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THE TAXATION OF THE OWNER-OCCUPIED HOUSE IN ITALY: 1974-2014

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The Taxation of Owner-Occupied House in Italy: 1974-2014

Abstract

The taxation of the owner-occupied house – the **"**principal dwelling**"**– was a recurrent central issue in the political and economic debate in Italy especially in the last 15 years. It may be useful, therefore, to address this issue, by both examining the theoretical aspects and reviewing the Italian legislation since the general tax reform of the seventies – whose starting point for direct taxation was the year 1974 – with respect to the two tax bases that can be used in the taxation of owner-occupied dwellings, namely the imputed income and the asset value. This paper first analyzes the tax treatment of principal dwellings in Italy on both equity and efficiency grounds over the past forty years and compares it with the solutions adopted in other countries; second an empirical assessment of the evolution of the total tax burden on owner-occupied houses in Italy is proposed.

JEL Classification: H21, H24, H71

Keywords: Housing taxation, Imputed rent, Irpef, Ici, Imu

1. Introduction

The taxation of the owner-occupied house – the **"**principal dwelling**"**[1] – was a recurrent central issue in the political and economic debate in Italy especially in the last 15 years.

The issue is long-standing and has always been very "hot" – in Italy as well as in other countries, like, for instance, in the US and in the UK[2] – because of the importance of the good subject to taxation and of the large number of potential taxpayers.

It may be useful, therefore, to address this issue, by both examining the theoretical aspects and reviewing the Italian legislation since the general tax reform of the seventies – whose starting point for direct taxation was the year 1974 – with respect to the two tax bases that can be used in the taxation of owner-occupied dwellings, namely the imputed income and the asset value.

A widespread opinion in Italy is that the overall tax burden on housing has increased in the last few years. However, the tax treatments differ according to the use of houses, and have changed over time, implying different effects on the tax burden as well as on the equity and efficiency of taxation.

The object of this paper is twofold. On the one side, the paper is direct to analyze the tax treatment of principal dwellings in Italy on both equity and efficiency grounds over the past forty years and to compare it with the solutions adopted in other countries. On the other side, the paper intends to present an empirical assessment of the evolution of the total tax burden on owner-occupied houses in Italy.

The empirical analysis is characterized by two main elements. The first is the rather broad time span (ranging from 1977 to 2012), which is characterized by important changes in the taxation of principal dwellings: on the one side, the inclusion, at first, of the imputed income in the tax base of the personal income tax (IRPEF), and then its exclusion; on the other side, the introduction of the taxation of the house value within local property taxes (ICI, IMU and finally TASI, which were subsequently applied). The second is the construction of a synthetic indicator (the virtual incidence on total personal income) able to measure the burden of taxation on residential property under both mentioned tax structures.

The paper is organized as follows: a sketch of theoretical issues is prexemptd in Section 2, while the taxation of the owner-occupied dwellings in Italy is analysed (and compared with that of other countries) in Section 3. The results of the empirical investigation on the incidence of the residential housing taxation in Italy are provided in Section 4. Section 5 collects some conclusions.

2. Theoretical issues

2.1. Characteristics of housing

The house is a durable consumer good: it provides a flow of in-kind services to the owner who directly uses it, or a cash flow (rent) if it is let. At the same time the house is an asset (and then a reserve of purchasing power) from which additional benefits are derived, like economic security, the broadening of economic opportunities (as, for instance, it can be used as collateral for contractual obligations, such as mortgages), social status.

[1]The "principal dwelling" is defined by the Italian law (see the Decree 201/2011) as the building that is (or can be) registered in the urban cadastre as a single real estate unit in which the owner and her/his family dwell habitually and are registered as residents.

[2] See, e.g., Rosen (1983) and Mirrlees et al (2011).

The total value of the services provided by the home (from which its value derives) depends on the specific characteristics of each housing unit (size, internal structure, quality of finishes, exposure, ..), on its environment (urban, historical, socio-economic position, ..) and on the availability of (public and private) services and infrastructures.

2.2. Justifications for the taxation of housing

There is a broad consensus in the international economic literature that the house ownership should be taxed, and that taxation should be a function of the income it produces (or could produce) and/or of its asset value. See, for example, Goode (1960), Aaron (1970), Rosen (1985), Poterba (1992), Vickrey (1993), Mirrlees et al (2011), and, as regards Italian scholars, Einaudi (1916), Visco (1980), Muraro (1982).

The inclusion of the income of housing in the personal income tax (PIT) base is justified on both equity and efficiency grounds.

The horizontal and vertical equity principles of taxation and the progressive structure of the PIT require that the tax base includes all income items (according to any income concept).

The equity reason is grounded on the income concepts. The income of a home – whether obtained in cash or in the form of direct services (whose market value is the "imputed" income) – is the fruit of a form of capital and then is part of the income as defined by Smith[3] and is included in the Shanz-Haig-Simons definition of income, as it increases the individual spending power (and thus the individual well-being).[4] According to both definitions of income, the taxable amount is the actual income of the dwelling, net of production costs.

The efficiency criterion, on the other hand, requires a uniform treatment of both the sources of income (financial assets, real estates and other assets) and the forms it can take (in kind or money), in order to avoid the distortion of individual decisions on the use of saving (financial or physical capital) and of residential real estate (direct use or lease).

Even the taxation of the asset value of the homes can be justified in terms of both equity and efficiency.

Two main equity reasons can be mentioned. First, individual well-being also depends on the benefits that arise from real estate even if they are not reflected in the property income: their contribution to the ability to pay would be neglected if the value of property were not taxed. Second, the empirical data show that the concentration of residential real estate is generally higher than that of income [5] – from which the redistributive function of property taxation is derived. The Gini concentration coefficients of income, wealth and the housing stock for Italy in some recent years reported in Table 1 support this point.

Table 1
Gini coefficients for Italy

	2008	**2010**	**2012**
Family Income (1)	0,353	0,351	0,356
Family Wealth (2)	0,607	0,623	0,640
Value of dwellings (3)	0,48	0,50	n.a.

(1) Source: Banca d'Italia (2014)
(2) Source: Banca d'Italia (2013)
(3) Source: Agenzia delle Entrate (2012)

[3] Cfr Smith (1776), book 2, chapter 2.
[4] Cfr. Simon (1938), pp. 49-50.
[5] As far as Italy is concerned, this point goes back to Benini (1932).

The main efficiency reason is based on the above mentioned factors affecting the value of housing. Some public services – largely provided by local authorities, such as public transport networks and waste collection; lighting, road maintenance and cleaning, road circulation; child-care facilities and schools; green areas; cultural services and entertainment supply – produce benefits enjoyed by house owners – either as direct users of housing, or, in the case of rented dwellings, through the highest rent that tenants (who are the direct beneficiaries of such services) are willing to pay. These services therefore affect the income and then the market value of homes. The benefit principle of taxation – which requires the coincidence of taxpayers and beneficiaries of public expenditure – claims for the role of property taxes for the financing of local authorities (see Musgrave, 1959).[6]

In conclusion, while equity underlies a tax on real estate as well as a more general wealth tax, efficiency calls for a tax on the market value of property as a means of financing local public bodies.

2.3. *Justifications for a preferential tax treatment of owner-occupied housing*

Despite the above mentioned reasons for the taxation of all houses – regardless of their use – arguments have been put forward for the preferential tax treatment of dwellings used as the owner's principal residence (see Aaron, 1970; Rosen, 1985; Baldini, 2008; Bono and Busetta, 2009; Pellegrino, Piacenza and Turati, 2012).

The equity reasons mainly rest on data showing that the value of the home stands for a high proportion of individual wealth for a large part of taxpayers – this argument, however, holds only if that share is greater for the poor – and that a relatively large fraction of homeowners is reprexemptd by low income elderly and young people. [7]

The more favourable tax treatment of owner-occupied housing would then reduce the concentration indexes for income and wealth.

A different motivation can be found in the "specific egalitarianism" (see Tobin, 1970), which, however, may justify fiscal support to housing residence only in the case of less well-off owners.

On the other hand, if the share of home-owners increases with income – as is the case of Italy (see Banca d'Italia, 2014) – the preferential tax treatment of owner-occupied houses enhances vertical inequity (see Vickrey, 1993).

In conclusion, the above mentioned equity reasons do not represent general justifications for a more favourable tax treatment of the owner–occupied housing: they appear to be limited to the lower income groups, and their validity is conditional on empirical data.

It is, however, questionable whether the preferential tax treatment is the most effective tool to reduce inequalities in income and wealth.

The justifications on efficiency grounds would be given by a variety of social benefits: greater interest for social problems from home-owners with respect to tenants, best school results achieved by their children (see Haurin *et al.*, 2003; Dietz and Haurin, 2003), lower participation to criminal activities. However, a question can be raised as to whether these effects are due to home-ownership, or to the higher income associated with it (see Aaron, 1970).

There would also be positive external effects on neighbours as higher expenditure for maintenance and improvements would be made by the owners who inhabit their dwellings

[6] According to this principle the tax should be a function of the benefits of public services and public infrastructure, and therefore it should not be applied to the entire asset value, but only to the capitalization of the higher income that can be obtained from the property as a result of those services.

[7] Including residents in homes enjoyed in a free use by a family member. (See Bono and Busetta, 2009)

compared to those who rent them. This effect, however, would not justify a general tax rebate for home-owners, but only tax allowances for those specific expenses.

On the other hand, the preferential tax treatment of the dwelling directly used by the owner distorts the individual decisions concerning the use of saving (between real and financial assets, thus affecting the composition of wealth), the use of real estate (direct use or lease of the dwelling while renting another house as residence) and the tenure status of residence (property, possibly with a mortgage, or lease).

An additional efficiency reason contrary to preferential tax treatments is the reduced mobility of home ownership, which can also have negative effects on the mobility of the labour supply.[8]

On efficiency grounds, therefore, the factors contrary to the preferential tax treatment of owner-occupied housing appear to prevail.

An example of the inequitable and distorting effects of such a tax treatment are shown in Table 2. The standard tax structure currently in force in Italy is assumed: a 21% (schedular) tax rate on rental income[9], a 26% (schedular) tax rate on interest income, the exclusion of the imputed income of the owner-occupied house from the personal income tax base, no personal income tax deductions for rents paid by tenants.

Four taxpayers are hypothesized, all enjoying € 20,000 net-of-tax labour income (or pension) and a capital (except the fourth taxpayer) of € 300,000, which produces an yearly income of € 10,000 – as monetary income or benefits in kind (imputed income). They made different choices and then they experience different situations:

• Individual A: home owner who lives in it;
• Individual B: home owner who let it and lives in a rented accommodation (receiving and paying the same rent);
• Individual C: owner of financial assets living in a rented accommodation;
• individual D: dweller in a rented accommodation.

Table 2
Hypothetical situations: a comparison

	(1) Net-of-tax Labour Income	(2) House (market value)	(3) Financial Assets	(4) Gross Capital Income (money or imputed)	(5) Tax on Capital Income	(6) Net Disposable Income + Yearly Value of Housing Services
A	€ 20.000	€ 300.000	0	€ 10.000	0	€ 30.000
B*	€ 20.000	€ 300.000	0	€ 10.000	€ 2.100	€ 27.900
C*	€ 20.000	0	€ 300.000	€ 10.000	€ 2.600	€ 27.400
D*	€ 20.000	0	0	0	0	€ 20.000

* Individual living in a rented accomodation

[8] Cfr. European Central Bank (2003).
[9] However, since 2013 a reduced rate of 15% (furtherly lowered to 10% for years 2014-2017) is applied in case of dwellings located in areas characterized by large excess demand over supply of housing for rent.

The distorting effects on individual decisions of the exclusion of the imputed income of the owner-occupied house from taxation clearly arise from the comparison of the following economically equivalent situations:
I) Same earned income + same capital, but different use of capital (Individuals A and B);
II) Same earned income + same capital value, but different composition of capital (Individuals A and C).

The situations envisaged in Table 2 can also be compared in terms of tax fairness. A problem of horizontal equity arises as regards the treatment of individuals A and B and of individuals A and C, who, despite their identical situations in terms of capital and income, are taxed differently. However, a vertical equity problem arises from the treatment of individuals A and D: they pay the same tax amount, despite only the former owns a capital and enjoys its benefits.

2.4. *The taxation of the owner-occupied dwelling*

As regards the annual taxes, the owner-occupied dwelling can be hit by the personal income tax and/or by a tax on the asset value of the house.[10]

According to the above theoretical framework, the PIT provision for the taxation of the owner-occupied house should be: the imputed income (i.e. the hypothetical market rent) is included in the tax base and the costs of producing that income (expenditures for maintenance and improvements; interest payments on mortgage loans for the purchase of the house) are deductible.

For what the tax on the asset value is concerned, the tax base should be given by the market value of the houses; tax rebates can be hypothesized for the sake of fairness in relation to the level of total income and to family composition (age, employment status, special needs or personal circumstances), in the form of deductions, tax credits or rate reductions.

Clear conclusions are therefore derived from economic theory:

1. Inclusion of the imputed income of dwellings in the tax base of the PIT and/or inclusion of the value of houses in the tax base of a wealth tax or of a tax on only real estate;
2. Deductibility of the costs of producing that income from the PIT tax base;
3. Possible tax rebates of the tax on the value of real estate, for the sake of vertical equity.

However, difficulties in determining the imputed income should be recognized.[11]Tax policy choices made in Italy and in other countries are only partially consistent with the above conclusions. The personal income tax rules generally admit the deductibility of both maintenance costs and interest on mortgage loans, and also provide incentives – in various ways and size, up to the total exclusion from the tax base – for the imputed income. On the other hand, the capital value of the dwelling is generally included in the tax base of the property tax – with the exception of Italy between 2008 and 2011 and again in 2013 – while only in a few cases tax rebates are granted to promote equity.

[10] The taxes on transfers of real estate (including the gift tax and the inheritance tax) are not dealt with here.

[11] A drastic (but minority) argument claims that the imputed income of housing should be excluded from the income tax base because of the difficulties in determining its true value (cfr. Bourassa and Grigsby, 2000).

3. The taxation of the principal residence

3.1. *The legislation in Italy: 1974-2014*

3.1.1. *Type of taxes and sub-periodization*

The owner-occupied houses in Italy have been hit by different types of taxes during the 1974-2014 period:

a) the PIT: IRPEF (a progressive tax on personal incomes, formally comprehensive, but with several exceptions, like interest incomes);

b) a schedular income tax: ILOR (a proportional tax on capital and business incomes, formally local but with all parameters fixed by the central government);

c) property taxes: ICI, IMU and TASI (local taxes on the value of real estate, with basic parameters fixed by the central government and some autonomy for municipalities in modifying rates and introducing deductions or tax credits, e.g. for low-income households).

The mentioned forty-year time span can be divided into three periods, depending on the type of non-personal taxes that are applied: ILOR, ICI, IMU, TASI.

In the first period (1974-1992) – 19 years long – the principal residence was hit by both IRPEF and ILOR.

The second period (1993-2011) – again 19 years long – was characterized by the presence of IRPEF (even if deeply changed over time) and by the introduction of the ICI (in place of the ILOR for real estate). This period, however, should be divided into three sub-periods (1993-2000, 2001-2007 and 2008-2011) according to relevant structural changes in the two taxes.

The third period (2012-2014) is only three years long, but substantial changes in local taxation make each year a sub-period. The very limited role of IRPEF and the substitution of ICI with IMU and later with TASI are the main characteristics.

3.1.2. *The first period: 1974-1992*

This period is characterized by a certain stability in the tax structure of both IRPEF and ILOR.

The tax base for both taxes is given by the cadastral rent of housing units – calculated at 1939 prices – which was revalued by applying updating coefficients (specific to each category of buildings). No deductions for maintenance costs are allowed, while interest payments on mortgage loans for the home purchase are deductible from the personal income tax base (with a maximum of 3 million lire, brought to 4 million in 1980).[12] The ILOR tax bill can be deducted from the PIT tax base. New buildings are exempted from ILOR for the first 25 years.

Despite the substantial stability of the basic structure of the two taxes, several changes in the parameters took place during the period. The updating coefficients of the cadastral incomes were increased six times – mainly because of the intense inflationary process – with an yearly revaluation of 39% on the average, affecting both tax bases.

The PIT rates were changed seven times (by reducing the number and increasing the size of the income brackets) and the ILOR tax rate two times: from the initial 14.7% to 15% (in 1977) and to 16.2% (in 1982). A 8% surtax on ILOR was introduced only for the year 1985. [13]

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[12] Since the conversion rate of the Italian lira with the euro was fixed in 1998 at 1.936,27 lire for € 1, the mentioned figures are nominally equivalent to about € 1.550 and € 2.066, respectively, but their real value was significantly higher.

[13] The period was also characterized by two experimental taxes: the SOCOF (a municipal surtax on buildings) in 1983 – which was applied to the same tax base as ILOR, but managed by the municipalities, which had the right to introduce the surtax as well as to choose the rate (among 8%, 12%, 16% and 20%) – and the ISI (a special tax on real estate) in

3.1.3. *The second period: 1993-2011*

The period 1993-2011 is mainly characterized by the introduction of ICI, a municipal tax on the cadastral *value* of real estate, replacing ILOR – a state tax on the cadastral *income* – but in fact maintaining the same tax base, as the cadastral value is determined by just applying a fixed coefficient (100) to cadastral rents. However, other relevant changes modified the PIT structure: the introduction of deductions which substantially reduced the taxable income of the principal residence and of deductions for the costs of house restructuring and maintenance. Regional and Municipal surtaxes to PIT were also introduced.

The above mentioned changes substantially reduced the level of taxation on owner-occupied houses (even bringing it to zero), while the PIT deductibility of the cost of production of the house imputed income (costs for maintenance and improvements and mortgage interest payments) were not repealed, giving rise to an unjustified benefit.

Some parameters of the two taxes have also been modified during the period: the application of the new cadastral values resulting from the review carried out in 1992, two revaluations of the fixed coefficients applied to cadastral rents (which implied an average annual increase of 1%) – which affected the tax base of both taxes –, two changes in the PIT rates, an increase in the standard tax credit for the principal residence which reduced the ICI tax bill.

This period should be divided into three sub-periods.

In the first sub-period, from 1993 to 2000 (8 years), the principal residence is subject to both PIT and ICI.

However, along with the introduction of ICI in 1993, the PIT tax bill on principal dwellings was greatly reduced thanks to a newly introduced deduction of one million lire (which was increased to 1.1 million in 1997, then to 1.4 million and finally to 1.8 million).[14]

At the same time, the deductibility of mortgage interest payments is replaced by a tax credit of 22% (later increased to 27%) of the interest amount (which would not exceed 7 million lire [15]).

In 1998 a 36% deduction for the costs of house restructuring and maintenance up to 150 million lire (equivalent to € 77,468) was introduced. In 2000 regional and municipal surtaxes, both at a rate of 0.5% were introduced.

It should be noted that the ICI tax base is given by the cadastral rent (at the new 1992 values) (increased by 5% since 1997) multiplied by 100. This implies that no independent assessment of the market value of properties is carried out, but this is approximated by the capitalization of the imputed income of dwellings (i.e. the cadastral rent) obtained by applying a 1% discount rate. As far as the tax base is concerned, therefore, switching from ILOR to ICI did not involve any substantial economic difference.

Municipalities may choose their ICI rates between 0.4% and 0.7%. For the sake of vertical equity a tax credit of 180,000 lire (increased to 200,000 in 1997) was allowed.

Sub-period 2 – ranging for 7 years, from 2001 to 2007 – is characterized by the exclusion of cadastral income of the principal residences from the PIT base, while maintaining both tax credits for the mortgage interest payments – however reduced to 19% (calculated over a maximum unchanged at 7 million lire, equivalent to € 3,615) – and for the costs of house restructuring and maintenance (which was indeed raised to 41 % in 2006, even if the maximum amount on which the tax credit is calculated is lowered to € 48,000).

1992 – that was applied to the cadastral value of real estate with a standard rate of 0.3% and a reduced rate of 0.2% (in addition to a deduction of 50 million lire) for the principal residence.

[14] Nominally corresponding to about € 516, € 568, € 723 and € 930, respectively.

[15] Nominally equivalent to about € 3.615.

This treatment is not economically logical, since the (even partial) deductibility of the costs of producing income finds its justification in the taxability of income.

The ICI structure remains unchanged, except for a change from 100 to 110 in the coefficient of capitalization of land rents in 2005.

In sub-period 3 – concerning years 2008 to 2011 (4 years) – not only the imputed income of owner-occupied house is excluded from PIT and the other benefits – i.e. the tax credits for mortgage interest payments (whose maximum amount allowed for calculating the tax credit is even raised to € 4,000) and for the costs for renovation and maintenance – are maintained but the imputed value of the principal residence is excluded even from the local property tax ICI.

During this period, therefore, the homeowners who directly use their dwellings enjoy the above mentioned fiscal benefits on the costs of producing the imputed income of the house without such income being taxed either directly (through the PIT) or indirectly (through the ICI taxation of its capitalized value).

3.1.4. *The third period: 2012-2014*

The third period consists of the three most recent and current years (2012-2014). While the above mentioned PIT preferential treatment of owner-occupied homes remains unchanged, significant (and contradictory) changes have occurred in the structure of property taxation.

The new municipal tax IMU – introduced in 2012 to replace ICI – provides for the taxation of the imputed value of all real estate, including the principal residence, thus innovating on the abolished ICI. [16] However, this provision was reversed in 2013. The exclusion from IMU of the owner-occupied house was confirmed for 2014, but a new tax to finance local Indivisible Services (TASI) was introduced and applied also to the principal residence.

Sub-period 1 (year 2012): the tax base of the IMU is the capitalization of the cadastral rent (revalued by 5%) obtained by applying a higher coefficient (160 instead of 110). The basic tax rate is 0.4%, with the option for municipalities to increase or decrease it up to 0.2%. For the sake of vertical equity a fixed allowance of € 200 and a deduction of € 50 for each dependent child (with a maximum of 4 children) are provided.

In the second sub-period (year 2013) the value of the principal residence is excluded from IMU, going back to the same situation of the period 2008-2011.

For sub-period 3 (year 2014) the exclusion of the principal residence from IMU is balanced by the introduction of TASI, whose tax base is the same as IMU. The basic rate of TASI is fixed at 0.1%, but municipalities may decide to bring it to zero or to increase it up to 0.33% (and to 1.06% in 2015). Municipalities may introduce tax rebates for the sake of vertical equity.

3.2. *The taxation of owner-occupied dwellings in other countries*

A brief review of the tax treatment of the owner-occupied house and of the relevant expenses in some OECD countries reveals a widespread lowering of the PIT burden over the last 50 years, while no such trend concerns property taxation on the value of real estate.[17]

The imputed income of the owner-occupied house is still included in the tax base of the PIT in the Netherlands, and the interest payments on loans for the purchase of the home receive a preferential treatment, resulting in an overall economically sound tax treatment.

Several other European countries have decided, through the years, to exclude the imputed income of the owner's residence from the tax base of the PIT. However, differences can be found in the treatment of mortgage interest payments. The UK (that changed the tax regime of the owner-

[16] For a critical analysis of IMU see Bises and Scialà (2012).
[17] Cfr. OECD (2006) and (2010).

occupied house in 2000), Denmark and Germany (which changed the taxation of housing since 2001) have provided the economically correct treatment of interests on mortgages, not recognizing them any tax relief. In other countries the decision to exclude the imputed income of the principal residence from the tax base of PIT was not matched by the abolition of the preferential treatment of the interest on mortgage loans. This is the case of UK (between 1963 and 2000), France (since 1964), Ireland (since 1970), Italy (since 2001) and Belgium (since 2003), and is also the tax treatment that has always been in force in the US.

On the other hand, it should be noted that in all the above mentioned countries the value of the principal dwelling is taxed under the property tax (usually aimed at financing the local authorities) – with the exception of Italy during the period 2008-2011 and in 2013.

Therefore, while the exclusion of the imputed income of the principal dwelling from the tax base of the PIT – which was carried out in Italy since 2001 – is open to criticism on both efficiency and equity grounds but is a widespread tax treatment in OECD countries, Italy was the only country to exclude the value of the owner-occupied house from local property taxation.

4. The tax burden on the owner-occupied dwelling in Italy: An empirical assessment

The review of the taxation of owner-occupied houses in Italy provided in the above sections shows that, despite the different (mix of) taxes applied between 1974 and 2014, the starting point for determining the tax base was always the cadastral rent updated applying specific coefficients according to the cadastral class to which each residential building is assigned and – in the case of taxation of the house value – a general capitalization coefficient set by the Ministry of Finance.

In this section, we provide an assessment of the impact of the overall taxation of owner-occupied residential real estate on total personal income.

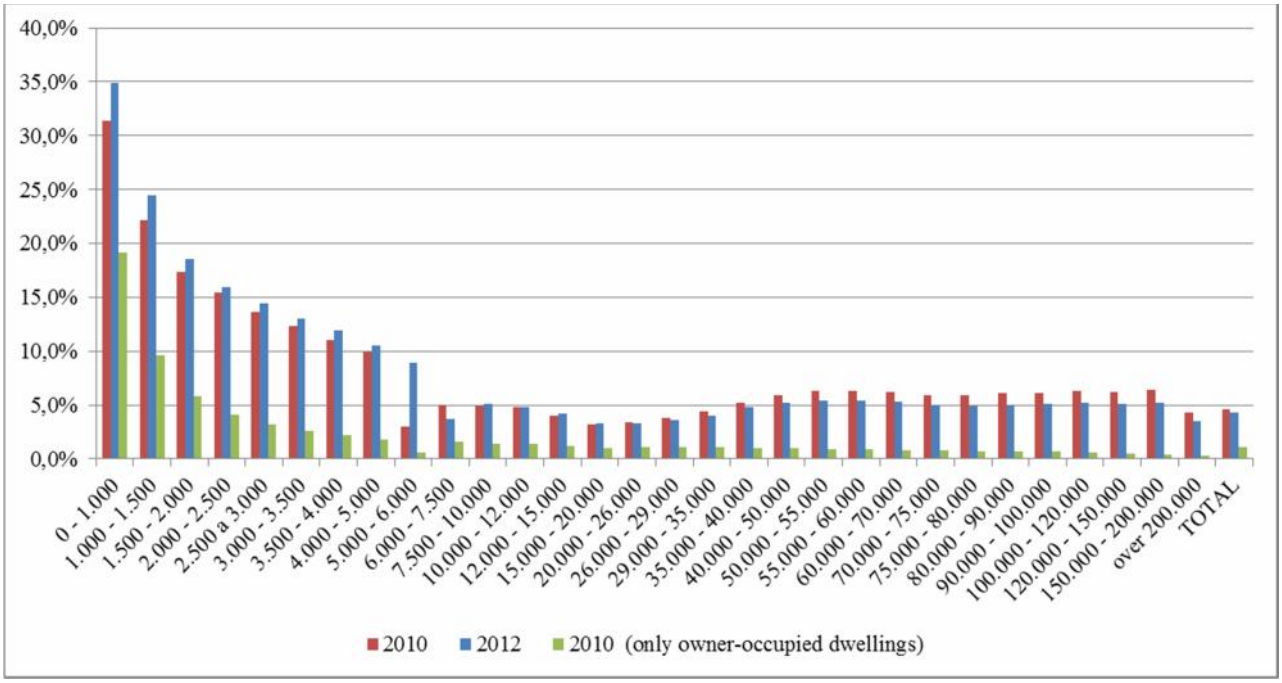
4.1. *Income from real estate and total personal income*

The share of income from real estate on total personal income is calculated for years 2010 and 2012 from reported incomes (Figure 1). For taxpayers with a total personal income above the no-tax area (about € 8.000), the share of real estate income does not exceed 6,4% of total income **(**and it is slightly increasing over income classes between € 15.000 and € 200.000).

It should be noticed that the share of the cadastral income of owner-occupied dwellings is pretty low. For taxpayers with a total personal income between € 10.000 and € 29.000 the imputed income from owner-occupied house is just about one third of total real estate income. If the analysis is limited to employees belonging to the same range of income, the income from owner-occupied house turns to be about 50% of total real estate income; therefore the aggregate data seem to be largely affected by the income of non-employees taxpayers (including retired).

Two main reasons may contribute to explain these figures. Firstly, the reported income from owner-occupied dwellings is the (revalued) cadastral rent, which, typically, is much lower than the income that could be obtained in the market, while the reported income from other real estate includes the income that is get by renting dwellings at market prices. Secondly, the reported incomes may be lower than actual incomes because of tax evasion. However, Italian taxpayers seem to consider investment in real estate as an important use of saving. As it will be shown later, the tax system may have favored this preference.

Figure 1 - Share of Reported Real Estate Income on Total Reported Personal Income



Source: authors' elaborations on *Analisi delle dichiarazioni dei redditi delle persone fisiche*, Dipartimento delle Finanze, 2010-2012

4.2. *The total tax burden on owner-occupied dwellings*

A measure of the virtual incidence of the whole annual taxation (whether on income or on value) of the principal residence on the per capita personal income is proposed here, and calculated for the period 1977-2012.

As sufficiently long time series of cadastral rents are not available, the virtual incidence is calculated with respect to three hypothetical dwellings, which are assumed:

1. to have been used for the entire period as the owner's principal residence;
2. to belong to the cadastral class A/3; [18]
3. to have been registered at the Land Registry (Cadastre) with a cadastral rent equal to 1.936,27 lire (equivalent to € 1), 2.904,405 lire (equivalent to € 1,5), and 3.872,54 lire (equivalent to € 2), respectively (at 1939 prices).[19]

The three houses are therefore supposed to differ only as regards their size or the quality of interior fittings, while the other characteristics are the same (location, overall qualitative features of the building to which they belong, etc.).

For each year the updating coefficients set by the Ministry of Finance are applied. It is assumed that with the revision introduced in 1992, cadastral rents have been substantially aligned with the actual rent updated with the coefficient set in 1991.[20]

[18] The cadastral classes for residential real estate are as follows: A/1 Luxury dwellings; A/2 Good level dwellings; A/3 Economic dwellings; A/4 Modest dwellings; A/5 Very poor housing; A/6 Rural type houses; A/7 Independent houses with a minimum of green or courtyard shared or private; A/8 Villas; A/9 Castles or buildings of eminent historical or artistic value. Most houses are however classified as A/2, A/3 or A/4. Cadastral class A/3 is the most frequent one, with 36,1% of residential houses belonging to it (Agenzia delle Entrate, 2013).

[19] The cadastral rents set in 1939 were still in force in 1976 (and until 1991) as basic rents (to be updated).

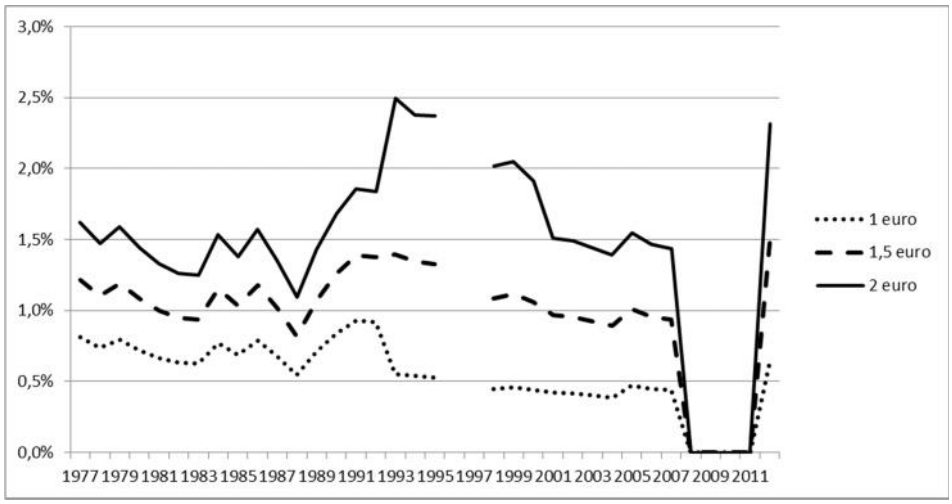
[20] In 1991 the update coefficient for a dwelling belonging to class A/3 was 388. It is assumed here that the new cadastral rents in force since 1992 correspond to the previous ones updated with a coefficient of 400.

The virtual tax incidence of the owner-occupied dwelling on per capita personal income is calculated through the following steps:[21]

1. computation of the IRPEF (+ILOR, until 1992) average effective tax rates from 1977 to 2012, defined as the ratio between total IRPEF+ILOR revenues and IRPEF tax base;
2. computation of the theoretical total tax bill on the owner-occupied dwelling, defined as the average effective tax rate IRPEF+ILOR (from step 1) times the updated cadastral rent (taking into account possible tax reliefs for principal residence);[22]
3. computation of the theoretical ICI (1993-2007) and IMU (2012) tax bill on the owner-occupied dwelling, defined as the standard tax rate (0,4%)[23] times the ICI-IMU theoretical tax base (taking into account possible tax reliefs for principal residence);[24]
4. computation of the overall tax bill on the owner-occupied dwelling, as the sum of the IRPEF, ILOR and ICI-IMU tax bills (from steps 2 and 3);[25]
5. computation of the overall tax burden of the owner-occupied dwelling, as the ratio between the overall tax bill on owner-occupied dwelling (step 4) and per capita personal income.

Figure 2

Owner-occupied dwellings: tax burden (% of per capita income)



Source: authors' elaborations.

[21] Data sources are reported in the Appendix.

[22] Neither the tax relief for mortgage loans nor the tax relief for maintenance costs are considered in this computation. It should be noted that these tax reliefs may affect the IRPEF tax revenue, and then the IRPEF effective tax rates computed in step 1.

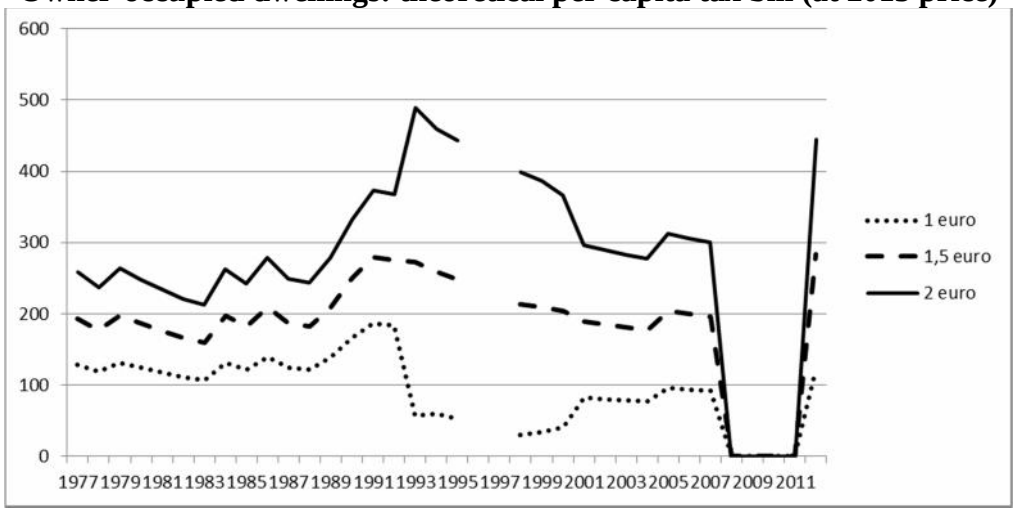
[23] With reference to the first ten years of operation of ICI, Pellegrino (2007) shows that the 85% of Italian municipalities did not change the tax rate on the principal residence. This provides support to our assumption.

[24] With reference to ICI and IMU, the general tax reliefs set by the central government are included in the calculation, except for the tax relief for cohabitant children under 26 provided by the IMU law.

[25] Both IRPEF and ICI were applied to owner-occupied dwellings only between 1993 and 2000 and just for houses with cadastral rent exceeding the tax deduction (see Section 3.1.3).

Figure 3

Owner-occupied dwellings: theoretical per capita tax bill (at 2013 price)



Source: authors' elaborations.

Figures 2 and 3 show the trend of the virtual tax incidence on per capita personal income of owner-occupied dwellings and the trend of the theoretical per capita tax bill (at 2013 price), respectively, in the 1977-2012 period. Data for years 1996 and 1997 are not available.

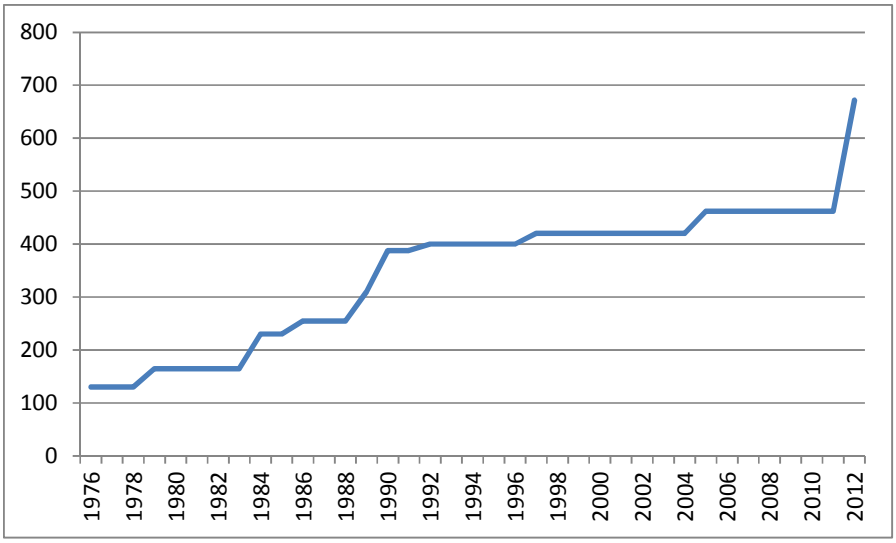
From 1977 to the end of the eighties, the virtual tax incidence on total personal income for dwellings starting from a cadastral rent of € 1 in 1976 ranged between 0.6% and 0.8%**,** eventually reaching 0.9% in the early '90s and then fell down remaining at less than 0.5% (except in 2012). For dwellings starting from a cadastral income of € 2 in 1976 the virtual tax incidence on total personal income reached 2.5% in 1993 and then went down, ranging between 2.1% and 1.4% (except in 2008-2011, when it was zero, and again in 2012, when it reached 2.4%).

The increase experienced in the virtual tax incidence up to the early '90s is mainly due to two factors: first, the steep increase of the updating coefficients of cadastral rents between 1988 and 1992 (Figure 4); second, the relevant increase of the IRPEF+ILOR average effective tax rate (from 22,8% in 1990 to 27,4% in 1992; cfr. Figure 5).

While the first factor is essentially exogenous, the second one could be affected by the changes in IRPEF and ILOR tax bases, which in turn are related to the updating of the revaluation coefficients, implying potential endogeneity.

Figure 4

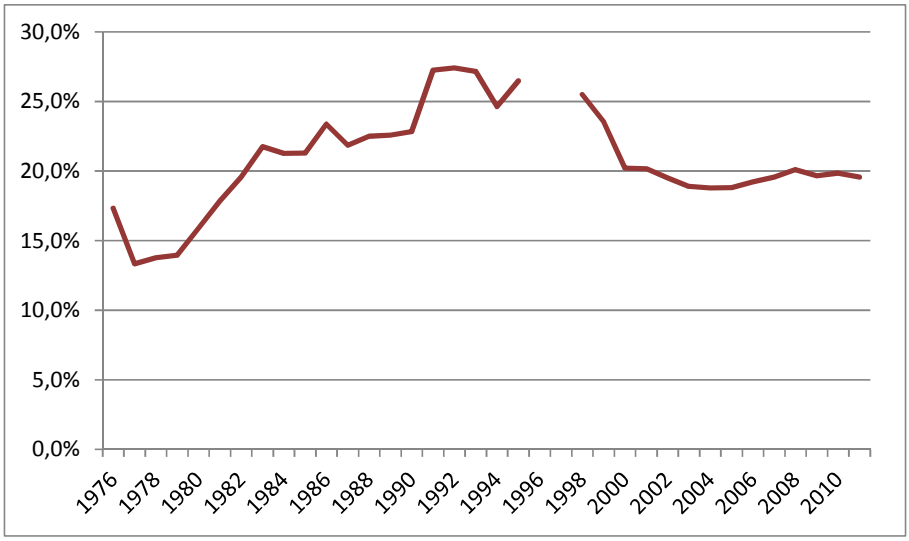
Update coefficients of cadastral rents (for class A/3)



Source: authors' elaborations.

Figure 5

Overall (IRPEF + ILOR) average effective tax rates



Source: authors' elaborations.

Following the introduction of the ICI in 1993, the tax burden on owner-occupied dwelling starts to decrease, reaching zero from 2008 to 2011.

It should be noted that, starting from 1993, the introduction of a tax deduction equal to 1 million lire (and higher in the following years[26]) for the owner-occupied dwelling brings to zero the average IRPEF theoretical tax bill.

In summary, under the mentioned assumptions, the shift of the taxation of principal residences from the scope of the PIT to the scope of local taxes (ICI-IMU) implied a significant reduction in the virtual tax incidence on total per-capita personal income.

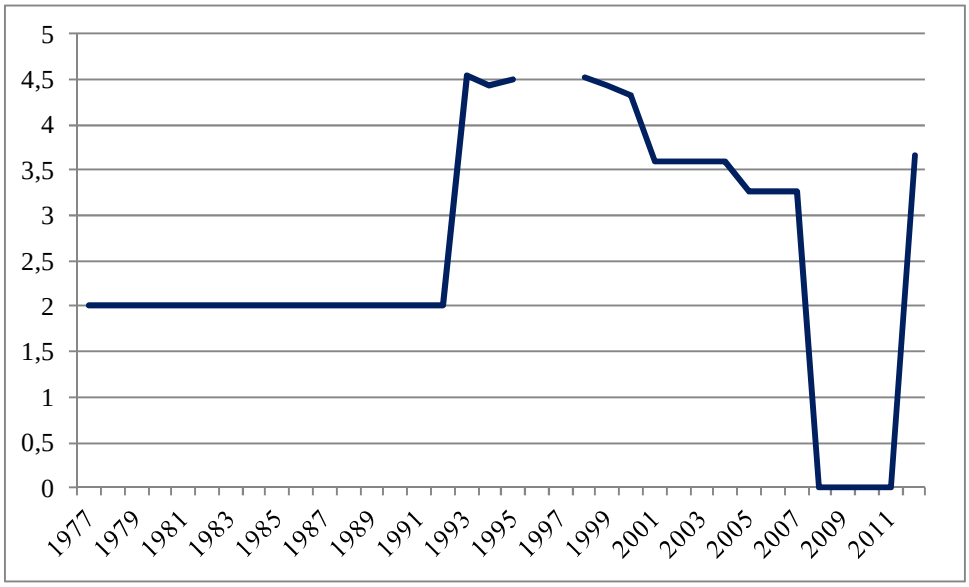
[26] See Section 3.1.3.

4.3. *Tax incidence for different cadastral rents*

Some hint about the redistributive effects of the replacement of IRPEF with ICI as the main (and eventually only) tax on residential houses, can be derived looking at the virtual incidence of taxation on owner-occupied dwellings with cadastral rent of € 2 with respect to that on dwellings with cadastral rent of € 1 (from Figure 2) shown in Figure 6.

Figure 6

Incidence of taxation on owner-occupied dwellings with cadastral rent of € 2 with respect to that on dwellings with a cadastral rent of € 1



Source: authors' elaborations.

When principal residences were taxed with IRPEF, for taxpayers facing the same IRPEF average effective tax rate the differences in the theoretical tax incidence of dwelling taxation was related only to differences in the cadastral rents. Under ICI taxation owners of dwellings with higher cadastral rents had to bear a higher incidence of taxation. In the first years after the introduction of ICI the difference in tax incidence between dwellings with rents of € 2 and € 1, respectively, in the provided exercise, more than doubled. The gradual substitution of IRPEF with ICI implied a shift from a redistribution between taxpayers with different incomes[27] to a redistribution between taxpayers living in dwellings with different cadastral rents.

5. Concluding remarks

This paper is focused on the issue of the taxation of the owner-occupied dwellings in Italy. Both the changes in the tax structure and some empirical results of the taxation of real estate between 1974 and 2014 were considered.

The various taxes that were applied to owner-occupied dwellings during the mentioned period cannot be considered as truly income or wealth taxes, since the tax base has been constantly related to imputed incomes based on cadastral rents rather than on market prices.

[27] Cfr Figari *et al.* (2012).

The tax structure has not undergone significant changes from 1974 to 1992. The same cannot be said if it is looked at the trend of the tax burden of owner-occupied dwellings on total income. In particular, up to the end of eighties the tax burden has fluctuated around a stable average, while it increased from the end of eighties and in the early nineties. This is mainly due to relevant increases in the coefficient of revaluation of cadastral rents and to a relevant increase of the PIT (IRPEF) average effective tax rate.

Starting from 1993 a reform in real estate taxation has been introduced. The main characteristics of this reform are the introduction of a municipal tax on real estate (ICI), the abolition of the schedular tax on capital incomes (ILOR) and the progressive exemption of owner-occupied dwellings from the PIT (IRPEF) tax base (without a reduction in tax reliefs for production expenses). These resulted in a progressive reduction of the tax burden of owner-occupied houses on total income, which reached zero from 2008 to 2011. In the latter years the theoretical tax burden came out to be negative, given the maintenance of the personal income tax reliefs for mortgage interests and for the costs of renovation and maintenance of housing.

It should be noted that the reforms in the taxation of real estate have been mainly related to the need to increase the fiscal autonomy of municipalities. From this point of view, the mentioned changes appear to be consistent with both the tax theory and tax reforms that took place in many OECD countries.

However, the mentioned reforms have not been without costs. In terms of efficiency, they have increased the rate of return of investments in owner-occupied dwellings. In terms of equity, they have aligned the tax bill on owner-occupied houses irrespectively of their different market values.

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Appendix Table 1

Year	Updating coefficients	IRPEF + ILOR Average effective tax rates	Owner-occupied dwelling deduction from IRPEF (euro)	ICI/IMU Tax rates on owner-occupied dwelling	ICI/IMU tax credit for owner-occupied dwelling (euro)	Declared per capita total income (euro)	Declared per capita income (euro - 2013 prices)	Theoretical tax burden on declared per capita income of owner-occupied dwelling
1976	130	17,3%				1603,38	14106,53	1,40%
1977	130	13,3%				2141,31	15950,62	0,81%
1978	130	13,8%				2428,28	16087,37	0,74%
1979	165	14,0%				2901,54	16608,44	0,79%
1980	165	15,9%				3630,89	17155,95	0,72%
1981	165	17,9%				4439,05	17667,43	0,66%
1982	165	19,6%				5112,69	17490,52	0,63%
1983	165	21,7%				5747,74	17099,52	0,62%
1984	230	21,3%				6376,17	17158,28	0,77%
1985	230	21,3%				7097,02	17586,42	0,69%
1986	255	23,4%				7581,58	17702,98	0,79%
1987	255	21,8%				8241,35	18394,68	0,68%
1988	255	22,5%				10481,27	22293,67	0,55%
1989	310	22,6%				9783,69	19518,46	0,72%
1990	388	22,8%				10540,31	19815,79	0,84%
1991	388	27,2%				11391,26	20128,36	0,93%
1992	400	27,4%				11926,31	19988,49	0,92%
1993	400	27,2%	516,46	0,4%	92,96	12183,68	19603,54	0,55%
1994	400	24,6%	516,46	0,4%	92,96	12483,12	19323,87	0,54%
1995	400	26,5%	516,46	0,4%	92,96	12733,95	18706,17	0,53%
1996	400		516,46		92,96			
1997	420		568,10		103,29			
1998	420	25,5%	723,04	0,4%	103,29	14446,22	19719,09	0,45%
1999	420	23,5%	929,62	0,4%	103,29	14023,67	18847,82	0,46%
2000	420	20,2%	Complete	0,4%	103,29	14603,84	19145,63	0,44%
2001	420	20,2%	Complete	0,4%	103,29	15393,82	19642,51	0,42%
2002	420	19,5%	Complete	0,4%	103,29	15609,80	19449,81	0,41%
2003	420	18,9%	Complete	0,4%	103,29	16142,82	19629,66	0,40%
2004	420	18,8%	Complete	0,4%	103,29	16710,26	19918,64	0,39%
2005	462	18,8%	Complete	0,4%	103,29	17220,39	20182,30	0,47%
2006	462	19,2%	Complete	0,4%	103,29	18191,33	20920,03	0,45%
2007	462	19,6%	Complete	0,4%	103,29	18535,71	20945,35	0,44%
2008	462	20,1%	Complete	exempt	exempt	18721,03	20499,53	0,00%
2009	462	19,7%	Complete	exempt	exempt	19007,67	20661,34	0,00%
2010	462	19,8%	Complete	exempt	exempt	19207,14	20551,64	0,00%
2011	462	19,6%	Complete	exempt	exempt	19502,84	20321,96	0,00%
2012	672		Complete	0,4%	200	19030,00	19239,33	0,29%