

# Mistakes, Misconceptions and Misunderstandings About the Italian Windfall Tax

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## The Wind Doesn't Fall – it Drops

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The very recent proposal ([COM\(2022\)473 final](#)) tabled by the EU Commission on a possible Windfall Tax to be applied on companies which benefited from the price dynamics of the fossil fuels is drawing the attention of academics and stakeholders on the states that have already played this card, in the attempt to collect resources for the state budget in a moment of distress and for the people in need.

Prominent Economists argued that wars are outstanding redistributive events: because of the conflict and the consequent disruption, wealth is redistributed outside the ordinary accumulation patterns (T. Piketty, *La Capital au XXIe siècle*, 2013, § 8). The same could be argued for pandemics (equivalent disruptive events), although in this case no definitive data support the conclusion.

The ongoing war in the east (such as the previous pandemic) seems to escape this pattern.

In both of them qualified businesses, and in particular multi-national enterprises (MNE), benefited enormously from the distress, increasing their profits remarkably. That was the case with pharmaceutical and internet service companies in the first situation and those operating in connection with the extracting, processing and trafficking of oil and gas in the second.

In ordinary times, corporation tax would automatically address the issue of redistribution, by hitting these companies' broader tax base. On the individual level, progressivity (as under article 53 of the Italian Constitution) would ensure a more profound redistribution of income.

This is not the case in moments of serious imbalances, where decisions are time sensitive and tax policy options have to be adopted swiftly, because of the immediate and ever-increasing need of resources to be spent. In such a scenario, ordinary income taxation would be insufficient or too late to achieve the goal.

In March 2022 the Commission raised for the first time the necessity to introduce a special tax to address the impressive profits made by oil and gas MNEs and the prices of oil and electricity that are spiraling out of control if left to the offer / demand mechanism. The proposal was immediately endorsed by the European Parliament in a resolution (May 2022) that urged the Commission to draft a Regulation introducing a Europe-wide windfall tax. The Commission delivered the proposal on September 14th.

## **The Italian Job**

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Just like with the Digital tax / Web tax before, some states decided to go alone and introduce a windfall tax without waiting for a comprehensive framework by the Union: Italy was one of them. The decision was taken as the Government was in need (and in a hurry) to raise money. This, in turn, was necessary to subsidize the third wave of crisis-relief incentives (in particular to minimize the price increase of electricity).

Attention turned to the companies which were benefiting more from the situation and thus were capable of granting such financial resources on the spot. A mere increase of the corporate tax rate would not have done, as the revenue flow would have arrived too late. Consequently, the strategy pursued by the Government was to consider the monthly adjusted VAT tax bases, whose periodic payment and assessment would grant revenue in a more timely manner.

On 21 March 2022 Italy introduced an “Extraordinary contribution to address electricity prices increases” (this is, literally translated, the name of the Italian Windfall Tax) that was amended later on 21 May. Not only oil and gas producers were called to pay (few of whose are resident in Italy) but also traders, resellers, intermediaries with the only exception of those managing trade platforms, clearing houses and ETS certificates. The tax rate was set at 10% at the beginning (soon increased to 25%) of the so-called extra profits.

The Italian strategy demonstrates a remarkable originality in the definition of extra-profits, as the new tax addresses the difference in the spread between active and passive operations (sales and purchases), net of value added tax (VAT) charged, as it emerges for the periodic reporting and payment for VAT purposes. The first differential is between the reporting in the period October 2020 – March 2021 and the same one year after, including April. In other words, if an oil company would earn more between October 2021 and April 2022 than what it earned from October 2020 to March 2021, then it would be liable to tax on that increase as the tax base assessed on, so to speak, a difference of differences.

The tax introduced would be a one-shot payment, a sort of extraordinary levy to be paid once. At the beginning it turned out to be a little more than a fiasco, though, as the revenue actually collected was unexpectedly low. This was due to an erroneous assumption by the legislator that the use of VAT (adjusted) as a reliable base would be a sufficient benchmark for the extra-profit: moreover, in the first release of the decree

introducing the tax (March 2022) the tax period was one month shorter, and the rate lower (10%). The advance payment due (and actually paid) was around 1 billion euro, while the Government had expected the overall revenue to be close to 10 billion instead.

It is interesting to observe that the European Commission is no less optimistic in this respect, as it allegedly expects the forthcoming EU windfall tax would generate no less than 140 billions euro of revenue, with little or no inflationary effect.

## **The European Vision**

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The European proposal (September 14th, to be adopted under Article 122, § 1 TFEU) for a more comprehensive Windfall Tax is getting traction, while a similar step was taken by the British Government earlier this summer. Apparently the Commission has made the most of the Italian experience, drafting an extraordinary tax to be charged on the same assumption: the need to address the disproportionate profits some companies are making while most people are suffering badly in this complex political and economical moment. A temporary tax as a consequence is supposed to tackle market distortion in the pursuit of the general interest, and in accordance with the principle of solidarity and social justice which is entrenched in many Constitutions.

Yet the European approach differs in many respects from the Italian one. As for the taxpayers, it considers oil and gas producers (including refiners) only: businesses involved in collateral services such as delivery and processing are therefore excluded. Secondly, it takes into account the adjusted income (not VAT) as a suitable tax base. Finally, it differs in terms of rate (33%), and it seems to introduce a sort of (adjusted) time-sensitive progressivity into corporate taxation.

The solution tabled at the European level is hence more selective and embraces only a (very) limited number of windfall profits beneficiaries (either resident in Europe or with an active branch here) with a possible asymmetric impact on the European market, due to the fact that oil and gas extractors and manufacturer are more active and present in some states than in others.

On the other hand, the Commission is also actively working on a price cap strategy, capable of taming the ever increasing costs of natural resources: alas, in this respect not all the countries seem to have the same understanding of the challenges posed to the Union, and are acting alone, as Italy has done for the Windfall tax earlier this year.

In such a scenario, two orders of questions might arise: whether such taxes are coherent and consistent with the Constitutional framework of the Country of the case, and whether a Windfall Tax would be the most appropriate tool to bring back fairness to the system. While the first answer is affirmative (but for one aspect), the second one might not be so straightforward.

## **The Constitutional Constraints**

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This is not the first case of an extraordinary Windfall Tax to be introduced in Italy. It happened once in the recent past, in 2008, with the so called “Robin Hood Tax”: a levy intended to “take from the rich and to give to the poor”, where rich were financial companies (essentially, banks) and oil and gas industries, which were benefiting from an unprecedented moment of growth. In the first case (namely, in case of banks) the tax was born out of sync, as the industry was about to be obliterated by the Global Financial Crisis that hit the USA in 2008 and reverberated in the old Continent two years after, eventually peaking in 2011. The tax was intended to be temporary when it was introduced (just like the Windfall Tax now) but then it was made permanent on request of the Government, only to be eventually struck down by the Constitutional Court (sentence n° 10, February 11th 2015).

Several aspects of the Windfall Tax might actually collide with the Constitutional principles, just like the Robin Hood Tax did in the past, yet the conclusion might not be the same. In 2015, the selectivity of the levy, its duration and its excessiveness (proportionality and reasonableness) were found problematic by the Constitutional Court under Articles 3 and 53 of the Italian Charter (economic solidarity, equality and ability to pay). The Court argued that selectivity is not per se an element incompatible with the Constitution, as long as the decision to target some business sectors and not others is “objectively justified, reasonable and proportional”. As for the excessiveness (the tax was actually an increase of the one routinely charged on corporations’ income) the Court observed that it was unsuitable to address the extra profits only as the base was incoherent with that assumption: eventually, no remedies were provided for the tax burden being shifted on to the consumers of the services and of the goods via an increase of prices. The duration of it was considered in the judgement too: the Court argued that a levy introduced in an extraordinary moment for extraordinary reasons could not be made permanent later. In other words, the application of it had to be necessarily limited in time.

The current scenario is different in many respects, as the Windfall Tax has not been made permanent (yet) by the Government, the extraordinary situation persists, the selectivity is coherent with the scope of the levy and the reference for its calculation is the exact period in which prices have increased.

Yet the Italian legislator built the taxable base in reference to VAT rather than to income. It could have avoided such spurious correlations with the Consumption tax as it did in 2008 (and how probably the Commission shall be doing), waiting for the annual tax return to unveil the extra profits. Yet it was done in a haste, and the adjusted VAT base was the only reliable benchmark although with a considerable approximation. The transaction recorded by VAT purposes might nor mirror the extra profits, influenced as they are by many other factors (including extraordinary operations within the VAT scope, an increase in quantity of the transactions that would lead to an increase in profits without necessarily implying an increase of prices, etc ...). This is where the risk of unconstitutionality is lying: the Achilles’ heel that the legislator probably has deliberately accepted as a price to pay to have money readily available via taxation.

## When the Profit is Excessive (and how to Measure it)

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If we were to paraphrase Karl Marx, we would say that every profit is intrinsically excessive. As such, it should be expropriated, not taxed. This is not obviously the case, nor is it the philosophy inspiring the Italian and European interventions in the matter.

Excessiveness can be actually measured in many ways, but it is always time sensitive, and path dependent. As the Global financial crisis in 2008 has clearly demonstrated, excessive profits by banks in the first decade of the century were by far offset with the immense losses coming after, and the Governments were urged to grant subsidies and grants to the very same companies they overtaxed just some years before.

The conclusion in this respect is that any judgment of excessiveness depends on the timespan considered. Both the Italian and the European legislator seem to have forgotten this aspect. In contrast, they seem to have kept it in mind when they decided not to tax pharmaceutical companies which over-performed during the pandemics: no Windfall Tax was ever conceived to target companies developing vaccines and making (arguably) outstanding profits out of it.

As to path dependency, the legislator seems to confuse the VAT base with income. If profits are to be charged with a tax, the appropriate tax base should be taken into account. It's a matter of coherency rather than proportionality. As a proportional (reasonable) tax charged on a base which does not meet properly the benchmark of ability to pay should be considered unconstitutional anyway.

Alternatives to these misconceptions and misunderstandings are possible. Research has developed techniques, rules and regulation to identify and calculate the fair price (arm's length price) relevant for tax purposes in every transaction since the 1990s. The OECD has implemented these techniques in a way to shield the respective tax base (for income tax purposes) in each country from possible aggressive tax planning strategies by multinational enterprises. When a cross border transaction occurs between associated enterprises, costs and revenues originating from it may be disregarded for tax purposes if they are not coherent with market prices. If such a condition is met, a cost is not entirely tax deductible, and as a consequence the tax base (and the tax liability ) of the respective company would increase.

A possible alternative to the strategy enacted by the Italian legislator would have been to extend those principles, and adjust the actual value of the transactions to the prices intended to be fair by the state (for tax purposes only). Such a solution would have the advantage to strike a balance between the need for more tax revenue and have an implicit capping to the costs of the natural resources, at least for tax purposes. A complicated, but necessary step toward a more unified approach to the challenges we have to stand united against.

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