PROMETEIA
DISCUSSION
NOTE N. 11

SEPTEMBER 2019

prometeia
ASSOCIAZIONE

FIGHTING TAX EVASION: OPTIONS FOR ITALY

Main points

- In Italy, tax revenues are high, but tax compliance is low.
- Low tax compliance applies, especially, to VAT and Personal Income Tax payable by the self-employed, which in Italy represent a significant share of total employment.
- Although the actions taken to increase spontaneous tax compliance over the years have reduced the VAT gap, it remains double the EU average.
- Increasing VAT compliance also improves collection of taxes on self-employment income.
- New information technology tools are being used to strengthen the efforts to fight tax evasion but further action is called for.

I. Introduction

Italy is a low-tax compliance country... Although estimates of the level of tax evasion are, inevitably, uncertain, the publicly available data and research carried out over time agree that the phenomenon is significant. According to the latest report of the Italian Ministry of Economy and Finance (MEF), the difference between the amount of tax and social contribution that, in theory, is due and what is actually paid is €109 billion per year, on average, during the period 2012-2016, i.e., 6.4% of GDP. Other estimates suggest even higher losses.

...compared to other EU countries. There are no official estimates at international level, but available studies place Italy among the countries with the highest levels of tax evasion. A recent piece of research, conducted for the European Parliament, suggests that the overall tax gap in the EU, resulting from domestic tax evasion, could be at least €750 billion and might be as much as €900 billion a year, around 5.5% of GDP. The same tax gap in Italy is estimated to be around 12% of GDP, much higher than the official MEF estimate (Figure 1).[1] Work on the size of the shadow economy, which is linked closely to evasion, consistently places Italy above the European average (21% vs 19.2% of official GDP in the years 2007-2016) at nearly double the level in France and Germany (12%).[2]

Why fight tax evasion. The benefits that would accrue from effective measures to fight tax evasion

1 *R. Murphy, The European Tax Gap, A report for the Socialists and Democrats Group in the European Parliament, January 2019. The study is based on 2015 data and applies two different metodologies to the estimation of the tax gaps. For both Italy and the UK, Murphy's estimates are higer then the official ones.*

2 *F. Schneider, Estimating the Size of the Shadow Economies of Highly Developed Countries: Selected New Results, CESifo DICE Report 4/2016 (December), and F. Schneider and C.C. Williams, The shadow economy, Institute of Economic Affairs, London, 2013.*

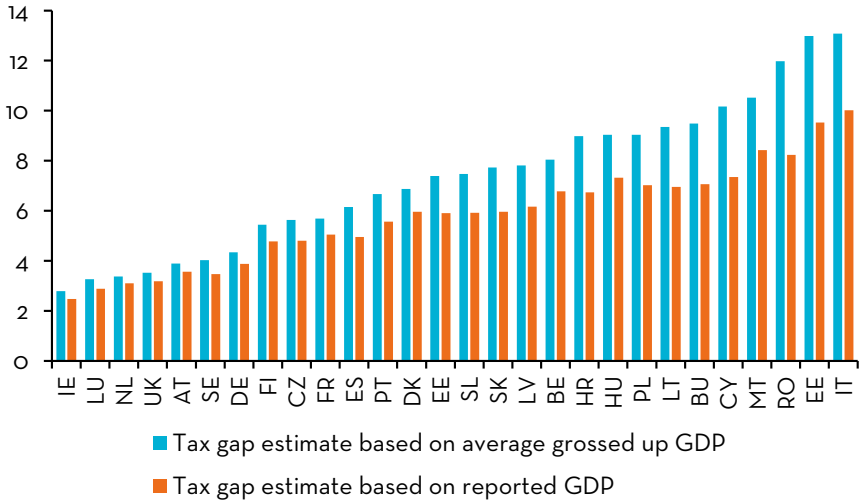


Figure 1

Suggested size of the EU tax compliance gap in 2015*

percentage of GDP

**estimates include: tax evasion, tax avoidance and tax liabilities declared by the taxpayer, but never paid.*

Source: The European Tax Gap, a report prepared for the Socialist and Democrat Group in the European Parliament, January 2019.

are well known and go beyond the most obvious - equity and recovery of revenue to finance public expenditure. In creating conditions of unfair competition between law-abiding and crooked firms, evasion results in resource allocation inefficiencies. It has been shown that tax evasion by small firms hampers productivity growth because it reduces the incentives to innovate.[3] In addition, because it distorts the data on income and wealth distribution, it creates inefficiencies in the distribution of public services.

Over the years, a number of measures have been taken to reduce the scope for tax evasion, aimed, especially, at encouraging spontaneous compliance. These actions, which have been focused mainly on VAT, have been complemented in recent years by new information technology tools, which are likely to make these actions more effective.

This note provides a review of the issues related to tax evasion in Italy. Section II describes the methodologies employed to estimate the level of tax evasion; Section III discusses the extent and composition of the overall tax gap; Section IV focuses on the VAT and self-employment Personal Income Tax (PIT) gaps, since these constitute the biggest component of tax evasion. In the last few years, Italy's governments have implemented various measures to address the tax compliance issue while, simultaneously, implementing other measures that have had - and are currently having - the opposite effect (Section V). Section VI concludes.

II. How to quantify tax evasion

Two methods are used to estimate tax gaps - top-down and bottom-up approaches. The top-down method represents international best practice for quantifying the gap in indirect taxes; the bottom-up approach is considered to be more robust for estimating the tax gap related to direct taxes, although official sources rarely employ this method. The top-down approach, generally, is employed also to provide official estimates of the gap originating from direct taxation.

The top-down approach estimates the theoretical taxable basis, tax by tax, and, by applying

3 Quantitative analysis shows that, in the period 1995-2006, tax evasion accounted for up to 15% of the cumulative differential growth of Italian productivity compared to France and Germany (E. Bobbio, Tax evasion, firm dynamics and growth, Bank of Italy, QEF No. 357, 2016).

the current fiscal legislation, it assesses the amount of revenue that would have been collected with full compliance. The difference between this amount and the amount actually collected is the tax gap. Thus, it includes both the gap between what taxpayers, theoretically, should have paid and what they declared as owing (assessment gap), and the gap between taxes declared, but not paid (collection gap). Official annual estimates of the tax gap, issued by MEF, follow this approach.[4] They rely mostly on macroeconomic data produced by the national statistical office, Istat, and include 87.5% of overall taxes, a very high coverage.[5] The tax gap calculated as a percentage of the amount of tax due provides a measure of compliance.

The bottom-up approach to estimation of the personal income tax-gap consists of comparing data on incomes, derived from administrative tax records, with data collected in surveys, or provided by internal fiscal agencies, or audit data ('discrepancy method'). None of the official estimates use this approach, but independent researchers, using survey data, such as SHIW (Survey on Household Income and Wealth) and IT-SILC (Italy's module of Statistics on Income and Living Conditions) have employed it to quantify the gap.[6] The method relies on the hypothesis that the incomes reported in surveys can be used as proxies for the true values, since anonymity is guaranteed to survey respondents. Indeed, on average, survey income data are higher than those derived from tax records and this difference is considered a measure of tax evasion.[7]

III. The estimates of tax evasion in Italy

The official top-down estimate of the annual level of tax gap was €109 billion on average, during years 2012 to 2016: of this, €11.4 billion was related to social security contributions and €97.6 billion to direct and indirect taxes. PIT on self-employed and small businesses and VAT accounted for 70% of total tax gap, at respectively €33.3 billion and €35.5 billion. Finally, €8 billion was related to corporate income tax (IRES), €6.5 billion to the regional tax on productive activity (IRAP), €5.2 billion to the tax on immovable property (IMU) and €3 billion to excise duties on energy and other taxes (rental incomes and television licences).

The lowest level of compliance is related to PIT owed by self-employed workers where the tax gap is 68%, while the overall VAT gap is 27% (Figure 2). There is a strong link between these two (see Section IV). For the self-employed, evading VAT goes hand-in-hand with under-reporting of income and, therefore, evading PIT and social contributions.

The bottom-up estimates for the self-employment PIT tax gaps are lower than the estimates from the top-down approach.[8] The average gap – the percentage difference between 'true' (survey) self-employment income and that reported in tax returns – ranges between 23.6% and

4 Since 2016, to monitor and evaluate the results of the fight against tax evasion, the Government relies on the 'Relazione sull'economia non osservata e sull'evasione fiscale e contributiva' annually prepared by a Commission established by decree of the Minister of Economy and Finance. The Commission is composed of fifteen experts in the economic, statistical, fiscal, labour and legal-financial fields, representatives of public institutions, Bank of Italy and Universities.

5 The only other advanced country that regularly undertakes similar comprehensive estimations is the United Kingdom, where the tax loss in 2017-18 is around 5.6% of tax liabilities, about a fourth of that of Italy (Measuring tax gaps 2019 edition, Her Majesty's Revenues & Customs).

6 See Table 1 for a review of the most recent studies.

7 Some caution is needed when performing this kind of assessment, since survey incomes can suffer from statistical limitations such as measurement error and under-reporting. The literature employing the bottom-up approach accounts for these limitations in different ways. For instance, Albarea et al. (2018) correct for underreporting by estimating the consumption function and, on this basis, retrieving consumption patterns that approximate 'true' income levels. Marino and Zizza (2012) adjust SHIW data to external sources, i.e. National Accounts for income aggregates and tax records for number of taxpayers.

8 Note that the bottom-up estimates are based on data for years 2000 to 2011.

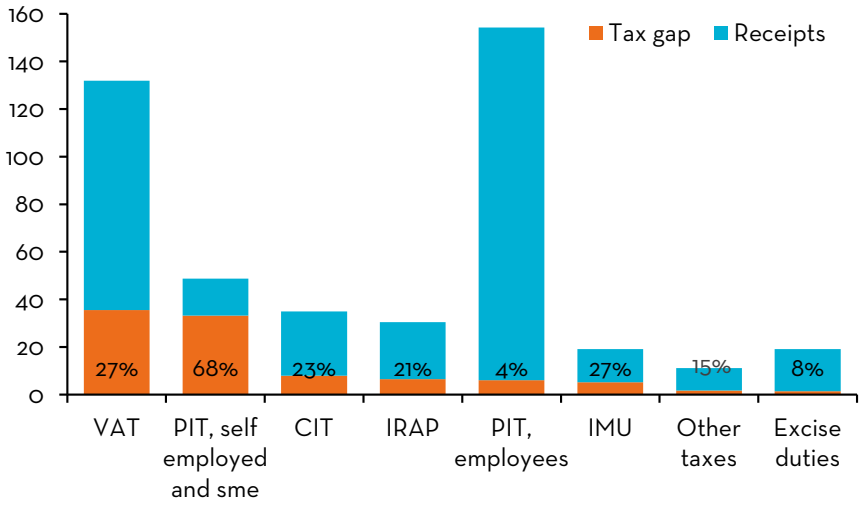


Figure 2

Tax gaps relative to tax due, 2012-2016

billions of euros and gap as percentage of total theoretical tax due

PIT: personal income tax;
CIT: corporate income tax;
IRAP: regional tax on economic activities;
IMU: tax on immovable property.

Source: Prometeia's calculations on MEF data.

Table 1 Bottom-up approach: Average tax evasion rate on self-employment income *(percentage)*

Author	Dataset	Income		North West	North East	Centre	South & Isles	Italy
Albarea et al. (2018)	IT-SILC 2011	gross	Simulation a *	21.3	24.7	22.3	27.5	23.6
			Simulation b *	36.1	37.9	36.8	39.6	37.4
			Simulation c *	38.2	40.7	36.9	42.2	39.4
Albarea et al. (2015)	IT-SILC 2011	gross		22.2	25.1	22.3	27.2	24.0
Marino and Zizza (2012)	SHIW 2004	net		North: 52.2		60.6	60.5	56.3
						Range 1st - 9th income decile		
Fiorio and D'Amuri (2005)	SHIW 2000	net		North: 69.7 - 3.7		66.3 - 9.0	77.0 - 25.0	70.6 - 7.8

Note: all the authors apply post-stratification procedures to get consistent numbers of taxpayers between survey data (SHIW or IT-SILC) and tax records or official population data.
(*) Simulation (a) is performed on original IT-SILC data, Simulation (b) is performed by applying a common adjustment factor to all incomes and Simulation (c) by applying income-specific adjustment factors.

56.3% (Table 1).[9] The differences across studies are substantial and depend mainly on the dataset and methodology employed. However, the evidence points consistently to a higher tax gap in the South and North East of Italy.

Tax avoidance. The scope of tax losses increases when also taking into account international tax avoidance, which has grown in size over time and is particularly relevant for multinational groups. Both the OECD and the EC are devising multilateral plans to tackle the problem of tax base erosion and profit shifting (BEPS).[10] The EC estimates that the EU annual revenue loss was €160-190 billion in 2015, of which €5-10 billion in Italy.[11]

9 *Early implementations of the discrepancy method on Italian data go back to 1996-1997. More recent works include: C. Fiorio and F. D'Amuri, Workers' tax evasion in Italy. Giornale degli Economisti e Annali di Economia, vol. 64, no. 2/3, pp. 247-270, 2005; M. R. Marino and R. Zizza, Personal income tax evasion in Italy: an estimate by taxpayer type. In: M. Pickhardt and A. Prinz (eds.), Tax evasion and the shadow economy. Edward Elgar, Cheltenham, UK, 2012; A. Albarea, M. Bernasconi, C. Di Novi, A. Marenzi, D. Rizzi and F. Zanantonio, Accounting for tax evasion profiles and tax expenditures in microsimulation modelling. The BETAMOD model for personal income taxes in Italy. International Journal of Microsimulation, vol. 8, pp. 99-136, 2015; A. Albarea, M. Bernasconi, A. Marenzi and D. Rizzi, Income under-reporting and tax evasion in Italy. Estimates and distributive effects. Senato della Repubblica Italiana, Documento di valutazione no. 8, 2018.*

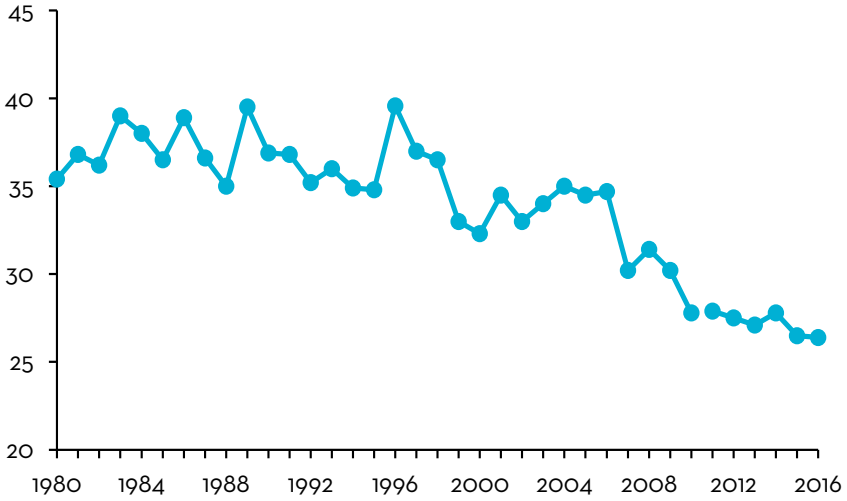
10 *By using the transfer pricing mechanism, companies expose costs in high-tax jurisdictions and turnover in low-tax jurisdictions.*

11 *Quantification of the scale of tax evasion and avoidance http://www.europarl.europa.eu/legislative-train/api/stages/report/current/theme/deeper-and-fairer-internal-market-with-a-strengthened-industrial-base-taxation/file/quantification-of-the-scale-of-tax-evasion-and-avoidance*

IV. The contribution of VAT and self-employment PIT gaps to the overall gap

The fight against tax evasion focuses mainly on VAT. This is for several other reasons than the amount of lost revenue. First, VAT evasion is at the root of income tax and IRAP evasion and, second, the VAT collection mechanism is more prone to fraud.

There has been a long-term reduction in the VAT gap, but there is much room for improvement. After peaking at around 40% in the mid-1990s, the VAT gap has been below 30% since 2010 (Figure 3).[12] However, collection of VAT continues to be rather inefficient compared to other countries: 'the VAT gap is among the highest in the EU, VAT efficiency is the lowest, and administration of VAT is weak'.[13] According to the European Commission, EU Member States lost €137 billion of VAT

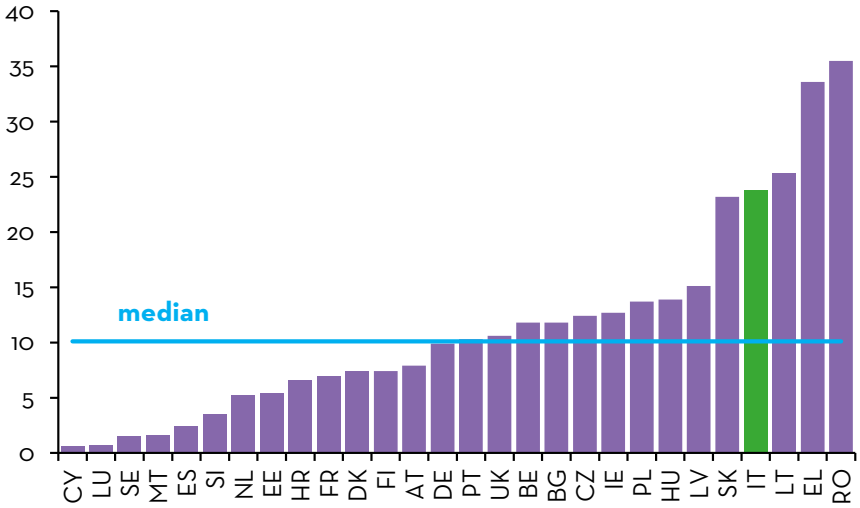


Source: Italian Revenue Agency (1980-2010) and MEF (2011-2016).

Figure 3

40 years of VAT gap in Italy

percentage of the VAT total theoretical liability



Source: EC, VAT gap report 2019, September 2019.

Figure 4

VAT gaps in the EU-28 Member States, 2017

percentage of the VAT total theoretical liability

12 *There is a break in the series at 2010, when the source of the estimated gap changed. Therefore, caution should be taken when comparing pre- and post-2010 data.*

13 *IMF, Italy, Enhancing Governance and Effectiveness of the Fiscal Agencies. December 2015. The VAT efficiency captures the departure of actual VAT revenue from the revenue that would result from a perfectly enforced tax, levied at a uniform rate on all consumption.*

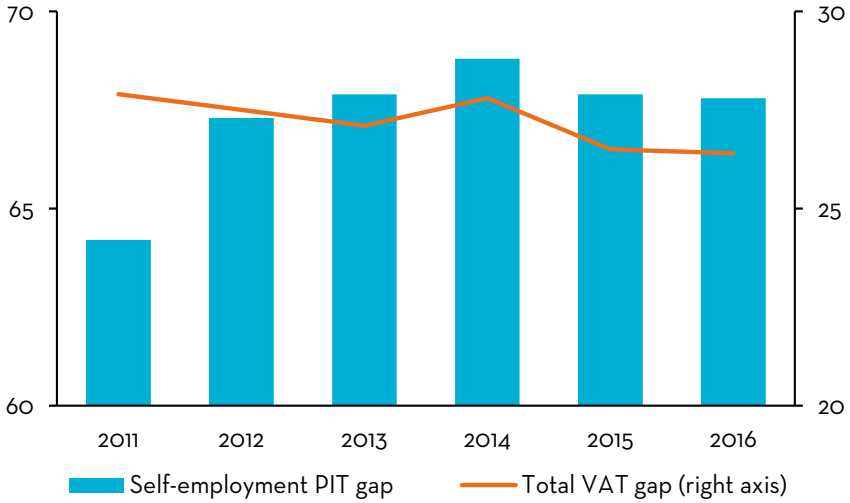


Figure 5

VAT and self-employment PIT gaps

percentages

Source: MEF.

revenue in 2017.[14] In monetary value, the Italian gap is the highest among the EU countries (€33 billion), followed by Germany (€25 billion), the UK (€19.2 billion) and France (€12 billion).[15] As a share of theoretical revenue, the Italian gap is 23.8%, which is lower only than Greece, Lithuania and Romania (Figure 4). Were Italy's VAT gap to be in line with the European median, Italy would recover around €20 billion annually.

The PIT gap related to the self-employment sector accounts for 34.1% of the overall direct and indirect taxation gap. In Italy, 23.8% of workers are self-employed versus an EU average of 14.9% in 2018.[16] The tax gap originates from the under-reporting of sales to final users by self-employed individuals and small businesses (hereafter 'self-employed'). Lower sales imply under-reporting of VAT by the self-employed and, consequently, under-reporting of incomes subject to PIT.

There is a link between the PIT and VAT gaps for self-employed. The volume of turnover affects both the VAT base and the PIT base and, therefore, is crucial for determining these tax bases. The PIT gap increased from 64.2% in 2011 to 67.8% in 2016 while the corresponding VAT gaps decreased from 27.5% to 26.4% (Figure 5). However, in 2013-2016, there was a positive correlation between these two gaps, suggesting the existence of a link between PIT evasion and VAT non-compliance by the self-employed.

V. Recent anti- (and pro-) evasion measures

In recent years, the Italian government has approved important measures aimed at increasing spontaneous compliance. The most effective of these have proved to be a split payment system for goods and services supplied to the public administration and the standardised system of mandatory electronic invoicing or e-Invoicing.

Under the split payment provision, the public administration purchaser is required to pay the

14 EC, Study and Reports on the VAT Gap in the EU-28 Member States, 2019 Final Report. This study uses the same methodological approach adopted by Italy, based on comparing fiscal and national accounting data. Despite harmonisation of the methodologies, the results obtained by the European Commission and Italy differ slightly, due mainly to the fact that the latter use more detailed information bases.

15 The €36 billion EC estimate is in line with the €35.2 billion MEF estimate, of which €26.2 billion is related to the assessment gap and €9 billion to the collection gap.

16 The shares for Spain, France and Germany are 12.5%, 10.2% and 9.4%, respectively.

VAT directly to the Italian Treasury, not to the supplier. This provision was enacted in 2015, for the public administration only, then, in 2017, was extended to companies controlled by government ministries and territorial entities. The tax collection agency estimated that, after two year of application, it had achieved revenue recovery of approximately €3.5 billion.

The use of e-Invoices has been mandatory for public procurement, since June 2014. Also, in January 2019, Italy became the first EU country to have mandatory e-Invoicing for all Business-to-Business (B2B) transactions and for all Business-to-Consumer (B2C) transactions for firms with an annual turnover greater then €65,000. The reduction in the VAT gap due to this provision is estimated by the government to be around €2 billion from 2019, although the first available data suggest a level of revenue recovery of around €3.5 billion.

Electronic filing and transmission of sales receipts will become mandatory for all businesses in Italy, starting from January 2020, which will give the tax administration access to all relevant data, allowing real time detection of VAT fraud.[17] Also, starting in 2020, a 'receipts lottery', similar to Portugal's 'Lucky Invoice', will be introduced. This will provide an incentive for consumers to obtain an electronic receipt from sellers, to give them a chance of winning a lottery prize.

The extensive use of technology has for long been recognized as the most effective way to improve tax collection. However, Italian legislation has not always been consistent in this direction. Traceability is mandatory only for wages paid by employers, and in order to benefit from deductions for property renovations and energy savings expenses. It was introduced for home rents and certain transport services in 2014, but, subsequently, this was repealed. Electronic transmission of customer-supplier lists was also short-lived; it was abolished in 2008, just two years after implementation, despite its positive effects on compliance.[18] The cash threshold for transactions was lowered to €1,000 in 2011, but then was increased to €3,000 in 2016. Similarly, electronic payments are not being sufficiently encouraged.

Some recently-introduced special tax regimes, such as the simplified flat-rate regimes for the self-employed and individual entrepreneurs with turnover up to €65,000, also reduce the effectiveness of evasion prevention. This simplified scheme exempts taxpayers from electronic invoicing and takes away the incentive to document the passive components of income, since they are provided by a lump sum rebate which does not depend on the costs incurred. In addition, it establishes a threshold effect that increases the incentive to conceal revenue or defer declarations above this threshold, due to the very high marginal rate that would be applied.[19]

Evasion seems to be fuelled by taxpayers' awareness of the weakness of controls. According to the Italian Court of Auditors, the taxes assessed in tax audits fell from €7.3 billion in 2017 to €5.5 billion in 2018. The probability of being audited remains low, with audits imposed in only 2.4%, on average, of the total number of the subjects considered. Data on financial transactions are largely under-utilized: out of the available 669 million records, in 2017 less than 10,000 were accessed by the tax authorities.

Various forms of tax amnesty have also reduced the incentives to comply. Again, according to

17 In 2015, Russia introduced a technology-led tax collection reform: every retailer was obliged to purchase a cash register that was linked directly to the administration data center, and companies were obliged to submit all invoices between businesses. The VAT gap of about 20% in 2014, fell to 1% in 2018.

18 The 2009 Annual Report of the Court of Auditors demostrates that this measure contributed to a 7% increase in annual turnover in 2006-2007, while its abolition caused a 11.9% decrease in 2009.

19 In the hearing on the 2019 draft budget law, the Italian Parliamentary Budget Office (PBO) estimated that an increase of €1 on €65,000 of revenue from self-employment would reduce disposable income by €5,900 euro and that it would take an increase of €10,000 in revenues to offset this loss.

the Court of Auditors, tax collection activity has been affected negatively by all the extraordinary measures implemented by successive governments such as voluntary disclosure, closure of pending tax disputes and cuts to pending payments ('rottamazione delle cartelle'). These measures led, also, to lower revenue than estimated: between 2010 and 2018 only €10.4 billion were collected from an estimated €21.8 billion.

VI. To sum up

Italy's economy suffers from long-standing and widespread low level of tax compliance. This causes loss of revenue, distortion to the allocation of resources and market inefficiency.

Tax evasion reduction is high on the policy making agenda and the data show a decline in the tax gaps, especially the VAT gap. However, the actions taken are not always coherent, which is exemplified by the size of the overall tax gap - still twice that of the main European countries.

VAT and self-employed PIT demonstrate the lowest compliance. The fact that VAT represents the biggest share of the overall gap is common to most countries, while the large contribution of self-employment to PIT non-compliance is specific to Italy's economy. This follows from and, at the same time, might contribute to the large size of the Italian self-employment sector, whose weight is twice that of the main European countries average.

Some recent measures, such as split payment and e-Invoicing, are proving effective for reducing the tax gaps. There is a wide consensus that the operational capacity of the tax administration should be strengthened to improve tax collection. The OECD, the IMF and the Italian Court of Auditors agree about the need for greater coordination among the various bodies, greater autonomy for the tax agency and the need for more staff.

The current policy debate is suggesting a number of steps that may reduce tax losses. A first example consists of new incentives to widen the use of electronic payment instruments and to limit cash payments, which represent more than 85% of all transactions. Another useful step would be the implementation of an existing suggestion to build individual-level fiscal risk indicators that automatically interlink fiscal turnover data and bank transactions. Finally, the launch of an awareness-raising campaign to contrast the compliant attitude of Italian citizens towards tax evasion.

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