



The changes in personal income tax, social security contributions and family allowances introduced by the Budget Law for 2007

The ISAE January Monthly Note analyzes some of the main measures affecting household incomes which were introduced by the last Budget Law: the revision of the personal income tax (IRPEF), the increase in social security contribution rates for employees and self-employed workers and the increase in family allowances.

Summing up, compared to the system in force in 2006, personal income tax is now characterized by a new set of tax brackets and tax rates and by the replacement of deductions from the tax base with tax credits. The elimination of deductions for dependents has the immediate effect of increasing the tax base for local surtaxes.

Furthermore, during the budget passage through Parliament, modifications with respect to the original Draft Budget Law were introduced which increased relieves for families with dependents, employees with incomes between 23,000 and 28,000 euros, pensioners and employees with temporary contracts. The analysis by standard categories shows that the new tax system reduces the burden for low and middle income taxpayers (for incomes up to about 35,000-40,000 euros) and increases that for higher income ones, for employees, pensioners and self-employed workers. The situation for taxpayers with pension or work income lower than the tax exemption threshold remains instead unchanged.

As for social security contributions, the new Law envisages for 2007 a (slight) increase in rates for employees – thus standardizing financing and calculation rates – and a higher rise (nearly two percentage points) for artisans and shopkeepers. Finally, for workers registered in the INPS separate contribution scheme (coordinated and constant or project collaborators), the contribution rate is now about five percentage points higher, nearing their situation to that of employees. While for employees the overall impact is virtually nil, for self-employed workers affected by such measures the rise in contributions more than offsets the reduction in the tax burden.

Lastly, family allowances were raised markedly with regard to both their amount and the number of recipients. In this case, fiscal benefits for employee households with children noticeably increased: for example, family where the household head is the only income earner, which has two dependent children and family income amounting to 25,000 euros, obtains a rise in disposable income of about 500 euros.

ISAE estimated the distributive effects on household disposable income of the above described measures, with respect to the system in force in 2006, using the micro simulation model ITAXMOD, based on the data from the Survey of Households and Wealth (SHIW) carried out by the Bank of Italy referring to 2002, updated to 2007.

The analysis indicates that households obtaining an increase in disposable income (of about 214 euros) reach 62%, whereas the disadvantaged ones are approximately 29% (for which the average loss equals about 450 euros).

Although advantaged households are concentrated in the middle income range, 47% of low income households (those in the first quintile) obtain an increase in disposable income, even if the share of family units in the same quintile that do not experience any change in net taxation remains high (at 34%).

The regional breakdown of data shows that households benefiting from the reform are mainly concentrated in the Centre (68.8%) and the North (62.3%). In the South, instead, a large percentage of households remain unaffected, because their incomes are too low.

The analysis by household's head income points to higher advantages for pensioners and employees (and assimilated ones) compared to self-employed workers.

As for the composition and the number of family members, the analysis shows that 68% of single income recipient households with only a dependent spouse and 60% of those with two dependent children benefit from the personal income tax reform.

Lastly, the results of the simulation indicate that the measures introduced by the Budget Law for 2007 increase the progressivity of the tax system, whereas the average tax rate for disposable income declines, albeit moderately.

Notwithstanding decidedly positive effects for most taxpayers, some aspects of the above interventions sound less convincing: most tax relieves derive from a complex system of measures which include aspects which are not completely consistent with the logic underlying the reform (i.e. the micro tax credits, "micro-detrazioni"). Above all, the set of instruments used for the support of both poor people and large families may not be the most adequate, since tax relieves do not affect very-low income households, and family allowances, which are a category measure, are mainly directed toward employees. These difficulties should be rapidly and decidedly tackled and new measures should be adopted so as to promote greater equity in Italy.



This Note examines some of the main measures of the recently approved Budget Law (Law 296/2006) which affect household disposable income, through taxes (direct taxes) and social security contributions, as well as transfers (family allowances). The recently adopted measures point to the realization of multiple objectives. In the general context of a reduction in the budget deficit, the revision of tax rates and brackets and of deductions actually aims at granting tax relief to medium-low income earners, as against an increase in taxation for wealthier taxpayers. The almost generalized increase in family allowances (through the rise in amounts and in the number of recipient households) is oriented toward raising and further spreading family support. Furthermore, the changes in social security contributions of quasi-subordinate workers are aimed at nearing their regime to the one of employees. For the latter, a slight increase in contribution rates was decided, which allows to uniform financing and calculation rates. Lastly, for artisans and shopkeepers, the years-long process of tax rate increases was accelerated.

The following paragraphs will illustrate the new personal income tax system and the structure of contributions and allowances defined by the 2007 Budget Law, also highlighting the changes - with respect to the draft initially presented by the Government¹- adopted during the parliamentary debate, and estimating the redistributive impact of these measures.

The new personal income tax (IRPEF)

The provisions for personal income tax (enclosed in paragraphs 6-8 of art.1) deeply change the system in force until December 31, 2006, modifying both the structure of tax rates and

brackets and the instruments that guarantee taxation relieves for work and pension income and households with dependents.

For the latter, the new legislation replaces deductions from the tax base, introduced in “two steps” by the previous reform (2003 and 2005 Budget Laws), with tax credits. Some characteristics of the previous system were maintained. Tax credits are actually adjusted according to the category of taxpayer (wage and salary workers, pensioners, self-employed workers) and to the dependent members, and decrease with the rise in income - thus accentuating the progressivity of the system already ensured by the tax rate structure -. Tax credits also set the income thresholds for the “no tax area”, below which no taxes have to be paid. The Budget Law for 2007 increased such thresholds for tax exemption to 8,000 euros (from 7,500 euros in 2006) for employees, to 7,500 euros (from 7,000 euros) for pensioners (7,750 euros for those over 75 years old) and to 4,800 euros (from 4,500 euros) for self-employed workers. Obviously, in the case of families with dependents, the no tax threshold is higher, thanks to tax credits: for example, for an employee with a dependent spouse the income threshold increases to about 10,400 euros, whereas it is above 14,800 euros if the taxpayer also has two dependent children (over three years old).

Nevertheless, if the taxpayer income consists also of the rental value of the owner-occupied dwelling, or declares deductible expenses (like social security contributions for self-employed workers), the actual tax credits are lower since, differently from the previous system, their decrease is calculated considering overall income gross of deductible expenses instead of net income. Thus the reference income for calculating tax credits is higher and the tax credits are lower.

Tables 1 and 2 show the exact amounts of the

¹ For a more detailed description of the Draft Budget Law and for an analysis of its redistributive effects, see the October 2006 ISAE Report.

above described tax credits, by income level.

Furthermore, tax credits have to be referred to work (or pension) periods in the reference year, and are alternative and thus not cumulative². The final measures include numerous changes with respect to the draft law. The main changes are the following:

- “micro tax credits”, between 10 and 40 euros, were adopted for employees in the 23,000 - 28,000 euros income range;
- a special treatment was reserved for employees and quasi-subordinate workers with temporary contracts, for whom tax credits, calculated according to the number of months of work, cannot be lower than 1,380 euros;
- pensioners over 75 year old benefit from new, slightly more generous tax credits;
- lastly, pensioners with pension income lower than 7,500 euros, who get only pension income and imputed rent of the owner-occupied dwelling, are tax exempt; without this new measure, these pensioners, for whom the overall income is higher than 7,500 euros because of the ownership of their principal dwelling, would have paid income tax.

With regard to tax credits for dependent family members, the main innovations of the Budget Law for 2007, compared to the initial proposal, are the following:

- tax credits for a dependent spouse were markedly increased thanks to the change in the coefficient for the calculation of actual tax credits and through the use of income brackets (see Table 2);
- tax credits for dependent children were raised for large families: the increase concerns household units with at least two children. Tax

credits were also extended to a larger number of families with at least three children, through the increase in the income threshold beyond which tax credits are zeroed (for households with three children, such limit moves up from 110,000 to 125,000 euros);

- new “micro tax credits” for the dependent spouse of between 10 and 30 euros for incomes in the 29,000 - 35,200 euros range were added;
- married couples can now split the tax credits for dependent children in half or allocate them entirely to the spouse with the higher income, in order to avoid that in the case of very low income one of the spouses cannot benefit entirely from the tax credits³;
- the Budget Law reintroduced a measure for household units where the spouse is absent, which had been cancelled by the draft law. In this case, the first child benefits from the tax credits which would have been granted to the spouse, if more favourable⁴.

Chart 1 shows the amounts of family tax credits, highlighting the adjustments (increases) with respect to the draft law.

The parliamentary debate did not bring any change for marginal tax rates and for brackets, which were nevertheless markedly revised with respect to the system in force in 2006. The new regulation increased the number of income brackets (from 4 to 5) and changed the value of intermediate tax rates (while the lower and the upper rates remained unchanged). On this subject, see Table 3, which summarizes the situation, also showing the one existing in 2002, before the “two step” reform adopted in the last term of Parliament.

² In this regard, the new measures penalize employees who become pensioners during the reference year: until 2006, they could cumulate work and pension deductions (weighting them with the respective periods), whereas now they have to choose the most favourable tax credits. However, as (partial) protection, the Budget Law confirmed the rules, already envisaged in the draft Budget Law, that assure that, in any case, tax credits for employee work or pension in the first income bracket (up to 8,000 euros or 7,500 euros) cannot be lower than 690 euros.

³ Clearly, the risk of not being able to obtain the entire advantage from tax credits remains if both husband and wife have very low incomes and none of their incomes reaches a level sufficiently high for benefiting entirely from the tax credits.

⁴ Actually this measure for the calculation of tax credits and exemptions was maintained by all the reforms of the last years.

Tab. 1 TAX CREDITS BY TYPE OF INCOME

Income brackets (euros)		Actual tax credit
	Employees (1) (2)	
0 – 8,000		1,840
8,000 – 15,000		$1,338 + 502 * [(15,000 - Y) / (15,000 - 8,000)]$
15,000 – 55,000		$1,338 * [(55,000 - Y) / (55,000 - 15,000)]$
More than 55,000		0
	Pensioners (1)	
0 – 7,500		1,725
7,500 – 15,000		$1,255 + 470 * [(15,000 - Y) / (15,000 - 7,500)]$
15,000 – 55,000		$1,255 * [(55,000 - Y) / (55,000 - 15,000)]$
More than 55,000		0
	Pensioners aged over 75 years (1)	
0 – 7,750		1,783
7,750 – 15,000		$1,297 + 486 * [(15,000 - Y) / (15,000 - 7,750)]$
15,000 – 55,000		$1,297 * [(55,000 - Y) / (55,000 - 15,000)]$
More than 55,000		0
	Self-employed workers	
0 – 4,800		1,104
4,800 – 55,000		$1,104 * [(55,000 - Y) / (55,000 - 4,800)]$
More than 55,000		0
	Additional tax credits for wage and salary earners	
Income brackets		Actual tax credit
23,000 – 24,000		10
24,000 – 25,000		20
25,000 – 26,000		30
26,000 – 27,700		40
27,700 – 28,000		25

(1) The tax credit for employees or pensioners of the first income bracket cannot however be lower than 690 euros.

(2) The tax credit for temporary employees (or assimilated workers) cannot however be lower than 1,380 euros.

Tab.2 TAX CREDITS FOR HOUSEHOLD DEPENDENTS

Income brackets (euros)	Dependent spouse	Actual tax credit
0 – 15,000		$800 - 110 * (Y / 15,000)$
15,000 – 40,000		690
40,000 – 80,000		$690 * [(80,000 - Y) / (80,000 - 40,000)]$
	Additional tax credits	
29,000 – 29,200		10
29,200 – 34,700		20
34,700 – 35,000		30
35,000 – 35,100		20
35,100 – 35,200		10
	Dependent children (1)	
Children over 3 years old (2)		$800 * [(80,000 + 15,000 * N - Y) / (80,000 + 15,000 * N)] * N$
Children under 3 years old (2)		$900 * [(80,000 + 15,000 * M - Y) / (80,000 + 15,000 * M)] * M$
Other dependent family members (2)		$750 * [(80,000 - Y) / 80,000] * AF$

(1) If the one parent is absent, the first child benefits from the tax credits which would have been granted to the dependent spouse, if more favourable.

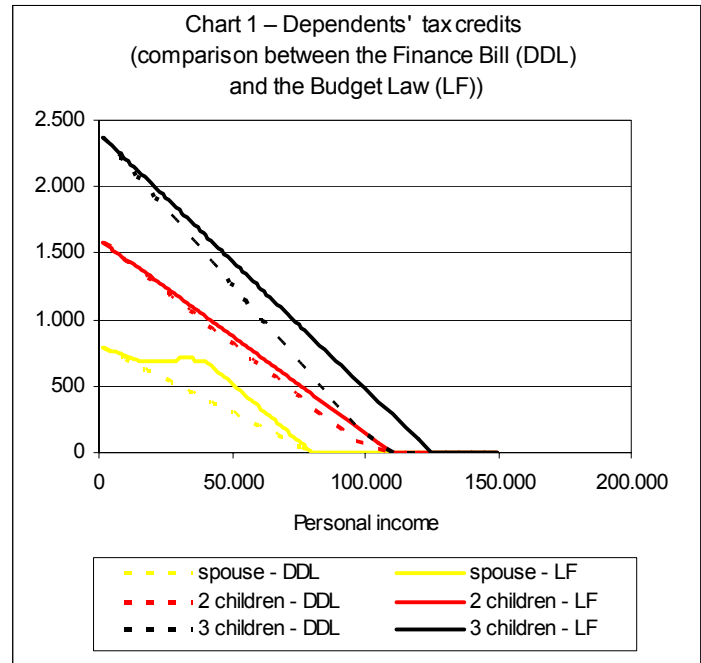
(2) N, M and AF indicate, in the order, the number of children aged more or less than three years and the number of other dependent family members. In the case of more than three children, the tax credits (800 and 900 euros) are increased by 200 euros (for all children).

Effective marginal tax rates are nevertheless generally higher than the legal ones reported in Table 3 and are different according to the level of income and the taxpayer's work and family situation. In fact, since both deductions and new tax relieves are calculated with respect to income, the rise in taxes by income level does not match the legal tax rate t , but depends also on the coefficients used each time for the calculation of deductions and exemptions (for an exact estimate of the new marginal tax rates, see Table 4).

All in all, the changes in the Budget Law which were introduced during the parliamentary debate should entail a general reduction in taxation for low and middle income taxpayers.

Nevertheless, attention should be paid to some aspects of the new regulation (already existing in the draft Budget Law) which affect the benefits obtained by taxpayers, significantly reducing, in some cases, their amount.

In addition to the fact that gross income, instead of income net of deductible expenses, is used for calculating tax creditstax credits, two more factors have to be noticed which reduce taxpayers' benefits sometimes markedly. Firstly, the new regulation abolished the so called "family tax planning" which gave the possibility to the parents to choose how to split children tax credits in order to obtain greater fiscal benefits (as illustrated above, the new regulation considers a 50% division or the entire attribution of tax credits to the spouse with the highest income). Secondly, there was a noticeable increase in local surtaxes, as indicated also in the Technical Note accompanying the Finance Bill, due to the



Tab.3 INCOME BRACKETS AND LEGAL MARGINAL TAX RATES

Income brackets (euros)	Marginal tax rates		
	IRPEF 2002	IRPEF 2006	IRPEF 2007
0-10,329	18	23	23
10,329-15,000	24		27
15,000-15,493	32	33	38
15,493-26,000			
26,000-28,000	39	39	41
28,000-30,987			
30,897-33,500	45	43	43
33,500-55,000			
55,000-69,721	45	43	43
69,721-75,000			
75,000-100,000	45	43	43
More than 100,000			

Tab. 4 LEGAL MARGINAL AND EFFECTIVE TAX RATES IN THE 2006 AND 2007 LEGISLATION

According to the 2006 legislation, taxation is calculated as follows:

$$T = t \cdot \left(Y - \frac{26000 + DEDL - Y}{26000} \cdot DEDL - \frac{78000 + DEDF - Y}{78000} \cdot DEDF \right)$$

where t is the legal marginal tax rate and $DEDL$ and $DEDF$ are potential deductions (from work and family origin); thus the marginal effective tax rate is

$$\frac{\partial T}{\partial Y} = t \cdot \left(1 + DEDL/26000 + DEDF/78000 \right)$$

The recently approved Budget Law makes the calculation slightly more complex, because the equations for the coefficients used for calculating tax credits vary according to the level of income. In summary (except in the case of micro tax breaks, and without taking into account tax credits for dependents children which are less than three years old and for other dependent family members) taxation equals:

$$T = tY - \left(L_1 + L_2 \frac{l_2 - Y}{l_2 - l_1} \right) - DETC - 800 \cdot \frac{80000 + 15000 \cdot N - Y}{80000 + 15000 \cdot N} \cdot N$$

where L_1 and L_2 are, respectively, the fixed and the variable parts of work deductions for the various income brackets, l_2 and l_1 the upper and lower levels of the considered range, $DETC$ the tax credit for the dependent spouse and N the number of children (more than three years old); consequently

$$\frac{\partial T}{\partial Y} = t + \frac{L_2}{l_2 - l_1} + \frac{800 \cdot N}{80000 + 15000 \cdot N} + C \quad C = \begin{cases} 110/c_1 & \text{if } Y \leq c_1 \\ 690/(c_3 - c_2) & \text{if } c_2 < Y \leq c_3 \\ 0 & \text{elsewhere} \end{cases}$$

where c_1 , c_2 and c_3 are the limits for income brackets concerning the tax credit for the dependent spouse (equal to 15000, 40000 e 80000, respectively).

indirect effect of the replacement of deductions for dependents with tax credits: the income base for calculating local surtaxes, which was net of deductions (as specified by the Internal Revenue Agency memorandum n. 31 of June 6, 2005), is now gross of tax creditstax credits. This change causes an immediate increase in taxable income and thus in local taxation (even without changes in the tax rates). The rise in surtaxes can also be heightened by the possibility given by the Budget Law to local authorities to increase tax rates, as well as by the automatic increase of regional surtaxes toward the maximum allowed level (1.4%), already present in the previous system for Regions with high healthcare deficits (in 2006, Liguria, Lazio, Abruzzi, Molise, Campania and Sicily). Finally, the exemption for recipients of non-work income up to 3.000 euros was abolished.

Main measures concerning social security contributions and family allowances

The Budget law envisages changes for contribution rates starting from January 1st, 2007. Pension contribution rates for artisans and shopkeepers, registered at National Social Security Institute (*Istituto Nazionale per la Previdenza Sociale* – INPS), were increased to 19.5%⁵ (and to 20% as of 2008). This rate is applicable for annual incomes between 13,598 euros (in 2007) and 40,083 euros, whereas for higher incomes up to 66.805 the rate is one percentage point higher. The gradual increase in rates was thus accelerated: according to the previous regulation, rates for artisans and shopkeepers would have increased from 17.6% and 17.9% respectively in 2007 (one

⁵ For shopkeepers, a pension contribution rate of 0.09% is added to the ordinary rate of 19.5% (art. 5 of the Legislative Decree n. 207 of March 28, 1996) in order to compensate for final discontinuance of business.

percentage point more for annual incomes over 40,083 euros) to 19% in 2014⁶.

For employees, the pension contribution rate paid by workers was raised by 0.3 percentage points. Due to this increase, the overall rate (for the employee and the employer) rises from 32.7% (8.89% for the worker and 23.81% for the employer) to 33%. At the same time, the difference between the financing rate and the calculation rate disappears, since both rates now amount to 33%.

Concerning workers enrolled in the INPS special fund for quasi-subordinated workers (*Gestione Separata*), that is to say workers whose income derives from quasi-subordinate jobs (the so called *collaborazioni coordinate e continuative*, now named *a progetto*, except in the state sector), from professional activities (for professionals without specific private category funds), from occasional jobs or door-to-door sales (for these latter categories annual income has to be higher than 5.000 euros) the following increases in rates were decided (1/3 for workers and 2/3 for employers):

- for workers who are not registered in other pension systems, the pension contribution rate was raised to 23% (compared to the previously set rates for 2007: 17.9% for annual incomes up to 40,083 euros and 18.9% for those above this threshold)⁷. The 0.5% surtax for financing benefits for maternity pay, sick pay and family allowances remained unchanged. The new pension contribution rate is applicable up to the maximum annual income of 87,187 euros in 2007. At the same time, the difference between the financing rate and the calculation rate disappears, since both rates now amount to 23%;
- the rate was set at 16% for the remaining workers registered in the INPS special fund for

quasi-subordinated workers - that is to say workers already registered in other pension schemes, or getting a direct or indirect pension -. The regulation in force in 2006, instead, differentiated the various categories of workers, applying a 10% rate for workers having other forms of mandatory social security arrangements, and a 15% rate for those getting a direct pension. As for workers who are not registered in other pension schemes, the 16% rate is applicable up to the maximum income ceiling.

In addition, the Budget Law for 2007 sets new family income ceilings and new amounts of family allowances for households with dependent minor children, only one or both parents and without disabled members⁸. The starting date for the new conditions is January 1st, 2007, which moves six months forward the usual revaluation, normally performed on the 1st of July.

The manoeuvre markedly raises the household income thresholds below which family allowances are granted, thus increasing the number of recipient households. Furthermore, for large households (with more than 3 children – or equivalent – under 26 years old), the calculation of family allowances comprises minor children but also those over 18 years of age but less than 21, if they are students or trainees. Finally, the amounts are recalculated and the relation to income revised in order to reduce the “poverty trap” effects that derived from the “step” reduction of the previous system.

⁸ These allowances for the family unit, which were introduced in 1988 for employees, pensioners and holders of social benefits deriving from payroll work, were extended from 2004 (Law 311/2004, art.1, paragraph 157) to workers with quasi-subordinate jobs (professional activity or coordinated and constant or project collaborations) registered in the INPS separate scheme and not in other separate contribution schemes. The old system of family allowances in fixed amounts was confirmed for independent farmers, sharefarmers, farmers, small independent farmers and pensioners of the special schemes for self-employed workers (artisans, shopkeepers and independent farmers, farmers and sharefarmers). The amounts of the allowances are small and have never been up valued. These amounts are directly related to the number of family members and are inversely related to family income thresholds, which are annually updated by INPS according to the inflation rate. The overall family income includes IRPEF taxable incomes of all family members obtained during the previous year. The allowance is due if the employee income or the employee assimilated income amounts to more than 70% of the overall income.

⁶ The contribution system for these self-employed workers maintains at 3 percentage point the reduction in rates for young people under 21 years old.

⁷ The previous system also envisaged a gradual increase in the financing rate up to 19% in 2013.

The top value of allowances (equal to 1,650 euros for households with one child, 3,100 euros for those with two children, etc.) is granted to families with overall income equal or below 12,500 euros. Above this limit, the allowance diminishes for each 100 euros increase in income by a variable amount which is based on the family type and the level of income (see Charts 2 and 3).

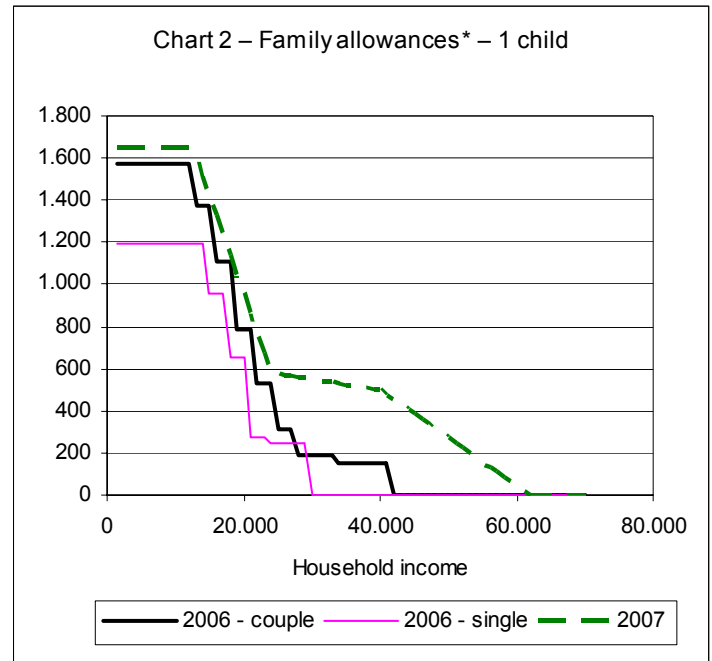
Furthermore, an “additional” allowance is granted to households with only one parent, without disabled members and with 3, 4 or 5 members other than the parent. Also in this case, the allowance diminishes toward zero according to a system similar to the one previously described.

For households with more than 5 members (with one or both parents), the allowance is increased by 15% and by a further 660 euros for the seventh component onwards.

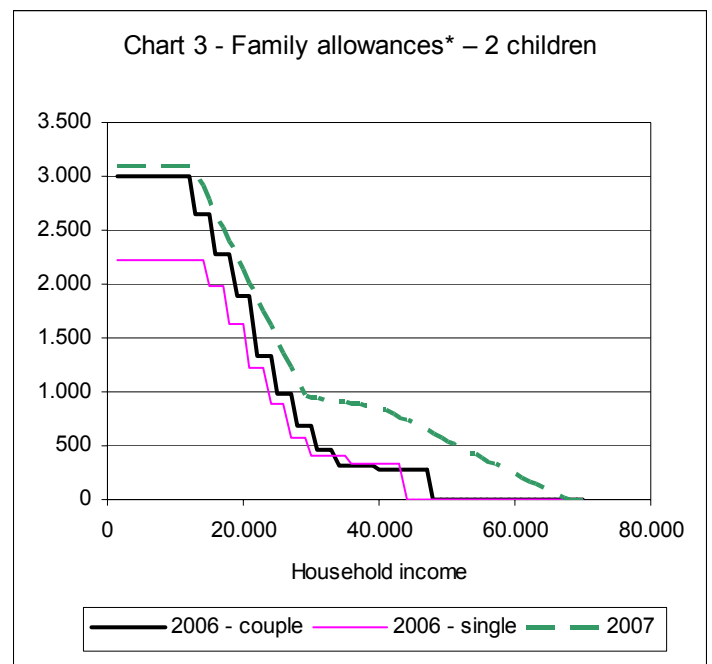
While income thresholds remain unchanged, the amounts of allowances for all other types of households with children are also revalued by 15%, and the cut in allowances due to the simultaneous presence of other dependent children and the increases established beyond the seventh component are confirmed.

The analysis by standard cases

The charts hereafter exhibit for standard cases the curves measuring the difference in the net tax burden (thus the difference in disposable income) with respect to the rise in income calculated according to the tax regime in force in 2006 and to the 2007 reform (including all the measures described above). When the curve is in negative quadrants, the new rules are more favourable, and vice versa



* For 2007 data, the “step” decline (which is much smoother than in 2006) was adjusted using a linear curve

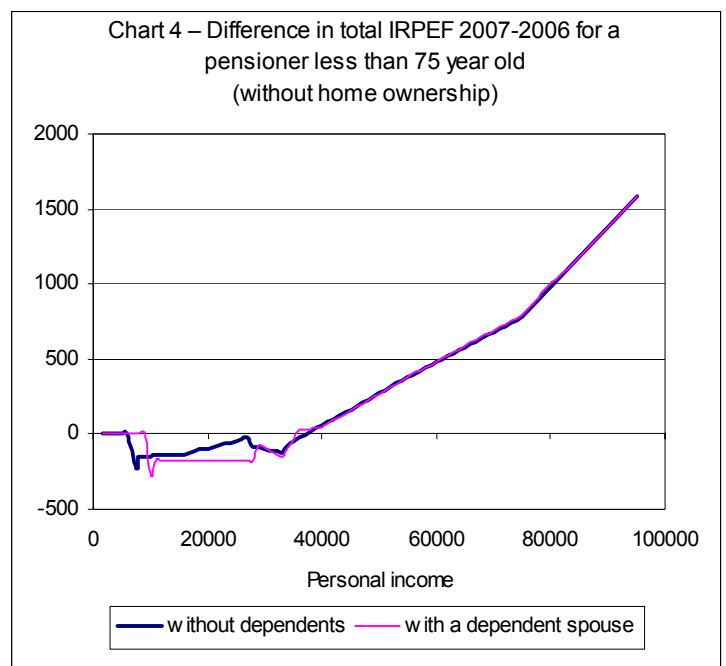


* For 2007 data, the “step” decline (which is much smoother than in 2006) was adjusted using a linear curve

when the values are positive. In all the charts, considered taxpayers have no real estate income and the calculations include a minimum IRPEF surtax of 1.1% (0.9% for the regional surtax plus 0.2% for the municipal one)⁹.

In the case of taxpayers with pension income and without dependent children (Chart 4), only the effects of the IRPEF change are considered (since these taxpayers do not have to pay social security contributions and do not receive family allowances). As previously noticed, there is no change in the tax burden for very low income earners since they are already included in the “no tax area”. A first “step” occurs close to the 7,500 euros income level (10,000 euros in the case of a taxpayer with a dependent spouse), at which according to the new regulations no tax is due (the taxpayer receives a benefit of 230 euros, and of 280 euros if the spouse is dependent). The benefit progressively declines (though remaining practically always higher for taxpayers with dependent family members) until the income reaches the threshold of 37,000 euros (36,000 euros in the case of a dependent spouse¹⁰). Beyond this point, the taxpayer undergoes a loss which rises up to a plateau of about 1.800 euros, reached when incomes are above 100,000 euros.

Advantages follow a non-linear trend, mainly for incomes up to about 40,000 euros, due to the elimination of the deductions from the tax base. Deductions in the previous system produced tax relieves which, though linearly



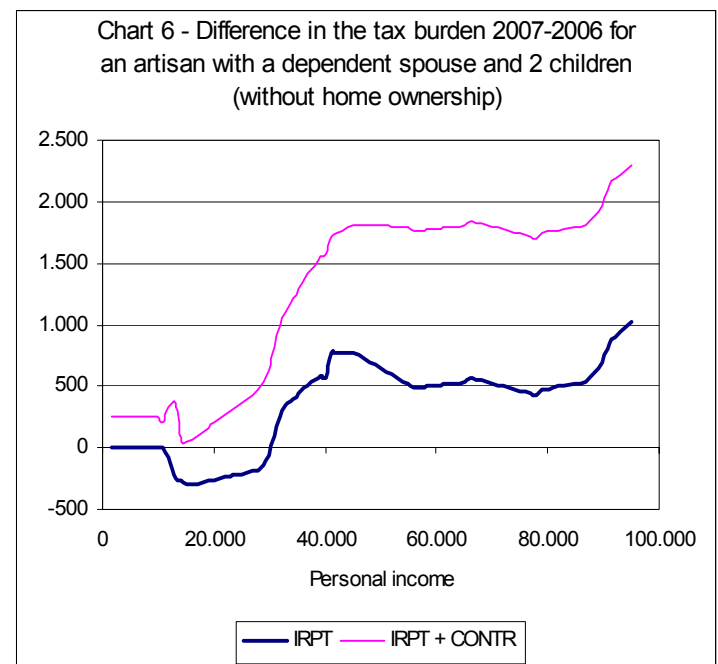
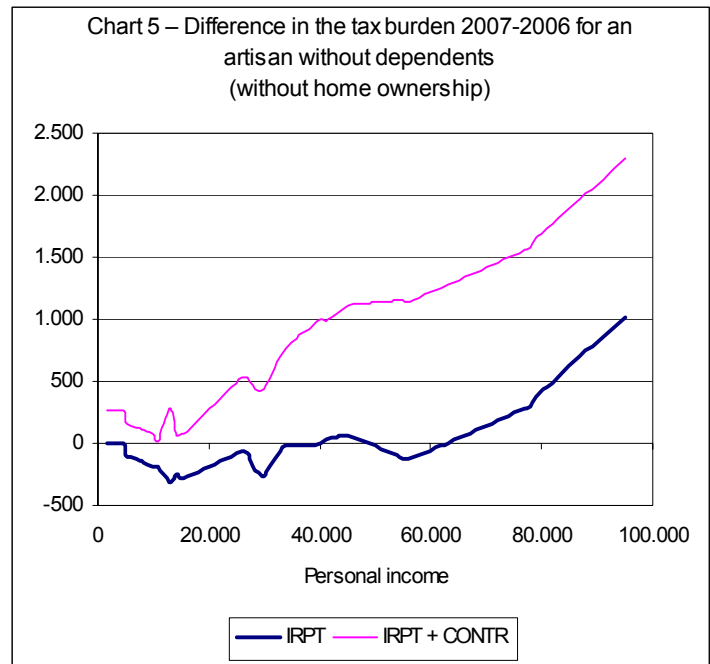
⁹ Many regions already had in 2006 a tax rate higher than 0.9%, at least for some income brackets: in addition to the regions, already considered before, with high healthcare deficits, there are also Calabria, Piedmont, Umbria, Veneto, Lombardy, Marche and, starting from 2007, Emilia Romagna.

¹⁰ This is a typical case that clearly shows the negative effect for taxpayers of the rise in the tax base which is used for the calculation of local surtaxes after the abolition of the deductions for dependents.

diminishing along with the rise in income, recorded “step” when taxable income moved in the upper bracket. This drawback does not exist with the new tax credits which guarantee (in the absence of “micro tax credits”) linearly diminishing tax reductions. As shown in the following charts, this happens for all kinds of taxpayers (all those benefiting until 2006 from deductions from the tax base that now have tax credits).

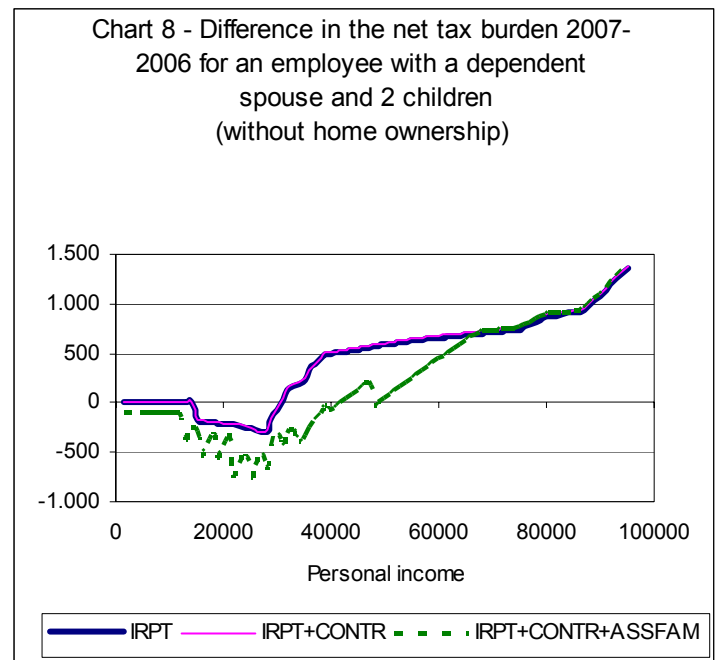
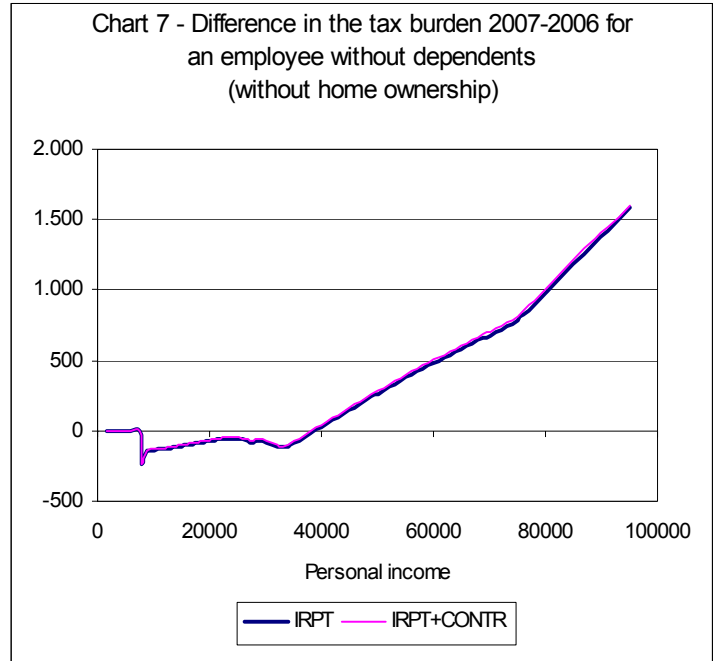
The change in the tax burden for artisans (see charts 5 and 6) practically follows the same pattern of pensioners, but with some important differences. The amount of tax reduction is generally higher than for pensioners and reaches a maximum level of 300 euros for incomes amounting to 13,000 euros for taxpayers without dependent family members and to 16,000 euros for taxpayers with a spouse and two dependent children. Also the threshold beyond which the tax burden increases is slightly higher (around 40,000 euros and 31,000 euros in the two cases considered). This phenomenon is the result of a decline in the tax base for these taxpayers, which is due to the increase in social security contributions. Nevertheless, with regard to the change in the overall burden, higher contributions offset the tax relieves also for lower income levels: overall, for workers without dependent family members and for those with a spouse and two children, the loss can reach 500 euros for incomes up to 25,000 euros and 28,000 euros, respectively, and grow up to 2,500 euros in the case of very wealthy taxpayers (with incomes higher than 100,000 euros).

Finally, charts 7, 8 and 9 illustrate the situation for employees. Due to the small increase in contributions for this type of



workers, the curves for the tax burden are equal to the ones for pensioners, with the same “step” corresponding to the increase in the exemption area and with similar benefits. In addition, also in this case, the income threshold above which a tax loss occurs is lower for taxpayers with dependent family members compared to the one for households without dependents. Nevertheless for employees also the new amounts and the new thresholds for family allowances become effective starting from January 1st, 2007, as clearly shown by the third curve in Charts 8 and 9: thus, thanks to the new allowances, gains are decidedly larger for low and middle income households, and reach the maximum level of about 750 euros for family income equal to 25,000 euros. Furthermore, the income threshold below which a gain is obtained is significantly higher (above 40,000 euros for overall household income), and family allowances improve the balance up to household income amounting to 65,000 euros¹¹. Lastly, it is worth noting that the rise in family allowances also advantages people who previously did not benefit from tax cuts because their income was too low for taxation: in fact, the maximum value of allowances for households with very low incomes rises by about 100 euros.

Finally, Chart 9 shows the change in disposable income for employees, in a situation in which both husband and wife work and generate 50% of household income each. For the same level of income, the gains deriving from the current IRPEF system are higher and



¹¹ As for the comparisons based on the change for the sole personal income tax system, also in this case the erratic movements of the gains in disposable income obtained considering family allowances is attributable to the “step” decline of the previous IRPEF system and the approximately linear decline of the current one.

more widespread, since both spouses fall within the most favoured income range¹².

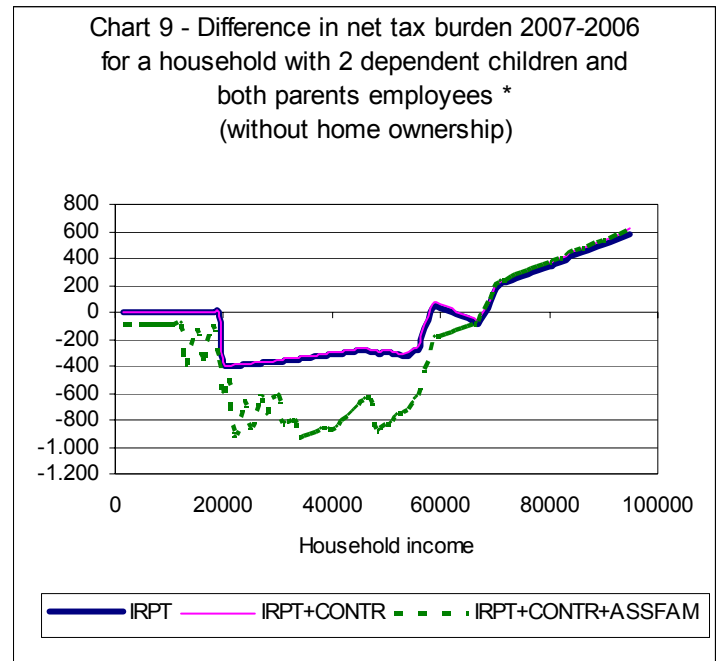
The results of the ISAE micro simulations

For analysing the distributive effects and the costs for public finances of the provisions contained in the Budget Law for 2007, ISAE used its micro simulation model for direct taxation and social security contributions ITAXMOD, based on the data of the Bank of Italy Survey of Households' Income and Wealth (SHIW) referring to 2002 (on a sample of about 8,000 households and 21,000 individuals), updated to 2007.

ISAE estimated the distributive effects comparing the personal income tax system for 2007 (IRPEF 2007) to the system in force in 2006 (IRPEF 2006), according to three different scenarios: the first simulation examines the reform in personal income tax (including the effects of the increase in local surtaxes due to the elimination of family deductions). The second and third scenarios comprise also the new regulations on social security contributions, and finally the new system of family allowances is added as well.

Tables 5 and 6 summarize the effects for households of the manoeuvre on personal income tax for 2007, according to all three scenarios.

With regard to the reform on personal income tax, according to the new measures about 63% of households will receive an average benefit of 170 euros, whereas 22% of



* Both spouses contribute 50% of the household income.

¹² While the new amounts of family allowances depend on the number of family members and not on the number of income recipients, the reference unit for the personal income tax is the individual and not the household: the tax is thus higher if income is generated by the sole family head, compared to the case of two income recipients.

households will undergo an average loss of around 470 euros. About 15% of taxpayers, exempt from the payment of income taxes and of surtaxes, because their income is particularly low, will not see any change in their disposable income.

When the new rules on social security contributions are also taken into account, the households' tax burden increases compared to the first scenario. The percentage of advantaged households actually diminishes to 57%, with a reduction for the average household gain to 149 euros, whereas the share of households subject to a larger burden increases to about 33%, with an average loss of 428 euros. The number of unaffected households lowers to 10%.

As for the last scenario, the increase in family allowances reduces the negative effects of the increase in social security contributions, even though, as shown hereafter, the benefits depend on the number of family members and on the composition of households. The combined effects of changes in the personal income taxes, local surtaxes, social security contributions and family allowances produce a benefit for approximately 62% of households, with an increase in disposable income of about 214 euros. The percentage of disadvantaged households, for which the average loss in terms of higher taxes amounts to about 450 euros, declines, symmetrically, to 29%.

Tables 7, 8 and 9 estimate the effects of the changes in IRPEF on disposable income by breaking down families according to the level of income, the geographic area, the source of household head's income and the number and composition of household members.

Table 7 shows that the benefits deriving from the changes in IRPEF and in local

Tab. 5 EFFECTS OF THE 2007 BUDGET LAW
(percentage values)

	IRPEF + local surtaxes	IRPEF + local surtaxes + social security contributions	IRPEF + local surtaxes + social security contributions + family allowances
Unaffected households	14.9	9.6	9.5
Advantaged households	62.9	57.0	61.8
Disadvantaged households	22.2	33.4	28.7
Total	100.0	100.0	100.0

Source: ISAE calculations based on Bank of Italy data (2004).

Tab. 6 EFFECTS OF THE 2007 BUDGET LAW

	Average family benefit in euros (1)	Average family benefit in percent of total income (1)	Average family loss in euro (2)	Average family loss in percent of total income (2)
IRPEF + local surtaxes	170	0.7	474	0.9
IRPEF + local surtaxes + social security contributions	149	0.6	428	0.8
IRPEF + local surtaxes + social security contributions + family allowances	214	0.9	451	0.8

Source: ISAE calculations based on Bank of Italy data (2004).

(1) Only advantaged families.

(2) Only disadvantaged families.

surtaxes favour mainly middle income households and in particular those in the 3^o quintile (81.1%), whereas 54.6% of the wealthiest ones (those in the last quintile) record an increase in taxation. As for the impact on the poorest households, the presence, in the first quintile, of the number of families with no taxable income, which consequently are not affected by the reform, is high (57.7%). The geographic breakdown of data indicates that households benefiting from the reform are mainly concentrated in the North and the Centre of Italy. In the South, instead, a large percentage of households remain unaffected, also in this case, because for many people incomes are too low. The splitting up of data, according to the source of the households head's income, points to a higher proportion of pensioners obtaining a reduction in taxation (74.7%), whereas the share is lower for employees (59.3%) and self-employed workers (46.6%). Considering the number of family members and the composition of households, family units with no dependents and those with only a dependent spouse benefit more than households with two children, since, according to the new provisions, the drawback increases with the rise in the number of dependent family members (due to surtaxes). Nevertheless, as shown hereafter, families with children record an increase in allowances which reduces the negative effects of new personal income tax regulations.

The addition in the simulation of changes in regulations for social security contributions, which entail a general increase in rates, causes, as previously highlighted, a fall in the number of households obtaining a benefit with respect to the previous scenario. Even though the increase in disadvantaged people characterizes mainly self-employed workers (about 73%), for whom the rise in taxation was harsher, a larger burden affects all

income brackets, also including poorest income recipients, as shown by the sharp increase in the share of disadvantaged households in the first quintile (29.3%).

The last scenario includes also the changes in regulations for family allowances. In this case, as shown in Table 9, the percentage of households obtaining a benefit from the manoeuvre increases (to around 62%), mainly concentrated in the second, the third and the fourth income quintiles. Even though the share of unaffected households in the first quintile remains high (34%)¹³, the share of households with very low income obtaining higher disposable income markedly increases, reaching 46.6%. As for geographic areas, a large proportion of households in the Centre and the North benefits from the change, whereas the highest shares of unaffected and disadvantaged households are, respectively, in the South and in the North. In this scenario, 64.3% of households where the head is an employee obtain a reduction in net taxation, whereas in the case of self-employed workers about 72% of households post a loss. This drawback for self-employed workers is the combined effect of less favourable income taxation, major increase in social security contributions and the fact that the increase in family allowances affects only employees (or assimilated workers). The last section of Table 9 reports the results of the simulations for the overall manoeuvre, according to the number of members and the composition of households. Clearly, compared to the previous scenario, there is no change in the percentage of households without dependent children advantaged and unaffected by the reform. In the case of households with two children, instead, the share of advantaged family units increases significantly (to 60% from 42% in the previous scenario).

¹³ Obviously these households have no taxable income and no dependent children.

Tab. 7 EFFECTS OF THE CHANGES IN PERSONAL INCOME TAX AND LOCAL SURTAXES
(percentage values)

	By equivalent household income quintile (1)					Total	Number of households
	1°	2°	3°	4°	5°		
Unaffected households	57.7	12.0	3.1	1.1	0.9	14.9	3,185,893
Advantaged households	37.0	74.6	81.1	77.3	44.6	62.9	13,409,263
Disadvantaged households	5.4	13.4	15.9	21.6	54.6	22.2	4,722,115
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	21,317,271

	By geographic area		
	North	Centre	South
Unaffected households	6.6	9.9	29.5
Advantaged households	65.4	68.5	56.2
Disadvantaged households	28.0	21.6	14.3
TOTAL	100.0	100.0	100.0

	By source of household head's income		
	pensioner	self-employed worker	wage and salary worker
Unaffected households	12.7	9.3	9.5
Advantaged households	74.7	46.6	59.3
Disadvantaged households	12.6	44.1	31.2
TOTAL	100.0	100.0	100.0

	By number and composition of household dependents		
	single	with dependent spouse only	with dependent spouse and two children
Unaffected households	12.6	12.0	31.9
Advantaged households	72.2	72.7	47.8
Disadvantaged households	15.2	15.3	20.3
TOTAL	100.0	100.0	100.0

Source: ISAE calculations based on Bank of Italy data (2004).

(1) Households incomes are made equivalent by dividing total income by an equivalence parameter. The range considered is the one defined by ISEE. The first quintile includes 20% of households with the lowest equivalent income; the fifth quintile includes 20% of households with the highest equivalent income.

Tab. 8 EFFECTS OF THE CHANGES IN PERSONAL INCOME TAX, LOCAL SURTAXES
AND SOCIAL SECURITY CONTRIBUTIONS
(percentage values)

	By equivalent household income quintile (1)					Total	Number of households
	1°	2°	3°	4°	5°		
Unaffected households	34.7	9.1	2.4	1.1	0.8	9.6	2,053,186
Advantaged households	35.9	70.5	75.0	68.2	35.3	57.0	12,148,000
Disadvantaged households	29.3	20.4	22.6	30.7	63.9	33.4	7,116,085
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	21,317,271
	By geographic area						
	North	Centre		South			
Unaffected households	4.2	5.5		19.6			
Advantaged households	57.9	64.0		51.5			
Disadvantaged households	37.8	30.5		28.9			
TOTAL	100.0	100.0		100.0			
	By source of household head's income						
	pensioner	self-employed worker	wage and salary worker				
Unaffected households	12.2	3.1	1.8				
Advantaged households	72.9	24.3	53.5				
Disadvantaged households	14.8	72.7	44.7				
TOTAL	100.0	100.0	100.0				
	By number and composition of household dependents						
	single	with dependent spouse only	with dependent spouse and two children				
Unaffected households	11.6	10.7	10.5				
Advantaged households	66.8	68.0	42.4				
Disadvantaged households	21.6	21.3	47.1				
TOTAL	100.0	100.0	100.0				

Source: ISAE calculations based on Bank of Italy data (2004).

(1) Households incomes are made equivalent by dividing total income by an equivalence parameter. The range considered is the one defined by ISEE. The first quintile includes 20% of households with the lowest equivalent income, the fifth quintile includes 20% of households with the highest equivalent income.

Tab. 9 EFFECTS OF THE CHANGES IN PERSONAL INCOME TAX, LOCAL SURTAXES,
SOCIAL SECURITY CONTRIBUTIONS AND FAMILY ALLOWANCES
(percentage values)

	By equivalent household income quintile (1)					Total	Number of households
	1°	2°	3°	4°	5°		
Unaffected households	34.0	9.1	2.4	1.1	0.8	9.5	2,019,890
Advantaged households	46.6	75.9	79.7	71.1	35.8	61.8	13,178,807
Disadvantaged households	19.4	15.1	17.9	27.7	63.4	28.7	6,118,574
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	21,317,271
	By geographic area						
	North	Centre		South			
Unaffected households	4.2	5.5		19.2			
Advantaged households	62.3	68.8		57.0			
Disadvantaged households	33.5	25.7		23.8			
TOTAL	100.0	100.0		100.0			
	By source of household head's income						
	pensioner	self-employed worker	wage and salary worker				
Unaffected households	12.2	3.1	1.5				
Advantaged households	73.1	25.4	64.3				
Disadvantaged households	14.7	71.6	34.2				
TOTAL	100.0	100.0	100.0				
	By number and composition of household dependents						
	single	with dependent spouse only	with dependent spouse and two children				
Unaffected households	11.6	10.7	10.0				
Advantaged households	66.8	68.0	60.2				
Disadvantaged households	21.6	21.3	29.8				
TOTAL	100.0	100.0	100.0				

Source: ISAE calculations based on Bank of Italy data (2004).

(1) Households incomes are made equivalent by dividing total income by an equivalence parameter. The range considered is the one defined by ISEE. The first quintile includes 20% of households with the lowest equivalent income, the fifth quintile includes 20% of households with the highest equivalent income.

Nevertheless, a still high share of households in this group records a rise in taxation. As pointed out by the analysis by standard cases (Charts 6, 8 and 9), the disadvantaged households are mainly those of non-employees with children, for whom the tax burden increases because of the rise in taxable income for local surtaxes, and those of wage and salary workers with middle-high incomes, who do not receive family allowances or receive them in a very low amount that does not compensate for the rise in taxation. By and large, this is the case of 30% of households with a spouse and two dependent children.

Tab.10 REDISTRIBUTION AND PROGRESSIVITY INDEXES

	G_{YL}	C_{YN}	C_{TX}	RS	K	t
IRPEF 2006	0.4051	0.3575	0.5731	0.0476	0.168	0.1235
IRPEF 2007	0.4051	0.3547	0.5844	0.0504	0.1793	0.1206

Source: ISAE calculations based on Bank of Italy data (2004).

Redistribution and progressivity indexes for personal income tax in 2007 compared to 2006 are reported in Table 10 (changes in social security contributions and family allowances are not considered). The first column shows the Gini index of before tax income, whereas in the second and third columns you may find, respectively, the concentration index for net income and the one for taxes, according to IRPEF 2006 and IRPEF 2007. The increase in the Reynolds Smolensky (RS) index (equal to the difference between the indexes of the first and the second columns) shows that the 2007 reform increases, though slightly, the redistribution of income compared to IRPEF 2006. The analysis of the K index (calculated as the difference between the values in the third and the first columns) demonstrates that the progressivity of the system increases, albeit moderately. The last

column of Table 10 shows that the average tax rate for household disposable income for IRPEF 2007 is practically equal to that for IRPEF 2006.

Conclusions

As shown in the above paragraphs, numerous changes affected the structure of personal income tax which, according to the ISAE simulations, slightly reduced the average tax rate and increased the degree of redistribution and the progressivity of the system. The main advantages accrue to low-middle income taxpayers and to households with dependents, whereas high income taxpayers suffer a loss. The significant increase in family allowances, with regard to both the amount and the number of recipients, brings an additional advantage for large households and significantly lessens the “step” structure which characterized the previous system, nearing a linear decline of family allowances with the rise in income with the aim of avoiding “poverty trap” mechanisms. As for social security contributions, the increase in contribution rates mainly penalizes self-employed workers, more than offsetting the considerable fiscal rebates obtained from the new regime.

Some technical aspects of the new IRPEF reduce the advantages deriving from the changes in tax rates, tax brackets and deductions: “family planning” was abolished; deductible expenses (and the main dwelling) are now included in the equation for calculating tax creditstax credits, thus slightly reducing their amount; tax exemption for “other incomes” (non-work income) up to 3.000 euros was cancelled; finally, the elimination of household deductions from the tax base has an impact on the local surtax proceeds, since the tax base is significantly higher (mainly for households with dependents).

Some doubts can be raised with regard to some aspects of the new tax regime. Actually, the main tax reductions derive from a complex and often poorly understandable system. In particular, the new regime of tax credits for the dependent spouse and the micro tax breaks do not seem consistent with the logic underlying new tax credits, which provide declining discounts with the rise in income, differently to what occurred in some cases with deductions in the previous system. Such measures seem mainly oriented toward increasing the benefits for some particular categories of taxpayers.

In addition, with regard to State family support, current monetary instruments should be integrated by major improvements in the network of services for households and by new regulations for better reconciling work and family/personal time (even though the Budget Law for 2007 includes the allocation of some funds for these purposes). Furthermore, in the current system all households cannot benefit from monetary disbursements: family allowances are granted only to employees (or assimilated ones), while tax credits cannot be enjoyed by people with no taxable income.

Likewise, taxation seems an inadequate instrument for supporting the very poor, since it does not affect people with incomes below a given threshold where no tax is due (unless one devises a negative tax). Also in this case, the best solution may be the adoption of a system which is not based on categories of taxpayers but uses means-testing, with more rigid selection and control mechanisms, similar to the systems used in most European countries, in order to provide a safety net for all citizens for avoiding poverty.

The above text was written by Carlo Declich, Floriana D'Elia and Rita Di Biase.