GAINERS AND LOSERS FROM A FLAT TAX: AN INTERREGIONAL PERSPECTIVE

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Abstract

Personal income taxation in Italy contributes significantly to public revenues, it is progressive and attains a good degree of income redistribution across individuals. It has also significant interregional redistributive effects, which contribute to reduce interregional income disparities. However, personal income taxation has some important drawbacks, primarily as regards equity and excess burden of taxation. Since 1994 there have been proposals to introduce a flat income tax. Such a reform would impact on the tax system equity and efficiency, but would also affect interregional income redistribution, an issue rather disregarded in the current debate on personal income tax reform.

Keywords: personal income tax, efficiency, equity, progressivity, income redistribution.

JEL classification: E62, H20, H23, H24, H70.

1. Introduction

Personal income taxation in Italy is a primary source of public revenues. IRPEF, the personal income tax, generates approximately 40% of total tax revenues and contributes to income redistribution across individuals thanks to its progressive structure. In addition, IRPEF has also relevant interregional redistributive effects, which contribute to reducing the relevant interregional income disparities that characterise Italy. Since 1994, proposals to introduce a flat income tax have been put forward as a way to address some important IRPEF drawbacks, primarily concerning its equity and efficiency. Such a reform would affect the tax system equity and efficiency, but would also impact on interregional income redistribution, with potentially undesirable effects in terms of interregional equity and regional economic convergence.

This paper describes the main features of the Italian personal income tax and analyses the potential effect on interregional income redistribution from the introduction of a flat tax. Section 2 briefly reviews issues of tax equity, efficiency and redistribution and section 3 describes the Italian personal income tax. IRPEF progressivity and its redistributive effects are presented in section 4, while section 5 focuses on IRPEF equity and efficiency. Sections 6 and 7 describe the flat tax reform proposal and section 8 presents some considerations on the impact on interregional income redistribution of such a reform. Section 9 concludes.

2. Tax systems: equity, efficiency and redistribution

Modern tax systems pursue a multiplicity of purposes. First and fundamentally that of raising revenues to finance government expenditures for goods and services offered to citizens and businesses and for investments in infrastructures and human capital. In addition taxes may be designed to correct market failures and sustain growth (e.g.: externalities, incentives,…) or to reduce income distribution inequality and improve social welfare. Thus, both efficiency and equity purposes add to the primary objective of raising revenues. Tax design is not an easy task. Particularly because

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the many tax policy objectives may be conflicting and taxes themselves may produce unwanted distortions both under equity and efficiency perspectives. Further, there are often efficiency and equity trade-offs.
The economic literature on optimal taxation specifically addresses these issues by “tracing the implications of taxes and quantifying (analytically) the trade-offs between the various objects of tax policy” (Atkinson and Stiglitz, 1976, p. 55). This strand of studies has its roots in the seminal works of Ramsey (1927), Mirrlees (1971) and Atkinson and Stiglitz (1976) and has reached significant results on the desirable tax structure to reduce the excess burden of taxation (i.e., the efficiency costs imposed by taxation). For instance, it investigates the optimal tax mix, it also suggests that a broad tax base and low tax rates are less distortive than a narrow base coupled by high tax rates; that simplicity is efficient because it reduces tax administration and compliance costs and because it fosters transparency and accountability. Though, simplicity may come at the expenses of equity, while the pursuit of equity may hinder efficiency by generating distortions and disincentives to economic activity. Further, redistribution through income taxes may negatively affect economic efficiency, if it reduces incentives to produce income (Mirrlees, 1971; Okun, 1975), but there is no strong empirical evidence that progressivity is harmful to growth (IMF, 2017, p. 13). Conversely, there is evidence that inequality hinders growth (Persson and Tabellini, 1994).
One common feature of modern tax/benefit systems is that they pursue income redistribution, although at different degrees across countries, and progressive income taxes play a major role in this respect. Indeed, progressivity may be a necessity, because a proportional income tax may not provide sufficient revenue if the tax rate is low and may not be sustainable for the poor if the tax rate is high. From an economic perspective, redistribution is desirable to prevent excessive inequality and income polarisation. Declining marginal utility justifies a higher tax levy for higher incomes. In addition, justice theories (Rawls, 1971) support progressivity and redistribution. Still, redistribution should guarantee vertical and horizontal equity. That is relative income position should not be reverted by taxation and the tax system should ensure an equal treatment of equals.
The degree of redistribution attained by a single tax can be measured using the Reynolds-Smolensky index, defined as the difference between the Gini index measured on income distribution before the tax and the concentration index measured after the tax (Reynolds-Smolensky, 1970). Significantly, the Reynolds-Smolensky index is equal to the product of an index of progressivity (Kakwani index) times an index of incidence. That is redistribution depends both on the progressivity and on the level of taxation (Kakwani, 1977; Lambert, 1993). These results imply that a tax needs to be progressive in order attain redistribution. In addition, no redistribution may be attained by a proportional or regressive tax. Still, the degree of redistribution attained by the public budget is a combination of the effects of both taxes and transfers (either monetary or in kind).

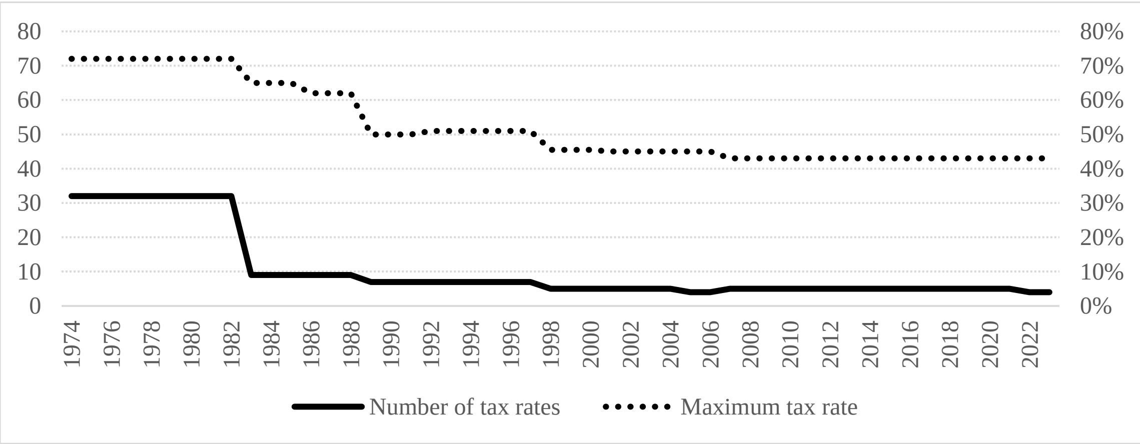
3. The Italian personal income tax: a brief description

According to the Italian Constitution, public expenditure is financed on the basis of the ability to pay criterion[1] and the tax system shall be progressive[2]. This latter provision implies that the tax system, besides colleting revenues, also fulfils a redistributive function. Significantly, the Constitutional requirement for progressivity concerns the overall tax system and not one single tax. Therefore, each single tax may well be either progressive, proportional or even regressive.
At the time of its introduction, in 1974, the personal income tax (IRPEF – *imposta sul reddito delle persone fisiche*) was intended to be comprehensive and progressive. Over nearly 50 years since its institution, IRPEF has undergone many changes that altered the initial tax design. To understand the current income tax structure, it is therefore useful to review briefly its evolution over time within the more general Italian tax system.

[1] Italian Constitution, art. 53, paragraph 1.
[2] Italian Constitution, art. 53, paragraph 2.

The current Italian tax system mainly derives from the tax reform of 1974, inspired by the works of the Commission for the Study of Tax Reform (Commissione Cosciani-Visentini). The Commission report published in 1964 envisaged a comprehensive unitary reform, rooted in the economic theory of taxation, but at the same time consistent with the limits and constraints of the specific Italian institutional conditions. In 1971 the Italian Parliament delegated the government to issue tax reform decrees[3], which were introduced in 1972-1974[4]. However, already during the implementation process, some alterations to the original design were introduced. These differences were partly due to the changed socio-economic conditions in 1974 compared to 1964. In 1974 the post-second world war economic boom was going to an end and the GDP growth rate had slowed down, inflation was soaring, international economic and financial conditions were less stable, international capital movements were liberalised. The resulting tax system, although inspired by the Commission report, was characterised by significant deviations from the report provisions.

Specifically, progressivity and redistribution were primarily pursued trough the new personal income tax (IRPEF), which also contributed significantly to total tax revenues. The IRPEF tax base was inspired by the concept of taxpayer's total income[5], and tax rates were increasing by brackets. However, there were deviations from the original design. The most significant concerned the personal income tax base: financial income was excluded. The tax base was further eroded over time and exemptions grew widespread: some types of income have been excluded and either subjected to an alternative proportional tax (e.g.: rental income, property income from second homes[6], self-employment income below a certain threshold, for which it is possible to opt for the so-called "regime forfetario", literally *lump-sum scheme* – from now on – or totally exempted). In addition, property incomes are imputed and there are specific assessment criteria for corporate income. As a result, the tax base significantly shrank, to an extent that employment compensations (*employment income* from now on) and pension income are probably today the only incomes to be fully progressively taxed.



[3] Law 825/1971.

[4] In 1972-1973 the tax reform was enacted through 19 decrees. Decrees n. 633 and n. 643 introduced, respectively, the value added tax and the municipal tax on increases of real estate value. Then there were changes to other taxes and levies, such as: registration fees (n. 634/1972), the inheritance tax (n. 637/1972), the mortgage tax and cadastral tax (n. 635/1972), the stamp duty (n. 642/1972), tax litigation fees, the municipal advertising tax and bill-posting duty (n. 639/1972), the amusement tax (n. 640/1972) and licence fees (n. 641/1972). New direct taxes came into force in 1974: the personal income tax (IRPEF – decree 597/1973), the corporate income tax (IRPEG – decree 598/1973) and the local income tax (ILOR – decree 599/1973). In addition the reform addressed income tax assessment (decree 600/1973), tax reliefs, (n. 601/1973), direct taxes collection (n. 602/1973) and related services (n. 603/1972). Finally, provisions for the revision of land and buildings cadastre and for the creation of a Tax registry were enacted.

[5] As suggested by Schanz (1896), Haig (1921) and Simons (1938): a personal income tax base should be an individual's "comprehensive income", that is the value of what she could consume in the tax year, while keeping her wealth constant (this would include all sources of real income, net of expenses incurred to earn the income).

[6] Second homes are exempted and taxed by a proportional local property tax, IMU. Main homes (i.e. where the taxpayer formally resides) benefit from income tax relief, but IMU is levied on primary residences classified as luxury properties (in the land registry, i.e. category A1, A8 or A9).

Figure 1: IRPEF, Number of tax rates and maximum tax rates, 1974-2022.
Source: Own elaboration.

Further, also the tax rate structure has been repeatedly revised. Since its introduction, IRPEF was progressive through tax rates increasing by brackets. In 1974 there were 32 brackets and the marginal tax rate ranged from 10% to 82%. Over time the number of tax brackets and the maximum marginal rate were reduced (figure 1), a trend common to most OECD countries. The most recent reform, in 2022, introduced 4 tax brackets as listed in table 1[7]. The current tax structure is characterised by relatively high marginal rates for rather low incomes, as compared to other EU countries (figure 2).
Finally, the number of tax expenditures (both tax allowances reducing the tax base and tax credits reducing the tax due) is very high and has grown consistently over time (MEF, 2011; Senato, 2017). Social security contributions are deductible and tax credits include those for specific sources of income (employment, pension, and self-employment income), family tax credits and tax credits for specific kind of expenditures (such as mortgage interest, medical expenses, education expenses, life and accident insurance, sport association's fees, rental fees). Tax credits for source of income and family are declining with gross income, thus enhancing progressivity. The former also define a minimum level of exempted income (no-tax area) for taxpayers earning employment, pension, or self-employment income. The no-tax area was recently introduced to reduce the tax burden on low incomes, and is common to many OECD countries (Baldini, 2021).

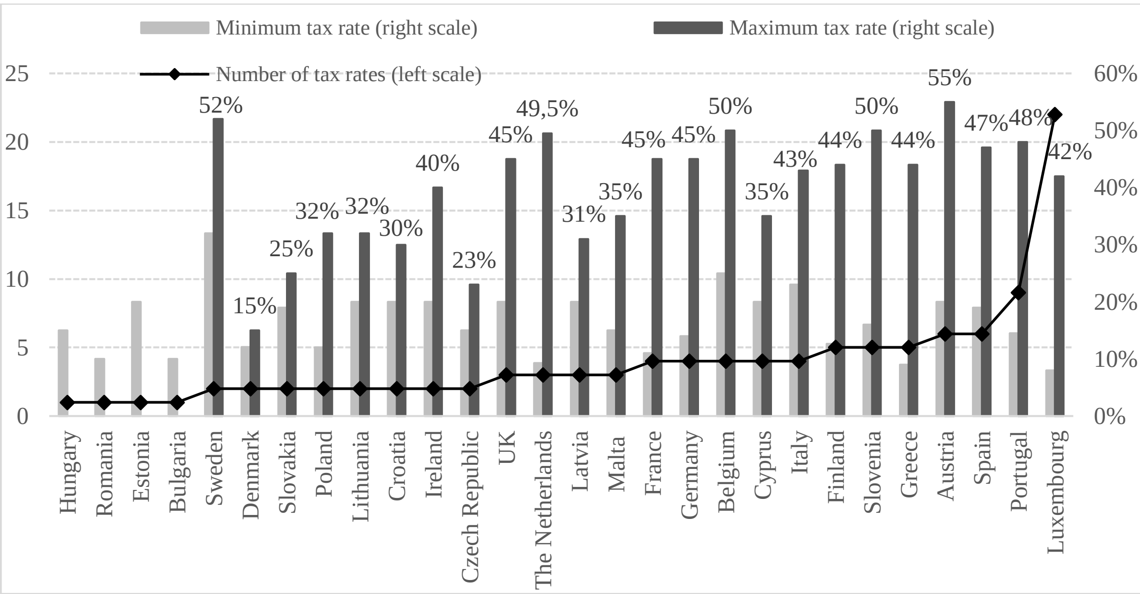


Figure 2: personal income tax in EU countries and UK.
Number of tax rates and minimum/maximum tax rate, 2022.
Source: Own elaboration on Eurostat data.

Tax brackets (gross annual taxable income) euro	**Marginal tax rate**	**% of taxpayers (2020)[8]**

[7] A Regional and a municipal income tax are also applied. For both, the tax rate varies according to the taxpayer's place of residence. The regional income tax rate ranges from 1.23% to 3.33% and the municipal one from 0% to 0.8% (0.9% for Rome). Municipal tax rates can be progressive, but they should conform to national income tax brackets.
[8] The distribution of taxpayers across brackets is based on data published by the Minister of the Economy and Finance (MEF). In the MEF dataset, total taxpayers are divided in many income classes, from 0 to above 300.000 euro. To complete table 1, data from different MEF classes were grouped, in order to reproduce IRPEF tax brackets' structure. However, in the MEF dataset, there is one class of income that includes taxpayers that fall in two different brackets. Taxpayers in MEF income class 26.000-29.000 euro needed to be divided between the second and the third brackets. This was done using the rule of thumb of apportioning two thirds of taxpayers in this class to the second bracket and one third to the third bracket. Therefore, data for the second and third brackets are estimates of actual data.

< 15.000	23%	44,5%
15.000-28.000	25%	32,8% *
28.000-50.000	35%	17,1% *
> 50.000	43%	5,5%

Table 1: IRPEF 2022, tax brackets, tax rates, distribution of taxpayers, fiscal year 2020. Source: Own elaboration on MEF data.

Today IRPEF is the main tax in the Italian tax system as regards both the number of taxpayers and total revenue. In 2021, IRPEF tax forms were filed by 41.2 million taxpayers. 84.5% of them had primarily employment (51.4%) or pension income (33.1%), while for only 6.3% the primary income was individual company income or self-employed income (including taxpayer under the lump-sum scheme) (figure 3). Total declared income amounts to 865.1 billion euro, of which 50.9% employment income and 33% pension income (MEF, 2023). Average income is 21,570 euro, but this figure displays a relevant variability across regions, with higher values in the North of the country compared to the South.

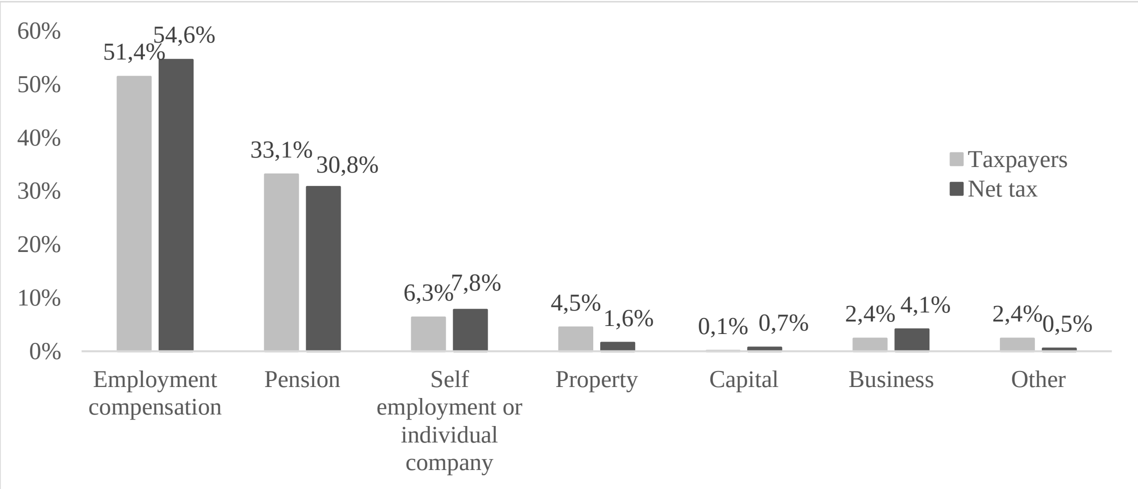


Figure 3: IRPEF, distribution of taxpayers and of net tax by main income source 2020. Source: Own elaboration on MEF data.

The region with the highest average income is Lombardia in the North (25,330 euro), while that with the lowest value is Calabria in the South (15,630 euro). Total revenue from IRPEF amounted to 198 billion euro, approximately 40% of total tax revenues (496 billion euro), 22% of total public revenues and approximately 11% of GDP (MER, 2023). Employment and pension income contribute to total IRPEF revenues by 85.4%, while other sources of income contribute only marginally to total IRPEF revenues (figure 4).

Due to the many changes introduced over time, the current tax structure is rather different from the one designed by the Commission for fiscal reform in 1964. Alterations affected every aspect of the tax structure, from the tax base to tax brackets and tax rates, to tax expenditures. Already a few years after its introduction, it was Cosciani himself who complained that the changes introduced had worsened the initial tax structure (Cosciani, 1983, p. 967): "our personal income tax (…) resembles an old mosaic, where some of the most important pieces have fallen and other are damaged, so that the original design is deformed and worsened"[9]. As a result, today personal income taxation in Italy has strong and important drawbacks as regards progressivity and redistribution, equity and efficiency, not to mention revenue generation.

[9] Translation from Italian by the author.

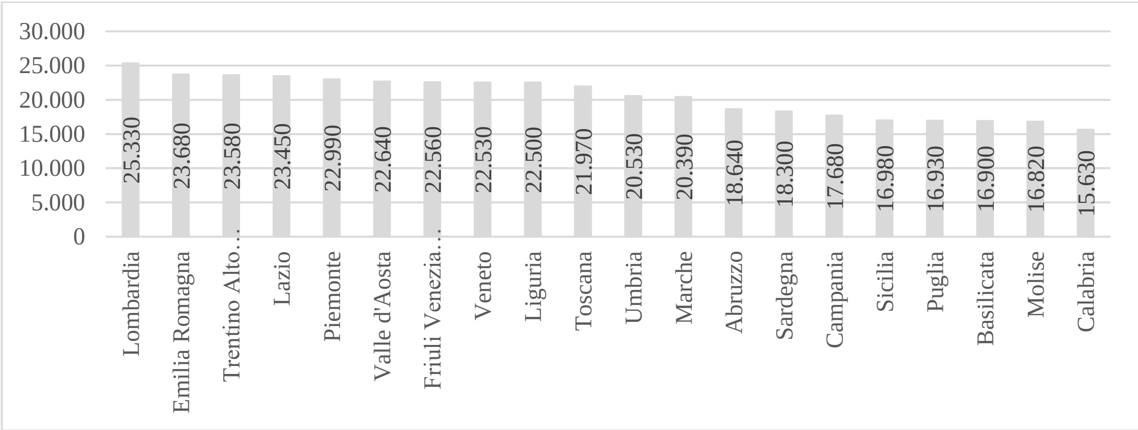


Figure 4: IRPEF, Average income by region, 2020 (thousand euro).
Source: Own elaboration on ISTAT data.

4. The Italian personal income tax: progressivity and redistribution

Italy is characterised by high income inequality, both interpersonal and interregional. In 2022 the Gini index[10] of personal income inequality in Italy was 0.33, above the EU27 average value of 0.3. In the EU, only Spain, Romania, Lithuania, Latvia and Bulgaria had a higher Gini index (figure 5). Interregional income inequality defines a clear North-South divide, which has its roots in historical socio-economic differences, with most Southern regions lagging behind the others (Daniele and Malanima, 2014). In Italy, the public budget has a significant redistributive power and produces a relevant reduction of income inequality. According to recent estimates, family income inequality measured by the Gini index is reduced by nearly 17% in 2022 (Istat, 2022). Also, interregional income inequality is smoothed by the public budget redistributive power, which reduces average income differences across regions (Arachi et al., 2010). Most income redistribution is attained by public expenditure (12%), but also taxes contribute significantly (4.9%) (Istat, 2022).

On the revenue side, the Italian personal income tax currently represents the main source of income redistribution, despite the many alterations to its initial progressive structure (Causa and Hermansen, 2019, p. 50; Bosi and Guerra, 2023, p. 149), and in 2019 it contributed to the reduction of the Gini index of income inequality by 4% (Liaci, 2021).

According to the decomposition of the Reynolds-Smolensky index, redistribution results from the combination of tax progressivity and tax incidence. Evidence on both these measures is provided for Italy by Baldini (2021). In 2019, the IRPEF average incidence on gross household income was 17% (significantly higher than in the 1970's when it amounted to approximately 12%). Tax incidence is rather low for the poorest taxpayers, mainly thanks to the no-tax area, then it increases for middle deciles of taxpayers and then decreases for top incomes. Over the years, the tax burden has increased to finance growing public expenditures.

As for progressivity, the Kakwani index was 0.208 in 2019, slightly higher than in 1979 when it was 0.188. Therefore, progressivity increased only marginally over time.

As a result of tax incidence and progressivity, the Reynolds-Smolensky index of redistributions in 2019 shows a redistributive impact of IRPEF equal to 0,0432 (Baldini, 2021). Similar results, although for earlier years and with different methodologies, are provided by Wagstaff et al. (1999) and Verbist and Figari (2014).

[10] The Gini index of inequality is equal to 0 for maximum equality and 1 for maximum inequality.

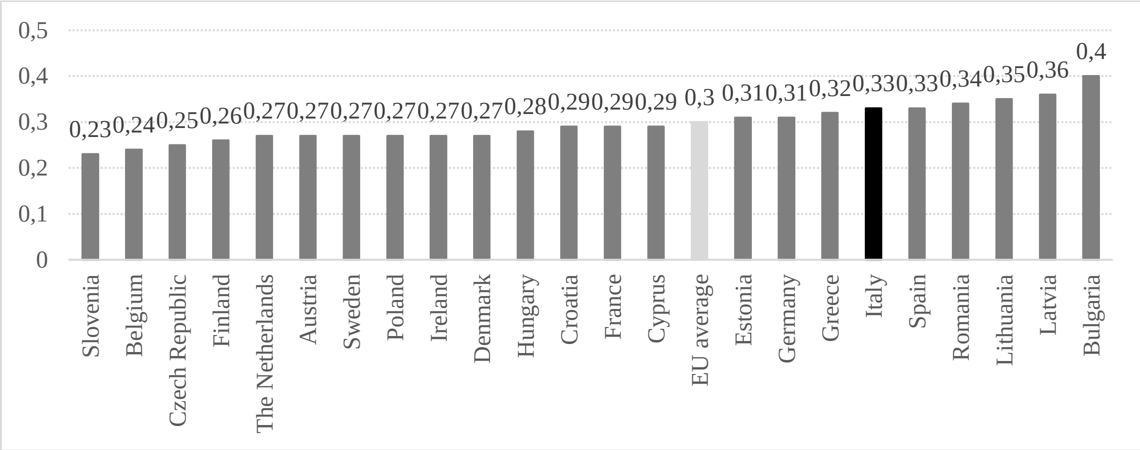


Figure 5: Gini index of inequality in EU countries, 2020.
Source: Own elaboration on Istat data.

Although IRPEF has a significant redistributive effect, its tax base is far from including all sources of personal income and this obviously has important distributional (and revenue) effects and implies significant problems of horizontal equity (Bises and Scialà, 2014). Redistribution by overall personal income taxation may be significantly different. Some incomes exempted from IRPEF (capital income, self-employment income under the lump-sum scheme, rental income) are generally taxed proportionally, with low tax rates, and they are mostly concentrated among high-income earners. Therefore, taxes levied on these incomes may produce negative redistributive effects.

5. The Italian personal income tax: equity and efficiency

Despite its progressivity, the many changes introduced over time have constrained both personal income tax equity (horizontal and vertical) and efficiency.

First, many sources of revenues are excluded from the tax base and either exempted or subject to substitute proportional taxes. Second, tax expenditures pursue both tax progressivity and other purposes (such as sustaining economic activity), but they cause substantial revenue reduction (Senato, 2017). In addition, exempted incomes and tax expenditures are generally concentrated on higher income earners (e.g., tax credits for building renovations or for corporate welfare, exemptions for second homes) and therefore produce a regressive effect. For instance, a significant regressive impact is caused by the exclusion from taxable income of capital and rental income, and their proportional taxation at, respectively, 26% (with some exceptions, mainly government's bonds taxed at 12.5%) and 21% (this latter rate is below the minimum IRPEF rate of 23%). The regressive effect is due to the concentration among higher incomes of both these sources of revenue. The exclusion of specific incomes to be taxed progressively has increased in recent years. Since 2012, real estate at disposal is taxed by IMU and not by IRPEF, productivity bonuses below 3,000 euro are taxed at a flat rate of 10% for taxpayers with a gross income below 80,000 euro. The lump-sum scheme, initially introduced in 2008[11] but then revised, allows self-employed or small company owners with a gross income below 65.000 euro (85.000 from 2023[12]) to opt for a flat tax at 15% on gross turnover multiplied by an economic activity-specific coefficient (which accounts for incurred costs in a lump-sum way).

In addition to the significant tax base erosion, tax evasion is estimated to be considerable (figure 6). The relevant difference in the propensity to evade by different income groups further increases the negative impact on equity. Tax evasion is mainly concentrated in self-employment income. In 2019 the IRPEF tax gap reached approximately 37 billion euro. Yet, the tax gap for employment and

[11] Law 244/2007.
[12] Law 197/2022.

pension income was approximately 4% of its potential value, while the tax gap for self-employed reached 68% (MEF, 2022). The actual tax base is therefore characterised by an excessive weight of employment and pension income (85% of total declared income). Tax evasion, therefore, violates horizontal equity, both among taxpayers with different sources of income and also among taxpayers with the same source of income but with different tax compliance attitudes (in this case tax evasion is also inefficient, because it affects the relative competitiveness of self-employed or companies).

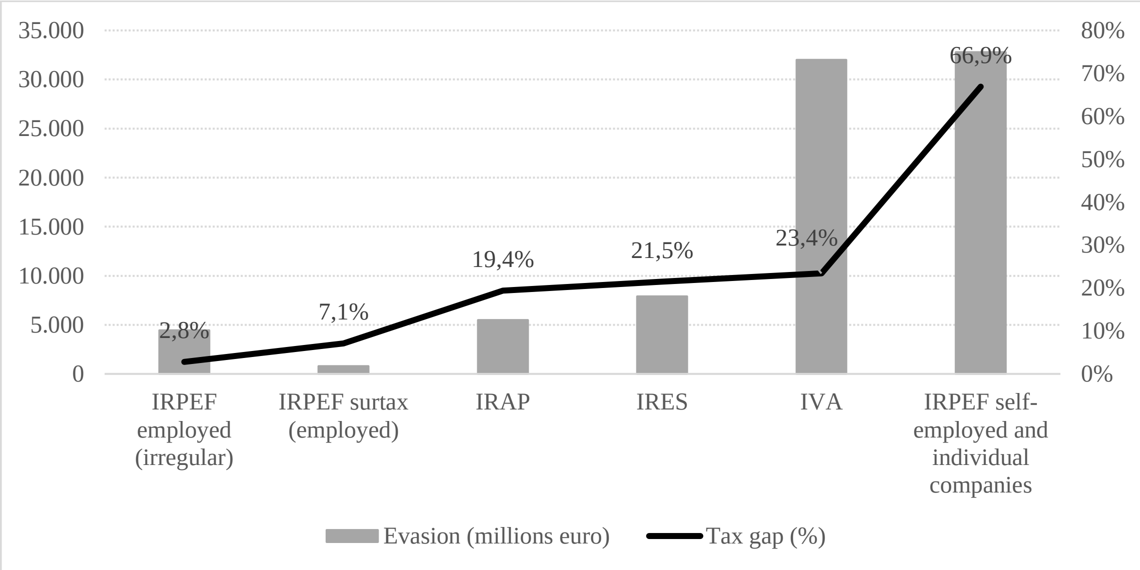


Figure 6: Italy, Tax evasion (left scale) and tax gap (right scale) for selected central government taxes, 2020.
Source: Own elaboration on MEF data.

Last, also due to tax evasion, employment income is the most heavily taxed by IRPEF and is also penalised, because other sources of income are often taxed according to lighter substitutive schemes. Baldini and Rizzo (2020, pp. 115-116) show that personal income tax incidence on average and above-average employment income in Italy is the highest among a selection of European countries. Once horizontal equity is lost, also vertical equity is therefore declining, because progressivity and redistribution necessarily concern only a subset of taxpayers. Therefore, as it stands now, IRPEF redistributive power is constrained and its contribution to public finances limited with respect to its potential.

Despite IRPEF progressivity, the overall tax system is not as much progressive, due to high evasion by self-employed incomes, exemption of many other sources of income, tax expenditures, mostly at the advantage of richer taxpayers. Progressivity therefore mostly concerns earned incomes, while taxation on other incomes is generally lower and proportional. Both horizontal and vertical equity are far from being attained.

Despite its original design as a comprehensive and progressive tax, IRPEF's structure today has therefore some undesirable characteristics, which undermine overall tax progressivity and violate the horizontal equity criterion. Nonetheless, on the tax side, it is the primary source of income redistribution, albeit this is mostly attained by taxing employed and pension income recipients.

6. The personal income tax: towards a reform?

There is wide consensus that the current tax system needs a reform, after nearly 50 years from its institution and after all the changes introduced, often in an uncoordinated and disordered way. Changes to the personal income tax, in particular, significantly altered the tax nature and structure, made it excessively complex, reduced revenues and constrained redistribution (Galli and Profeta, 2020, p.7). The reform should therefore primarily aim to improve this tax efficiency and equity.

Quite surprisingly, however, in Italy since the early 1990s the debate on tax reform has mostly claimed for a reduction of the tax burden, rather than for improvements of the tax system progressivity and equity. Arguably, the same reasons beneath all the distortions to the original personal income tax design, contribute to explain this attitude. Among them, widespread aversion for tax levies, dissatisfaction for public services and discontent for public sector inefficiency and excessive bureaucratic burdens and slowness have surely contributed to exacerbate anti-taxation attitudes and have resulted in significant political support for tax reforms focused on tax rate reductions. In addition, the flaws of the current progressive income tax are often deemed unsolvable and therefore a reduction of marginal rates' number and level is deemed the only way to restore equity, reduce complexity and improve transparency of taxation. Under this perspective, lower tax rates would reduce propensity to evade and would grant the same treatment to different sources of income, by taxing labour income at levels similar to those currently applied to other incomes.

A tax scheme that could respond to all these requirements is a flat income tax, as was first proposed by Friedman (1962): a proportional tax applied to total gross personal income (with a no-tax area to exempt lower incomes and tax credits limited only to those expenses that are necessary to produce income). A flat tax has some advantages under an efficiency perspective if compared to a tax progressive by brackets. It is simpler and more transparent, it reduces taxpayers' compliance costs, it does not create disincentives to produce income (because marginal income is always taxed at the same rate), it does not create any incentive to shift income from one source to another (as all incomes are treated the same), finally, if the single rate is sufficiently low, fiscal pressure is reduced (and thus also incentives to evade). As for horizontal equity, a flat tax applies the same rate to all, thus guarantees equal treatment to all taxpayers (although it is debatable whether this is truly equitable and desirable).

A flat tax has been introduced in the 1990s and early 2000s in many Eastern European countries (characterised by low economic development, low public expenditures, less developed democratic systems, and by the need to restore trust in the political system after the fall of Communist regimes). However, most of these countries abandoned the flat tax and increased the number of income tax rates during the second decade of the 21st century[13], when their democratic systems consolidated, and welfare systems developed (causing increased public expenditures that needed to be financed). In these countries, the introduction of a flat tax resembles the initial stage in the development of modern tax systems (similarly to what happened in western countries in the late nineteenth century, at the dawn of western tax systems, when proportional income taxes were first introduced).

A proposal for a flat income tax in Italy was first put forward during the 1994 political elections campaign. Since then, slightly different flat tax schemes have been repeatedly proposed by centre-left political parties or think tanks, generally coupled by a reduction of marginal income tax rates. The most striking feature of these proposals, the widespread favour they receive and the related political debate, is that important issues are overlooked, such as guaranteeing the Constitutional requirement of tax system progressivity and ensuring sufficient revenues to finance public expenditure.

Although none of the flat tax proposal put forward since 1994 has ever got close to implementation, some of the income tax changes introduced over time are consistent with this idea of the tax system. For instance, the lump-sum scheme is essentially a flat tax at 15% for a subset of taxpayers (i.e., self-employed with a gross income below 85.000 euro).

7. Plans for the introduction of a flat personal income tax

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[13] The following European countries introduced a flat tax: Estonia (1994), Lithuania (1994-2019), Latvia (1997-2018), Russia (2001), Serbia (2003-2010), Slovakia (2004-2013), Ukraine (2004), Georgia and Romania (2005), Albania (2007-2014), Macedonia (2007-2023), Czech Republic (2008-2013), Bulgaria (2008), Bosnia-Herzegovina and Byelorussia (2009), Hungary (2013).Currently in Europe only eight countries have a flat tax, of hich four in the EU: Bulgaria, Estonia, Hungary, Romania (figure 2).

The current Italian government, in power since 22 October 2022, has clearly stated that it intends to implement a personal income flat tax, although gradually and respecting the progressivity principle. The first steps have been the extension of the lump-sum scheme to a wider share of self-employed (up to 85.000 euro of gross revenues), the incremental flat tax for self-employed who don't opt for the lump-sum scheme, the planned increase of the no-tax area for pension income up to the same threshold currently applied to employment income (8.500 euro), a revision of tax expenditures, and a planned reduction of IRPEF tax brackets from 4 to 3. At the time of writing, there is no final decision on the new tax rate structure, but only an enabling bill that delegates government to reduce the number of tax brackets. According to the current political debate, one of the most feasible outcomes could be an extension of the first rate (23%) to both the current first and second income brackets and unchanged rate/brackets for higher incomes. Such a change would obviously benefit all taxpayers above the lower threshold of the current second bracket. They would all pay lower taxes on their income between 15.000 and 28.000 euro.[14] Obviously the tax savings in monetary terms would be the same for all taxpayers with an income above 28.000, but it would be declining as a percentage of total income when total income increases. Progressivity would apparently be preserved, although with an altered structure.
Clearly, the overall impact on progressivity and redistribution will depend on how this reform will be financed, because both public revenue and expenditure contribute to total redistribution. A reduction of tax revenues can be expected, both due to the new tax rate structure and to other measures.
Proponents of the reform trivially solve the problem of revenues, by theorising tax revenues' increases incentivated by tax rate cuts. The reasoning goes that tax rate cuts will foster a sudden rise in economic activity and will prompt tax evasion vanishing – a simplistic Laffer curve argument with no solid empirical or theoretical foundations. In particular, it is highly unlikely that IRPEF evasion will spontaneously and significantly reduce thanks to this reform. First, tax evasion from employment and pension income is already very low (figure 6), and second, tax savings from this reform are very limited for most taxpayers. Therefore, there are no significant incentives to comply with tax legislation for those who currently evade. Similarly, targeted measures to reduce tax evasion have already been implemented in the past, but contrasting tax evasion cannot be a short-term solution to ensure increased public revenues or to finance tax reforms (Liberati 2021, p. 36). Most significantly, among the measures to reduce tax evasion, an important role can be played by actions directed to change taxpayers' incentives and their expectations that tax administration will implement strict contrasting policies. However, the current government is providing no strong signal that this will happen. The statement that "evasion by necessity"[15] will be tolerated is surely not the right way to reduce the propensity to evade. Even less effective is comparing taxes on small shopkeepers with protection money paid to Mafia.[16]
Nonetheless, the issue of financing revenue contraction is relevant, because a balanced public budget is a necessity, especially in a country with a high public debt such as Italy (about 145% of gross domestic product in 2022). Thus, deficit spending not being a feasible option, the only foreseeable measure to counterbalance eventual revenue reductions (if the magic of tax evasion waning does not come true) are tax expenditures' cuts or public expenditure restructuring. Unfortunately, such measures would further negatively impact on the progressivity of the tax/benefits system. As for tax expenditures, together with tax rate by brackets, they contribute to make the income tax progressive. Therefore, their reduction would reduce progressivity. Further, as the income tax is currently

[14] Those below 15.000 euro would not benefit, but their tax burden is very limited or null, thanks to the no-tax area and other tax expenditures.
[15] Vice minister for the economy Maurizio Leo, press declaration on 17 March 2023 (https://www.ansa.it/sito/notizie/topnews/2023/03/17/fiscoleo-penale-per-casi-gravi-non-per-evasione-necessita_6b195aba-4402-4b95-acc1-83f2fbe4ed29.html, last accessed 18/3/2023)
[16] The Italian President of the Council of Ministers, Giorgia Meloni, on 26/5/2023 declared: "L'evasione devi combatterla dove sta (…) non sul piccolo commerciante a cui chiedi il pizzo di Stato solo perché devi fare caccia al gettito più che all'evasione fiscale" (https://www.corriere.it/politica/23_maggio_26/meloni-dare-caccia-piccoli-evasori-pizzo-stato-fe20165e-fbf4-11ed-a01c-bd767ff4b328.shtml, last accessed 30/5/23).

primarily levied on employment and pension income, these taxpayers would carry most of the burden caused by reduced revenues, with undesirable effects in terms of horizontal equity. Finally, although improving public expenditure efficiency and effectiveness is desirable (Bulman, 2021), the savings and progressivity impact of expenditure restructuring is unclear, because the Italian government has so far provided no details on the measures to be implemented. However, any reform on the expenditure side needs to be carefully designed, because in Italy, as well as in most western economies, public expenditure is the primary source of redistribution (Causa and Hermansen, 2019). In conclusion, there is no solid evidence that the reform implemented so far will not negatively affect progressivity and redistribution.

Whatever will happen to this reform, the Government has declared that it is only an intermediate step towards the introduction of a personal income proportional tax for all. Therefore, this latter reform is the most interesting one to analyse. However, it is worth noticing here that, if the plans to introduce a flat tax won't come into effect, mainly for the lack of sufficient resources, personal income taxation will have to cope with the effects of the interim measures introduced (extensions of the lump-sum scheme, incremental flat tax for self-employed, reduction of tax rates,…), which reduce both horizontal and vertical equity.

8. Redistributive effects of a flat tax: an interregional perspective

A flat tax has some desirable properties under an efficiency perspective (Friedman, 1962). Though, its introduction in Italy could reduce both revenues and progressivity, thus negatively impacting on redistribution, equity, and public finances (Baldini and Rizzo, 2020). These are exactly the reasons why such a system is generally not implemented in modern developed countries.

Revenue reduction could be avoided by setting a very high tax rate. Still, this is not desirable under an efficiency perspective, because of its negative impact on incentives and economic activity. Incidentally, a high rate also does not seem to be consistent with the current Italian government vision for tax reform.

Further, the main way tax policy can reduce income inequality is through progressive income taxation (Gerber et al., 2018), but, by definition, progressivity is lost with a flat tax. This issue is overlooked by proponents of the reform, and simply solved by planning tax allowances or credits for lower incomes, which are intended to restore progressivity. Though, economic theory is clear that a proportional tax with tax credits or allowances is progressive for lower incomes and then rapidly becomes proportional for middle-high incomes (Bosi, 2015, p. 143). To extend progressivity to wider groups of taxpayers, the marginal tax rate would need to be set at higher levels, but as seen before, this is undesirable under an efficiency perspective. Given that IRPEF is the only progressive tax, it is not clear whether limited progressivity and exclusively for the very low incomes would satisfy the Italian Constitutional requirement for the tax system to be progressive.

In addition, besides progressivity and interpersonal redistribution, in Italy there is another dimension of equity that is significant, that of interregional equity. Italy is characterised by significant territorial economic disparities and income is highly unevenly distributed across regions. The public budget significantly contributes to smoothing these differences by redistributing income and thus it fosters interregional equity (Arachi et al., 2010). Therefore, any tax reform should be evaluated also for its territorial impact. On the revenue side, territorial redistribution is the result of tax incidence and tax progressivity. Both would reduce with a flat tax set at a relatively low rate. Southern Italy is characterised by relatively lower incomes and therefore most of the tax reduction would accrue to residents of Northern regions. As described in table 2, the percentage of taxpayers that would benefit from a flat tax would differ significantly across geographical areas.

However, no definitive conclusions can be drawn on the reform effects, until the level of the unique tax rate will be chosen. As described in table 2, if the tax rate is set at 23%, taxpayers in the first bracket would not get any benefit, and in Southern regions they are definitely a higher percentage of total taxpayers, 57% against 38% in the Northern regions. Similarly, if the tax rate is set at 25%, taxpayers in the first and second brackets would not get any benefit, and again they are a higher

percentage in Southern regions, 85% against 76% in the Northern regions. The richer Northern regions would therefore benefit more than the poorer Southern ones, thus squeezing redistribution from taxation.
Interestingly, also the number of self-employed is higher in the Centre and North of the country (respectively 30% and 20% more taxpayers than in the South, table 2), so any measure that lowers the tax burden on this category potentially further reduces redistribution.
The extension of the lump-sum regime has already benefited the Northern regions more, because of the higher concentration of taxpayers falling into this scheme. A flat tax would further positively impact on these same regions, because of income differentials across regions: lower incomes who will not benefit are more concentrated in the South, and higher incomes in the North.
Although with tax evasion and tax base erosion a progressive tax may not attain the desired redistributive effects, abandoning progressivity may produce worse equity outcomes, both in an interpersonal and interregional perspective.

Tax brackets (gross annual taxable income), euro	**Marginal tax rate**	**Distribution of taxpayers by brackets, Italy and geographical areas** [17]			
		Italy	**North**	**Centre**	**South**
		Number			
< 15.000	23%	18.333.158	7.739.450	4.114.082	6.479.626
15.000-28.000	25%	13.503.061	7.487.532	2.964.206	3.051.323
28.000-50.000	35%	7.056.268	3.919.841	1.616.265	1.520.162
> 50.000	43%	2.283.295	1.348.591	554.608	380.096
Total		41.175.782	20.495.414	9.249.161	11.431.207
		Percentage			
< 15.000	23%	44,5%	37,8%	44,5%	56,7%
15.000-28.000	25%	32,8%	36,5%	32,0%	26,7%
28.000-50.000	35%	17,1%	19,1%	17,5%	13,3%
> 50.000	43%	5,5%	6,6%	6,0%	3,3%
Total		100,0%	100,0%	100,0%	100,0%
Self-employed on total taxpayers			1,28%	1,41%	1,09%

Table 2: Distribution of taxpayers by brackets and geographical area using current brackets (2023) and last available data from 2021 tax declarations (fiscal year 2020).

Source: own elaboration on MEF data.

9. Conclusions

The current structure of the Italian personal income tax has many and relevant flaws. Both horizontal and vertical equity are restricted by tax base erosion, tax evasion, and tax expenditures. Thus, the need for a comprehensive reform of personal income taxation in Italy is widely acknowledged. However, any reform proposal needs to take into account the significant role of IRPEF in the Italian

[17] Data for the second and third brackets are estimates. For reasons and methodology, see footnote 8.

tax system, both as concerns revenue and redistribution, and should be evaluated for its efficiency, equity and revenue impact.

The proposal to substitute IRPEF with a flat tax (with a marginal tax rate yet to be decided) implies a radical transformation of personal income taxation. This reform could yet have a positive effect on horizontal equity, because all taxpayers would be taxed under the same regime, instead of under the current diversified system. However, such a reform would produce significant problems, primarily a reduction of tax revenues, of vertical equity and progressivity.

It would thus have a significant impact on the Italian tax/benefit system and would need to be evaluated with reference to the Constitutional requirement of progressivity of the tax system. Significantly, a reduction of tax progressivity would have relevant effects on redistribution, both interpersonal and interregional.

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