

The Italian experience also provides some interesting lessons for the taxation of cross-border capital flows. The application of tax on accruals at source within individual accounts – particularly mutual funds – is not currently compatible with existing double tax treaty practices which tend to distinguish between dividends and interest on the one hand and capital gains on the other. In other words, the 12.5% tax on accruals is not considered by the tax authorities of the country of residence of foreign investors in Italian mutual funds as a withholding tax on a source of income which can give rise to double taxation relief<sup>32</sup>.

## **6 Final considerations and proposals for future improvements**

The Italian tax reforms have been very short-lived and it is difficult to draw many conclusions regarding the working of capital markets and the behaviour of investors. The introduction of accruals based taxes was accompanied by a number of developments that contributed to very significant adjustments in portfolios. Unfortunately even event studies do not appear to be provide much information because the “equaliser” never actually came into effect. The conclusions one can draw from this experience must consequently be of a different type.

The Italian Tax Reform of 1998 is illustrative of the difficulties that any attempt to implement a close variant of the Haig-Simons concept of “comprehensive” income taxation has to face. The solution found by the Italian authorities was an elaborate equilibrium between several peculiar features of the tax system:

- a) a “dual income tax” regime where income from capital and capital gains are taxed at proportional rates;
- b) very low tax rates on income from capital and capital gains;
- c) taxation upon accrual for managed accounts and retrospective capital gains taxation on individual accounts;
- d) compliance costs borne largely by financial intermediaries.

At first sight, all these elements seem essential for the coherence of the overall construction and may limit the appeal of the “Italian model” of taxing capital income for other countries.

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<sup>32</sup> Relief is typically available for withholding taxes on dividends and interests. This has led the Italian

Most of the drawbacks commonly imputed to accrual based taxation (such as liquidity problems that could force some taxpayer to dispose the asset in order to pay the tax) appear to have been of secondary order importance in the Italian context due to the low level of tax rates. These issues will arise more forcefully in a tax system where capital income is taxed at high and progressive tax rates. Furthermore, in such a framework it would be quite hard to defend limitations on the deductibility of capital losses from other sources of income. This in turn would raise doubts on the effective yield of the tax.

At the same time the Italian experience suggests that tax revenues (and especially tax credits) under an accrual regime can be very volatile and can give rise to serious problems particularly if accrual taxation is applied to the income of collective investment vehicles.

Retrospective capital gain taxation is the requisite complement to the accrual based taxation implemented on managed accounts. The demise of the “equaliser” is a warning signal that should be taken seriously: there exists a gap between the methods and concepts used by economists in analysing issues like the “lock-in” effect and the methods and concepts that can be used in the political and legal arena for upholding ex-post adjustments of realised income. Even the more sophisticated adjustments such as those put forward by Auerbach are not immune from political pressures and “ex-post” equity considerations. When accrual and retrospective capital gains taxation are both implemented, as in the Italian case, an individual that had invested in a asset yielding below-normal return and taxed according the to Auerbach method could legitimately complain of being discriminated with respect to investors taxed on an accrual basis. As the ruling of the Italian tax tribunal regarding the constitutionality of the “equaliser” suggests, it is difficult to argue in the political arena that net-returns would have been the same as under the accrual system if portfolio allocations had been changed as would be dictated by rational behaviour.

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authorities to introduce a complex system of refunding of tax for foreign investors.