposed by the state include a number of manufacturers' excises and consumption taxes on such commodities as gasoline, diesel oil, sugar, alcohol, beer, coffee, electricity, and textiles. The state also holds a fiscal monopoly on tobacco and on salt. There are also local consumption taxes on electric power, meats, building materials, and soft drinks.

As in the case of the general turnover tax, the justification of these other indirect levies is found mainly in their yield, and in some cases they may have perverse economic effects. For example, the tax on automobile sales, which is highly progressive with respect to horsepower, is imposed at the same rate on old cars as on new ones. This, when combined with high gasoline taxes, creates a strong preference for new cars and leads to the premature destruction of old ones. Thus automobile taxation fails to limit the number of vehicles or to relieve road congestion and encourages shifts to newer cars with low fuel consumption.

Equity Versus Growth

The heavy reliance on indirect taxes in the Italian tax system, when taken together with the Tax Administration's inability to prevent a considerable amount of income tax avoidance within the middle and upper income classes, has meant that the over-all distribution of tax burdens has been for the most part either proportional or regressive as one moves up or down the income scale. Although this has aroused some protest from the lower income classes, and has probably been a factor in the high percentage of votes cast for the extreme left, the question remains whether this development has been favorable to economic growth.

A proportional distribution of tax burdens may, of course, favor the accumulation of savings by the upper income classes; it may also have fewer adverse effects on incentives to save, invest, or manage enterprises than would a progressive distribution. Finally, proportional taxation may serve to contain certain excesses in total consumer demand, and so temper the effect of rising income on mass expenditures among the lower income classes.

A strong and equitable progressive income tax also has some definite advantages from the standpoint of economic growth. In the first place, the principal way of combining the requirements of economic development with those of monetary stability is to formulate and follow an "income policy." But an incomes policy requiring self-restraints on the part of labor, or other means to prevent wage increases, calls for the control of other incomes as well. One cannot expect the masses to accept austerity unless certain standards of fiscal equity are maintained, presumably involving sacrifices for the others.

Second, progressive income taxation may not have such negative effects on personal savings as one might suppose from the way in which the average propensity to save rises with income. The research findings of Friedman, Modigliani, and others have cast some doubt on an unqualified proposition that savings increase more than in proportion to income in a given community in a given period of time. But beside this, one has to consider that consumption often rises from a desire to emulate. This desire seems to be particularly strong in countries experiencing sharp increases in income starting from levels much lower than those prevailing in more advanced countries. The lack of effective progressive income taxation in Italy seems to have been responsible for the exceptionally high level of consumption attained by large social groups belonging to the medium and upper income classes, and the consumption patterns of these groups appear to have exerted an upward thrust on all consumption patterns, including those of the lower income groups.

As a result, the average propensity to save in all income classes has probably been reduced, while the increments received by wage earners have gone, not into savings, but into expenditures for "something more" than the normal consumption necessities. Cars and other durable goods, and a rich diet including much meat, are now considered normal by the Italian population, although that country's national income is still not high enough to provide everyone with these semiluxuries. Instalment credit has made it possible for many Italians to spend beyond their present financial means, so that long-awaited increases in income have enabled them to pay off old instalment contracts and to go deeper into debt.

Third, in Italy a lot of private saving is used for speculation, is hoarded, or is spent on such luxury items as villas and yachts rather than invested in industrial or agricultural enterprises. Furthermore, those persons who enjoy large capital gains from the sale of land or securities are often from the *rentier* rather than the entrepreneurial class. This money, too, is as likely to be invested in assets which seem likely to produce more capital gains than in a business venture which promises to earn a profit.

In any case, there is a considerable difference between a tax system which uses a broadly based income tax as a flexible instrument of fiscal policy and one such as the Italian in which the use of personal taxation on medium and high income classes is virtually renounced. With a weak personal income tax, the potency of fiscal policy as an instrument of stabilization is greatly impaired. During the initial phase of its postwar expansion, Italy was able to get along fairly well despite the crudeness of certain of its instruments of public policy. During this phase, both unemployment and underemployment made inflationary pressures relatively easy to control, as did rapid technological progress and increasing productivity. But in the next phase of its recent development, a strong personal income tax may be very important.

Flexibility of the Tax Structure

Despite the weight given to indirect taxation in the Italian tax structure, there is perhaps more flexibility in it than one might expect, in the sense that revenue yields are fairly sensitive to changes in levels of national income and business activity. IGE is paid on an ad valorem basis, and remittances must usually be made every week or every month. Therefore, as the volume of business transactions changes, the IGE revenue changes too. The gasoline tax is a specific levy that has to be paid as the product is put on the market, and the same is true of most excises and national consumption taxes. Most of these taxes are imposed on commodities which have a high income elasticity.

Owing to the cadastral method of assessment and to the exemption of new estates, real taxes on agriculture and buildings cannot be very sensitive to a rise in national money income. The RM tax and the personal income tax are more sensitive to economic fluctuations; their yields tend to rise with increases in the level of economic activity. But the existing system of assessment and collection introduces a systematic lag between changes in income levels and changes in tax receipts. Individual taxpayers file their returns for any given year on the basis of the income they had received in the previous year. The tax authorities usually publish the current year's tax rolls around June, and, except for taxes on wages, collections extend over twelve months beginning in August. Notwithstanding the practice of withholding taxes on wages and salaries, the collection of these levies is not much quicker. The firm that withholds taxes on wages paid weekly or monthly during one calendar year has to remit these amounts to the Tax Administration during the following year in six bimonthly instalments. As a result of this collection lag, business enterprises enjoy temporary excesses of liquidity during periods when wages or tax rates are rising.

It must be added that it is a widespread practice for enterprises to underestimate their profits in their annual returns. The Tax Administration does make periodic checks of returns and, since it is accustomed to regard underreporting as normal practice, ordinarily systematically increases reported taxable profits. Consequently, most enterprises prefer to keep their annual returns as low as possible. One result of this "pull and push" operation is that a considerable portion of the tax ultimately paid (possibly as much as 50 per cent) is collected with much delay.

Proposed Tax Reforms

There is a growing consensus in Italy that the existing tax system should be reformed. As regards the direct taxes, stricter methods of assessment and a more energetic administration are much needed. Personalization of the schedular income taxes and simplification and unification of the system of direct taxes is also necessary, although these changes will raise many technical and broad policy problems. Some persons contend that a property tax should be introduced to redress the discrimination against labor income in the schedular tax. Others would, on the other hand, favor lower rates for labor income instead of bringing in the new tax. There are also problems associated with the taxation of corporate income. Here the high rate of the real tax on profits might be replaced by changes in the rate structure of the corporation tax, but then the problem of the tax treatment of small business (both incorporated and unincorporated) would have to be faced.

As for indirect taxation, the prevailing view is that the present complex of indirect taxes should be abolished and replaced by a much simpler system composed only of a general value-added tax (which would replace the IGE) to be assessed at uniform rates on gross value-added minus gross investment, and of a wholesale or purchase tax which would be imposed at differentiated rates and would replace all state and most local commodity taxes. Local communities would have only a few taxes on commodities, which could be assessed locally: electricity, meat, building materials, and building rents. It has been estimated that the present yield of all local consumption taxes could be obtained if the local authorities were given the present state and local taxes on these four items.

These changes are opposed mainly on administrative, psychological, and political grounds. Although the outsider may find IGE extremely complicated, the Italian Tax administration maintains that this is the easiest tax to collect and the only one by means of which it is possible to raise as much revenue as is needed to combat inflation and to reduce budget deficits. It is true that IGE produces a considerable yield with a limited effort by the tax authority. But this is largely due to the imprecision of assessments, which allows a large amount of evasion. It is also true that the tax authority can rely on IGE to provide large additional revenues at times of financial difficulty. But this is a very crude instrument from the point of view of economic policy. Moreover, raising the general IGE rates during a period of inflation might be self-defeating, since any increase might be transmitted to consumer prices and, through the escalator clause connecting wages to the official living-cost index, automatically to money wages.

The capacity of IGE to raise additional yields is broad only if a general rise in rates is considered; it is much more limited if a policy of raising only the rate on selected commodities is considered.

The IGE administration is prepared to introduce a certain amount of rate discrimination, but not to the extent of making fine distinctions among commodities. It is accustomed only to differentiate among classes of enterprises that are only roughly defined, and between the various methods of assessment, which is a very different thing.

Another reason for the opposition to a reform of the indirect tax system, such as that outlined above, is the fear of taxpayer opposition to such a burden of indirect taxation if the aggregate rate of tax on individual commodities should become easy to figure out. The Italian indirect tax system is now about as "indirect" as one could imagine, since in it taxes are not only concealed in the prices of commodities but are also scattered through many different stages and components of production. No producer or dealer has much idea of the amount of indirect tax in the goods he manufactures or distributes. This maximizes the extent of tax illusion. But at the same time, many Italians know in general that they are being heavily taxed, and they are troubled by the arbitrariness and the unnecessary complexity of the system. All this adds up to the development of a very poor attitude toward paying taxes.

III. TAX INCENTIVES FOR GROWTH

Let us now examine some specific features of the Italian tax system which are of particular interest to us as instruments of tax policy for economic growth. These are (1) the so-called tax on companies, (2) the accelerated depreciation allowances and the allowances for new investment, and (3) the special incentives given for investment in the *Mezzogiorno* and in the depressed areas of central-northern Italy.

The Tax on Companies (Imposta sulle Societa)

The tax on companies, which was introduced in Italy in 1954, is considerably different from the corporation taxes found in most other countries. It consists of a 15 per cent tax on business profits exceeding 6 per cent of the company's invested capital, and a

0.75 per cent tax on invested capital.[4] This pair of taxes was, of course, designed so as to give a "pincers" effect. The invested capital declared for purposes of the 0.75 per cent tax must be the same as that used in calculating the 6 per cent exclusion from the tax on "excess" profits. Consequently, if a company underdeclares the value of its invested capital, it runs the risk of having to pay a heavier profits tax; or if it overstates its invested capital in order to minimize this risk, it of course has to pay a higher tax on its capital. In theory, therefore, the pincers system is supposed to compel corporations to make realistic declarations. However, there are many exceptions.

In the first place, a corporation may succeed in underassessing both profits and capital. Since the tax administrators frequently check the value of a company's invested capital by comparing it with profits and vice versa, the opportunities for substantial avoidance of both taxes are good if tax administration is weak, as it tends to be in Italy.

Second, the pincers method may not work in the cases of corporations whose profits on invested capital tend to be less than 6 per cent.[5] This may be the case particularly for corporations whose capital consists mostly of undeveloped land which they intend to hold until such time as they are ready to sell, or to use it themselves for building purposes. Under Italian law, capital gains do not have to be included in taxable profits until such time as the asset has been disposed of, or until its appreciated value has been indicated in the company's balance sheet. Therefore, corporations owning assets of this type may, for a considerable period of time, understate the true value of their capital assets and enjoy substantial tax advantages without jeopardizing their position with respect to the tax on "excess" profits. The company tax has in this way encouraged investment in land for building purposes, and has thus fostered the

[4] Invested capital is defined as the paid-up capital stock of the company plus all surplus reserves (except those representing fixed or determinable liabilities) and any undistributed profits carried over from preceding periods.

[5] Profits subject to the 15 per cent tax are calculated net of the RM tax and other "real" income taxes. Consequently, a corporation may earn up to as much as 9 per cent on its invested capital without becoming subject to the companies tax, since "real" taxes tend to run about 30 per cent of corporate income.

inflation of land prices and the diversion of capital from other more productive uses.

The tax on companies also favors new industrial enterprises as long as they have low profits. Such enterprises reduce their tax liabilities by understating their invested capital until such time as they begin to earn high enough profits to make them subject to the 15 per cent tax on excess profits. Thus, new enterprises may secure personal income tax advantages for their stockholders by retaining and reinvesting their earnings for a number of years without increasing their company tax liabilities. From this standpoint, the tax may be said to favor capital accumulation and to reward initiative on the part of small, growing firms.

Enterprises with low productivity due to low capital intensity may also be helped by this mechanism in their efforts to modernize. Their productivity can of course be increased through an increase in investment and renewal of equipment. Such firms can reinvest their profits and increase their capital without any increase in the corporation tax on capital until a substantial productivity increase has been achieved and the pincers system becomes effective.

In a dualistic economy like the Italian one, having enterprises with quite different strengths and possibilities for growth, there may be good reasons to have a tax favoring enterprises with low productivity. The less an enterprise is taxed, the more it is able to grow and to reinforce itself. But this is true only from the point of view of the income effects of taxation.

From the point of view of incentives, there are opposite effects. It is self-evident that a corporation tax structure such as the one described above taxes marginal profits quite heavily and puts a differential burden on risky enterprise profits. To be sure, this disincentive is felt only after an enterprise crosses a certain threshold. Yet it may also work against an owner-operated business that is growing rapidly and is considering the possibility of raising more capital through incorporation.

The status of the Italian company tax might possibly be improved by the adoption of special measures which would favor enterprises having fluctuating incomes and newly incorporated businesses. For example, consideration might be given to the possibility of averaging profits of several years and to the deduction of some specific reserve funds used to cover certain definite risks.

The greatest fault of the Italian company tax scheme, however, seems to be that it deals in the same way with real estate companies or family companies set up mainly to reduce personal income tax liabilities on personal properties as it does with enterprises carrying out industrial activities. In some instances its rates favor the retention of profits. This may be justified when it encourages industrial development, but unfortunately this is not always the case.

On the other hand, severe tax burdens on companies having a limited family basis may be justified by the fact that these companies are suspected of being instruments for evading personal taxes. Yet often the result is that some small industrial enterprises are penalized when they should have been helped to grow. The economic difference between the small family company that carries on a business enterprise and the one organized to administer capital possessions is quite large; the former corresponds to the entrepreneur type and the latter to the *rentier* type. A tax policy designed to promote economic growth ought to differentiate between these two cases and should at least avoid giving a more favorable treatment to the *rentier* than to the entrepreneur.

Accelerated Depreciation and Investment Allowances

Let us next consider some of the provisions of the Italian tax statutes permitting accelerated depreciation and granting initial allowances for new investments.

Accelerated depreciation became a permanent feature of the Italian tax system in 1951, when business enterprises were given the opportunity of reducing, by not more than two-fifths, the period of depreciation with respect to investment in new plant and equipment, as well as in the enlargement, conversion, and rebuilding of existing buildings or machinery. Thus, in addition to normal depreciation, accelerated depreciation not in excess of 15 per cent of the cost of the asset is allowed in each of the first two years of the depreciation period. A similar additional allowance not in excess of 10 per cent of cost is permitted in the third year, which adds up to

40 per cent. Moreover, the accelerated depreciation period starts in the year in which the investment is made, whereas the ordinary depreciation period starts in the year in which the new investment begins to produce.

In addition to the accelerated depreciation allowances described above, an extra 10 per cent of cost could be taken as an initial allowance under a 1956 statute which was effective only for the years 1957-59 inclusive. This allowance could be taken only for purposes of the RM tax on profits, and in no case could it exceed 5 per cent of the firms's "reported" income.[6]

This temporary initial allowance for new investment has been extended, and in 1963 a new bill was introduced which would extend it for another three years and, in addition, raise the allowance itself from 10 to 15 per cent. Moreover, the limitation on the size of this allowance with respect to income would be lifted from 5 to 12 per cent. If enacted, these proposed changes in the law should be particularly helpful to new and growing small enterprises whose profits are likely to be small in relation to their new investments. Both the 1956 law and the 1963 bill limit the extra allowances to enterprises which are taxed on the basis of their accounts. The aim of this limitation is, of course, to encourage small enterprises to elect to be assessed on this basis. The limitation may, however, serve only to diminish the impact of the temporary allowances on economic growth. The attempt to achieve two objectives through this one statute may reduce the likelihood of attaining either.

Under the Italian tax laws, the straight-line method is the only one allowed for purposes of normal depreciation. The basis for depreciation is always "historic" cost. Changes in the purchasing power of money are not thought to be relevant to the assessment of asset values. Therefore, an enterprise which sells an asset at a figure higher than the purchase price less depreciation realizes a taxable capital gain which must be included in the profits of the year in which the sale took place. This is so even if, at the time when the asset was purchased, money had a purchasing power higher than

[6] It was thought that this last clause would stimulate enterprises to report taxable incomes nearer to the true ones in order to enjoy a larger allowance for new investment.

the one current at the time of sale. It must be added, however, that in the years immediately following the war, special extraordinary rules were adopted to take account of the effects of postwar inflation on the nominal and real values of enterprises' assets.

It is likely that such extraordinary measures would be introduced again if a great inflationary explosion were to happen, whereas they will not be reintroduced as long as we have only "creeping" inflation and some scant inflationary pressure. It must, however, be added that an enterprise may always revalue its capital assets spontaneously, pay the tax on capital gains, and increase the basis of them for depreciation. At any rate it remains true that straight-line depreciation based on historic costs, with the possibility of some evaluation of assets at nominal prices, tends to include some capital in taxable profits. Accelerated depreciation and additional allowances for new investments are needed, first of all, on these grounds.

There are, of course, other reasons too. First, tax deductions relating to production costs are somewhat restrictive in Italy. They are regulated by the principle that a cost may be deducted only when it is inherent in that production; i.e., not all production expenses actually supported can be deducted, only those which "cannot be avoided." In practice it is very difficult to separate inherent expenses from noninherent costs, and the principle of inherency is applied in dubious cases as a restrictive rule. Businessmen often complain that this rule fails to recognize the necessity of certain costs connected with technological and industrial progress and modern selling systems. So far, Italian tax authorities have shown a tendency to resist these pressures on the general front of the inherency rule, and yet to make concessions on the "specific" front of deductions related to depreciation and investment allowances.

According to the claims of businessmen, official coefficients of tax depreciation are often calculated on periods longer than those usually taken into account when early obsolescence is expected. However, in a substantially dualistic industrial structure such as is found in Italy, it is difficult to establish coefficients of depreciation that will be equally good both for technologically advanced business and for the others that make use of tools and machinery which to the advanced business would appear bare scraps. In any event, the initial investment allowance and the accelerated depreciation have been conceived as measures to encourage capital accumulation in any kind of enterprise.

Some critics object to these policies on the ground that the government should not try to stimulate investment by strengthening the self-financing capacity of business firms. This, it is said, tends to direct economic development primarily along the same lines and within the same firms that have already been successful. Moreover, these policies are said to encourage industrial concentration. In reply to the last point, it may be suggested that, with the integration of the Italian economy into the European Common Market, firms which would appear large in relation to the Italian market may turn out to be small in relation to the European one.

Tax Incentives for the Development of Southern Italy

In Italy the idea of tax exemptions for underdeveloped areas took hold in 1951, when a new plan was devised to give systematic aid to the South (continental *Mezzogiorno* plus Sicily and Sardinia). The plan was adopted and the *Cassa per il Mezzogiorno* was established.[7]

Tax benefits given in the South may be classified as follows: exemptions granted to profits produced in the South, exemptions granted to profits made in any part of the country but invested in the South, and various concessions in the field of indirect taxation.

Profits arising from investments made in southern "technically

[7] The *Cassa per il Mezzogiorno* (which should terminate in 1965, although it will probably be extended with some modifications) devoted its funds mainly to public works during the first period of its activity. After 1958, the *Cassa's* efforts were addressed, to a greater extent than before, toward giving loans at reduced rates and capital funds to new industrial undertakings in the South and, lastly, toward technical assistance. A new law of 1957 obliged public enterprises controlled by the Ministry of State Participation (i.e., corporations in which the majority of shares is held by a public holding owned in its turn by the state) to allocate 40 per cent of their new investment to the South. A variety of industrial enterprises (a huge new steel plant by Finsider, IRI, in Taranto, petrochemical enterprises and oil refineries by ENI, some new plants in the fields of cement, engineering, and so on) were thus realized. It was hoped that these enterprises could become the nucleus of a new industrial development, attracting a variety of other enterprises. So far, however, the process seems to be quite slow.

organized" industrial enterprises are exempted from the RM tax for a ten-year period from the date of investment. The exemption is granted to all undertakings started before June 30, 1965. The exemption does not cover local rates added to RM and special state additionals,[8] or corporation tax or national and local personal income taxes.

Industrial income alone is exempted. Income derived from properties or shares owned by the enterprise or from a commercial activity not complementary to or integrated with the industrial activity is wholly taxable, although the industrial income of the same enterprise is exempted.

The exemption covers only industrial enterprises with fixed installations, machinery, and other equipment "technically organized" for production. Many questionable cases have arisen in respect to this point. And it has been held that neither a movie theater nor a hotel are technically organized industries according to this law. The same ruling has been made with respect to commodity transportation, but in the case of a dry-cleaning establishment the answer was in the affirmative, on condition that such an enterprise was equipped with modern machinery and was organized as an industry and not a small artisan's shop. The exemption is given not only to entirely new enterprises but also to new investment in the reactivation, transformation, or enlargement of former enterprises. In these cases, the ten-year period of exemption begins from the date of "increased capacity," and affects only the increment of investment. Thus the old part of an enterprise might not enjoy the exemption, while the new part of it would.

Income supposed to come from "new capacity" is determined in the initial year of its operation as a percentage of the aggregate "industrial" income of the enterprise. This percentage remains fixed throughout the ten-year period of exemption, whatever may be the aggregate industrial income of the enterprise in each single year thereafter.

Another tax benefit favoring the South consists of an exemption

[8] RM accounts for about two-thirds and local and state additionals to it for the remaining one-third of the total burden of real taxes on profits. Local authorities "may" (but are not obliged to) reduce their rates on these industrial undertakings.

from the RM tax of profits earned anywhere in Italy, by enterprises taxed on the basis of accounts, when they are invested in the South for improvement and conversion of agricultural lands or industrial plants fulfilling the criteria of the southern economy's "organic development." The exemption cannot, however, exceed 50 per cent of the total expense of the project in which the investment is made, or 50 per cent of the profits reported by the taxpayer making the investment.[9]

This benefit has been granted to profits taxable from fiscal year 1958/59 to fiscal year 1964/65. The investment must be undertaken within the year following that in which the exemption was granted, and must be finished within three years. When these conditions are not met, the taxpayer not only loses the exemption but also has to pay a surcharge equal to 50 per cent of the tax. Taxable profits not reported by the taxpayer are excluded from the amount on which the 50 per cent exemption is calculated.[10]

A third group of tax advantages for southern development consists in a variety of concessions in the field of indirect taxation. The most important, perhaps, is the exemption from customs duties on machinery imported from abroad and installed in southern enterprises.[11] Other important exemptions are those for the registry taxes due on chartering of corporations and on loans granted for industrial undertakings in the South, and those for local consumption taxes on building materials employed in factories and in public works in the *Mezzogiorno.*

Until recently, the effects of these tax exemptions appeared rather

[9] Suppose taxpayer A has 1 billion lire of "reported" taxable profits and invests 800 million in a plant in the South. He enjoys the exemption only on 400 million because of the limit of 50 per cent of the cost. Suppose, then, that taxpayer B has also 1 billion of "reported" taxable profits and invests the whole of it in the South in a plant costing 2 billion. B's exemption will cover only 500 million because of the limit of 50 per cent of reported profits. Since the RM tax is about two-thirds of total taxes on profits, total saving of real taxes is about one-third of the aggregate burden in the most favorable case. Personal and corporate taxes, of course, must still be paid.

[10] Since 1960, tax exemption has also been granted to firms which invest in the shares of other companies, on condition that the capital so invested is devoted entirely to ventures in the South, which would be entitled to the exemption under the law. If the shares are subsequenttly sold, the exemption is rescinded, and any taxes previously saved must be paid in full.

[11] This exemption has raised much criticism among Italian producers of investment goods, e.g., those of machinery for electric power plants.

small and disappointing, since few industrial businesses have so far developed in the *Mezzogiorno*[12] apart from the ventures by state enterprises. Moreover, new undertakings have been particularly limited in the case of small and medium-sized enterprises belonging to light industry and big industry's subsidiary and collateral sectors, which represent the "nursery" and the "connective tissue" of a growing industrial area. It must, however, be said that in the last two years things have changed a bit. Actually, a larger number of enterprises have settled in the South, or are at least considering the possibility with greater interest than in the past.

The effects of tax exemptions for new investment in new areas need time to mature. After the tax exemption is granted, some time must elapse before enterprises become fully aware of the benefit and, above all, before the exemption can enter into investment decisions. New ventures materializing today are often the result of a decision process which matured only after several years of study and discussion. The risk of modifying decisions already made in order to take into account the new fact of tax exemption may be actually very high. It would therefore be unreasonable to expect that a newly introduced tax benefit should become operative very soon.

The tax benefits for the South cover a variety of taxes and situations, although their quantitative aggregate impact for the single taxpayer appears on balance not to be great. The exemption for profits produced in the South is quite high in terms of tax rates, and yet it is limited with respect to time, i.e., the first ten years. It often happens that several of the first ten years of a new venture end without any profit or even with some loss.

Moreover, in 1956, the "carryover" of each year's losses to the next five business years was introduced in the Italian RM tax system. This reduced the advantage of a ten-year exemption for many enterprises, since the carryover may be sufficient to eliminate tax liabilities for a number of business years. Similarly, "accelerated" depreciation and allowances for new investment reduce the relative attractiveness of the ten-year exemption for incomes produced in

[12] Since a large number of credit incentives were also given to the South, some criticism must also be directed at them. The cumbersome procedures and the heavy mortgages attached to these credit facilities seem to have been responsible for their poor results.

the South as well as of the differential treatment in favor of the profits invested there.

A full exemption of profits earned anywhere in Italy and employed in the South perhaps might be more effective than the ten-year exemption of profits derived from new ventures, since it would have an immediate and important income effect in addition to the incentive effect. Small and medium-sized firms might derive great advantages from such income effect, especially in underdeveloped areas where investment risks are high and the financial market is quite limited.

A capitalist deciding to invest in the South may often prefer to associate with another Italian or foreign enterprise that already has had some experience in the field, instead of venturing in entirely on his own. It must then be recalled that such investments have been eligible for the exemption on profits only since 1960. It is, therefore, only since that year that the whole provision has had substantial scope, so it is too early to judge its effectiveness on the basis of the results.

Italian taxes are not well assessed. Therefore the effective tax rate on profits is often less than the "legal" one, and the actual tax savings that would result from an exemption would tend to be smaller than the legal rules might lead one to expect. Furthermore, in a situation of weak tax assessment, the very request for an exemption may have the result of calling the attention of the administration to the accounts of the taxpayer applying for it. As a result, instead of paying less, he might end up paying more.

Strong incentives were needed to move the new ventures from North to South in an economy such as the Italian one of the 1950's, when expansion in the North was very easy and fresh manpower was readily available there because of internal migrations, whereas southern environmental conditions were rather poor. In the former area there were also many external economies, and in the latter too many external diseconomies. However, now congestion is spreading in the North, and in the South some external economies are finally developing.

As new enterprises are brought to the South by credit or tax incentives or by the law governing the location of public enterprise investment, environmental conditions favorable to establishing other new enterprises are automatically created. Undoubtedly, the disadvantages to be overcome are still great and, therefore, a big push is still necessary.

Although the South has plenty of labor and wage rates are lower than in the North, these advantages have not played a significant role in promoting southern enterprises. Higher wages paid in the North often correspond to higher productivity made possible by the existence of skilled labor locally available and capable of training and directing the unskilled labor recruited in the South.

In the South, on the other hand, lower wages are paid to native labor, whereas skilled labor has to be imported from the North in order to train, direct, and integrate the local labor force. Northern skilled workers have to be paid higher wages than in the North in order to compensate them for the displacement cost.

The population of northern Italy has a lower propensity to immigrate, and yet that region has a much larger supply of entrepreneurial skill and qualified laborers. On the other hand, the workers of southern Italy have a high propensity to immigrate and much less entrepreneurial skill and technical know-how. No wonder, therefore, that in a country like Italy population as well as production end up by concentrating in the North.

Up until now, the government's efforts to industrialize the South have been too widely dispersed. Better results might be obtained if its efforts could be concentrated in small, strategically chosen areas.[13]

In this way, "growth centers" might be established which could in time bring about a self-sustained growth process in the limited geographical areas.

The new strategy of development based on growth centers is little by little becoming a part of the Italian government's policy for the South. At present, however, attempts to make use of it are being limited to public enterprises, whatever their field of activity may

[13] Sometimes the easy availability of initial capital to start new enterprises in the South appears to have led to waste, with difficulty in finding further capital for the enterprises. Technical assistance might be helpful in reducing this waste, which is often caused by inexperience.

be, and in a timid sort of way to public works in general. Furthermore, as yet no fiscal or financial aids have been developed to support such a policy. Instead of granting moderate tax concessions to all industrial investments made in the South, more substantial ones might be given to enterprises operating within established "growth poles." If this were done, entrepreneurs who planned to establish new businesses in the areas selected could anticipate the probable location nearby of many other industrial enterprises, public works, and other facilities.

Unhappily, the policy of developing a limited number of growth centers is faced with two kinds of difficulties. The first is that there are too many local pressure groups scattered throughout the underdeveloped area, each of which is trying to build its own growth centers. Second, some control over the prices of building land is needed if the policy of spatially concentrated industrial development is to be effective. The more limited the area of any chosen growth center is, the easier it will be for the present landowners to reap much of the gain from industrialization.

Brief mention should also be made of the tax concessions that are currently being given to industries in the depressed areas of central and northern Italy. The profits of new small industrial firms and handicraft firms established in this area and considered "depressed" during the period from 1857 to 1965 are given a ten-year exemption from the RM tax and from state and local additions thereto.[14] According to the law, these exemptions apply to those central-northern areas that are characterized as mountainous and to local communities recognized by the government as "economically depressed," so long as they have less than 10,000 inhabitants.

Any local community whose population increases above this level after the benefit has been granted (perhaps under the effect of the incentive itself) cannot lose the "depressed area" qualification.

These tax concessions, which were intended to aid certain depressed areas of cental-northern Italy, have not worked out satisfactorily. In practice they have been little more than occasional and paternalistic concessions given to some of the less wealthy local

[14] Enterprises employing no more than 100 workers, exclusive of white-collars, are considered "small" by the law.

communities under the pressure of local political representatives, quite outside of any comprehensive governmental program. Some of the areas qualified as depressed were actually not suited for industrial development, while in other areas nearby, not so designated, conditions were more favorable for industrialization.

In order to carry out an efficient policy of space reallocation, a comprehensive program should be developed and the whole problem of tax incentives should be reconsidered. Districts should be viewed from the standpoint both of their existing economic structures and also of what they will have in the future, each one separately and then all together within the framework of a complete system of public choices and alternatives. Above all, it should be recognized that the granting of financial aid and tax concessions on a piecemeal basis makes no sense and accomplishes nothing.

COMMENT

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Francesco Forte has offered some very interesting comments on the effects of recent Italian tax policy on economic growth. But I think that what we can learn from this policy is what should *not* be done rather than what should be done to foster growth. It is my opinion that the fiscal system in any country, and this is particularly true in the case of Italy, can be explained better in terms of some sociopolitical theory than in terms of the economic analysis of the value alternatives.

Nevertheless I shall myself make a few comments on the problem under consideration, mostly from the point of view of an economist who is interested in an analysis of the factors accounting for growth. Two different problems arise when one considers Italian tax policy in relation to the country's program for economic development. The first concerns the actual structure of the tax system, and the second the way in which tax policy should be administered in order to foster economic growth.

Forte has already shown very clearly how the actual structure of the tax system was shaped through the successive introduction of new levies without any consideration to the over-all impact of the tax system on economic growth. Perhaps we should recall the main reasons why the system is so inefficient. First, the cost of collecting taxes is very high because there are so many opportunities to avoid them. Second, the manner in which indirect taxes are imposed distorts patterns of productions. Third, the direct tax system tends to penalize productivity. Fourth, the system fails to serve as an automatic stabilizer. Fifth, the procedure whereby personal income and business profits are determined and taxes are collected creates a sense of insecurity which is not conducive to enterprise, especially on the part of small and medium-sized firms.

The need for tax revision in Italy is now widely recognized. Something has to be done, but for two reasons the situation has not changed substantially. First, we need to create a more efficient system of reporting and collecting taxes by combining some levies and by changing our system of checking tax declarations of profits. We still adhere to the principle that every personal declaration should be checked, although we know that in fact only a few can be checked. As a result, the risk of being checked is so low that widespread evasion is encouraged. Second, the revisions which we make must be sufficiently general to convince people that the new measure will not introduce a new kind of fiscal discrimination against somebody, or in favor of somebody else. In any general tax revision, tax rates must be fixed at a reasonable level. In theory, the Italian income tax is one of the most progressive; but in fact it is rather regressive. It could be made more progressive if the government had the means to reduce evasion and if it would make empirical analyses of the effects of rate changes on total tax revenue. The latter is particularly important if we are to answer those who object to radical changes in the tax laws on the grounds that we do not know what their revenue effects are likely to be.

Let me now make a few comments on the way in which I think our fiscal policy should be administered in order to foster economic growth. I have in mind particularly the needs of countries where there are regions that are depressed or underdeveloped. In these countries, it is generally felt that the national government should establish a long-range program to provide the facilities needed for economic development. This is required, first, because only in this way will it be possible to gain the perspective needed for the development of some sectors, and second because economic development should be concentrated in certain sectors and in a few regions in order to bring about the required take-off for the economy as a whole. To implement the plan for economic development, the government must create the necessary amount of social capital at those times and in those regions where it will serve the plan best. Furthermore, in order to achieve effective utilization of resources and at the same time avoid too much concentration of capitalist power, there must be some integration of public and private enterprise. The need for this is diminishing somewhat because Italy's participation in the Common Market has intensified the competition between large firms.

The question of whether it is advisable to foster investment by tax exemption of profits can, in my opinion, hardly be settled in general terms. Sometimes increases in consumption are needed, sometimes increases in private investment, and sometimes increases in public investment. Sometimes a certain amount of public investment may be required before private investment opportunities can be exploited, as is the case in the South of Italy.

I agree with Forte about the desirability of a tax on value added and a purchase tax only on the last transfer of the commodities. Our present system of indirect taxes badly distorts the structure of production. I think that indirect tax rates should be adjusted from time to time in order to maintain the desired balance between present and future consumption and in order to foster investment as opposed to consumption as well as to foster public investment as opposed to private investment. A tax on value added may make this easier.

I come now to my final point. Perhaps I am more pessimistic than my friend about the usefulness of tax exemption as a means of fostering economic development in some special sector or some particular region. But I believe that when you start such a policy, it tends to become generalized and, therefore, inefficient. To the reasons for this pointed out by Forte, I would like to add a few more.

First, a system of fiscal exemptions creates confusion in the minds of the people and fosters a general feeling that fiscal policy is designed to discriminate against some interests and favor others.

Second, a subsidy could be more easily directed than a tax exemption toward those activities, sectors, or regions where it would contribute most to economic progress. The present system of giving tax exemptions for investment in certain regions has a twofold negative effect on the allocation of resources. It does not result in enough public or private investment to permit the maximizing of internal economies in the favored areas and it discriminates against other regions by encouraging mere shifts of activities.

Third, the administration of subsidies is much more flexible than that of tax exemption. Subsidies can be designed so as to affect the initial cost of setting up or of enlarging an activity.

Finally, a subsidy policy can be more easily coordinated with other policies, such as the investment policies of firms controlled by the government, and the formation of social capital by the national or local governments. I believe that it is only by coordinating these different kinds of subventions that an effective program for the economic development of underdeveloped regions can be worked out.