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journal homepage: [www.elsevier.com/locate/ejpoleco](http://www.elsevier.com/locate/ejpoleco)Who do you blame in local finance? An analysis of municipal financing in Italy<sup>☆</sup>Massimo Bordignon<sup>a,\*</sup>, Veronica Grembi<sup>b,d</sup>, Santino Piazza<sup>c</sup><sup>a</sup> Catholic University of Milan, Department of Economics and Finance; CESIFO, Munich, Italy<sup>b</sup> Catholic University of Milan; CEIS Tor Vergata; VSE, Prague, Italy<sup>c</sup> I.R.E.S. Piemonte - Socioeconomic Research Institute of Piedmont, Italy<sup>d</sup> Mediterranean University of Reggio Calabria, Italy

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## ABSTRACT

We study the effect of introducing a less transparent tax tool for the financing of local governments. A political agency model suggests that politicians with stronger re-electoral incentives would raise more tax revenues and use more the less transparent tax tool to enhance their probability of re-election. This prediction is tested by studying a reform that in 1999 allowed Italian municipalities to partially substitute a more accountable source of tax revenue (the property tax) with a less transparent one (a surcharge on the personal income tax of residents). Exploiting the existence of a term limit for mayors, we use a Difference in Difference approach, to estimate how mayors facing re-electoral concerns reacted to the introduction of the less transparent tax tool compared to mayors facing term limit. We find results in line with theory. We also show that the reduction in the property tax is larger in smaller municipalities and in municipalities with lower level of social capital. The normative implications are then discussed.

## 1. Introduction

Traditional claims in favor of fiscal decentralization support better representation of local preferences and better accountability of local politicians (Lockwood, 2006). Yet, skepticism remains. An interesting and well-founded objection is that decentralization is not akin to separation; in a unitary State, even when decisions on important public services are delegated to local governments, financing often largely remains in the hands of the central government (see Ambrosanio and Bordignon, 2006; Boadway, 2006). According to critics, this implies that decentralization may weaken, rather than strengthen, political accountability, leading to less efficient equilibria (e.g., Devarajan et al., 2007). Intuitively, if citizens are uncertain about whom to blame for the taxes they have to pay, they will be less able to punish or reward the right politicians for their behavior. In turn, this will lead to more leniency in the provision of public services. Accordingly, it is financing and the transparency of local taxes that are key ingredients of a successful decentralization process.

Given its policy relevance, it would be clearly important to assess the validity of this claim. Doing this in general terms may be

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difficult, but one can learn from specific real world examples. This is what we do in this paper, by focusing on an important local finance reform in the Italian context. In 1999 Italian municipalities were offered an additional source of tax revenue, allowing them to levy a surcharge on their residents' personal income tax (PIT) base, which is the most important national tax. This surcharge was to accompany the traditional source of tax revenue for cities (since 1993), that is, a property tax (ICI) raised on the municipality housing wealth, with slightly different rules for the house of residence of taxpayers (where selective deductions could also be offered) and commercial buildings (where only the tax rate could be varied). However, there was an important difference between the two tax tools. While decisions concerning the property tax could clearly and unambiguously be attributed to the municipal government, this was not the case for the PIT surcharge. Central government maintained its full powers on PIT, including the definition of tax rates, tax base and tax brackets – all features that are usually marginally altered on a yearly basis by the central government. Municipal governments could only raise a flat surcharge on their PIT base, by 0.2% yearly up to a total of 0.5% in three years. In contrast, the average central government tax rate on the PIT base was about 20% in our sample in the same period (1995–2005). As a result, citizens might have had problems in disentangling the part of the total PIT due to municipal decisions.<sup>1</sup> On the contrary, the property tax rate was independently paid directly by each house owner to the municipality where the estate was located. This task required each taxpayer to get informed about the property tax rate and the tax allowance, which are usually set up and changed on a yearly basis by municipal governments.

Based on this, it is plausible to assume that the municipal surcharge on the PIT national base was for most citizens less “transparent” than the municipal property tax, in the sense of allowing for a less precise attribution of responsibility to the different levels of government (e.g. [Bordignon and Minelli, 2001](#))<sup>2</sup>. This would suggest that the political incentives for using the two different taxes may also have been different<sup>3</sup>. In the next section, with the aim to clarify these different incentives, we set up a simple agency model of politics ([Besley, 2007](#)). The model is written by having the Italian tax reform in mind, but its insights are clearly generalizable. Thus, in the model, municipal politicians (i.e. “Mayors” from now on) may be of two types; competent or incompetent. Incompetent Mayors can replicate the fiscal decisions of competent Mayors, but at a higher cost in terms of effort. The economy lasts two periods, an assumption that captures an important institutional feature of Italian municipal governments as Mayors are subject to a term limit (they can only run twice; see [Section 3](#)). Lacking electoral incentives, incompetent Mayors would then raise more taxes and exert less effort than competent ones. However, in their first term in power, incompetent Mayors may nevertheless prefer to imitate the efficient ones, in the hope that this will result in a re-election, because citizens cannot directly observe the type of Mayor, but only try to infer it by observing his tax choices. Using this simple model, we then study political equilibria in the two cases, when Mayors can only use the property tax and when they can use both the property tax and the tax surcharge on PIT. Importantly, in the latter case we assume that citizens are unable to discern precisely which part is played by each level of government in setting up the total PIT tax rate. We show that pooling equilibria are more likely to occur after the reform than before it. In equilibrium, incompetent Mayors make a larger use of the surcharge rate on PIT, which can only be imperfectly observed by citizens, as this offers them a less costly way to imitate the competent local governments.

Several empirical implications derive from these theoretical observations. In order to test some of them, we compare the tax behaviour of Mayors at their first term with the tax behaviour of Mayors at their second term. Intuitively, the former Mayors can be reelected and therefore have stronger electoral incentives than the latter. Specifically, the model suggests that eligible Mayors should increase local tax revenues more, and use the less transparent tax tool more, than non eligible Mayors. Moreover, provided that municipal and national income taxes are strategic complements (as suggested by the bulk of the empirical literature on vertical tax externality, e.g. [Besley and Rosen, 1998](#); [Esteller-Moré and Solé-Ollé, 2002](#); [Brühlhart and Jametti, 2006](#)), eligible Mayors should also reduce property taxation more than non eligible Mayors. We test these predictions on a unique dataset of 7,583 Italian municipalities in the period 1995–2005. We use a Difference-in-Difference approach to identify the effect of the PIT surcharge on the tax choices of Mayors, defining the treated Mayors as those who were up for re-election. To avoid unobservable differences between Mayors who were or were not re-elected, our baseline specification is tested on a sample of municipalities in which all Mayors completed two terms, so that the same individuals are compared across the two terms.

Our results show that after the introduction of the PIT surcharge, eligible Mayors, with respect to Mayors at their final term, increased total tax revenues by 8%, reduced the property tax rate on commercial buildings by almost one percentage point (1.4% at the mean of property tax), and increased deductions on the property tax on residence houses by 11%. Descriptive evidence also shows that eligible Mayors used the PIT surcharge by 10% more than non eligible Mayors. These results are robust to the inclusions of several controls and robustness tests, and they were not driven by anticipatory effects. Furthermore, a number of tests corroborates our accountability story. In particular, it turns out that the reduction in the property tax is larger in localities where one would have

<sup>1</sup> It is true that the municipal surcharge rate is indicated in the PIT tax form of each tax payer. But, as a matter of fact, most Italians never actually come to see their tax bill. For employees, the PIT, including the municipal surcharge tax, is directly withheld by the company they work for on a monthly base; and most self-employers also use tax professionals to fill properly their tax forms.

<sup>2</sup> Proving that the PIT surcharge was less visible to taxpayers is obviously difficult, but one can at least invoke some anecdotal evidence. For instance, an online research on the Italian national newspaper with the largest number of local editions (*La Stampa*) in the period 1999–2006, returned 5,736 hits for the term *ICI* (Local Property Tax), 2,743 for the term *IRPEF* (national PIT) and only 658 for the term *addizionale comunale sul reddito* (PIT surcharge) (details available from the authors on request), suggesting that press coverage for the latter was much more limited than for the other two. Similarly, according to a survey run by [Censis \(2011: p.11\)](#), in the ranking of the most hated taxes by Italians the Local Property Tax is in the third position, while the national PIT scores fifth. The PIT surcharge is not even mentioned in this ranking.

<sup>3</sup> Alternatively, one could argue that the property tax is “salient” for taxpayers ([Chetty et al., 2009](#)), while for some reasons, they do not pay the same attention to the income tax. Some predictions of our model would be the same in both cases, but the normative implications would be different. We come back to this in the conclusions, after having discussed our empirical results.

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