



# The effect of direct democracy on the level and structure of local taxes<sup>☆</sup>



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## ABSTRACT

We study the effect of direct democracy on local taxation. Our setting is the German federal state of Bavaria, where in 1995 a state-wide reform introduced the possibility to initiate direct democratic legislation into the local government code. Relying on a sample of all Bavarian municipalities over 1980–2011, we hypothesize that complementing a representative form of government with the initiative process leads to (i) higher local tax rates and (ii) a shift of the local tax mix from taxes with broader (property taxes) to taxes with narrower bases (business taxes). For identification, we rely on a difference-in-discontinuity design. Our results suggest that the ease with which local initiatives can be implemented – measured by signature and quorum requirements – increases local tax rates and shift the tax mix toward taxes with narrower bases.

## 1. Introduction

Since the 1970s, direct democratic institutions have been identified as potential determinants of budgetary outcomes (for a recent review, see Matsusaka, 2017). The underlying argument is that if voters have the right to bypass parliamentary representatives through direct legislation, the influence of the voter's position relative to that of the legislative agenda setter should grow. More formally, this hypothesis is formulated through standard spatial models which show that in equilibrium direct legislation leads to policies that more closely reflect the median voter's preferences, with the size of the effect conditional on, among others, the severity of representative agency problems (Gerber, 1996; Matsusaka and McCarty, 2001).

In the economics literature this reasoning has been so far empirically tested with respect to government size (i.e. public spending), with a wide consensus that, at least in the post World War II period, referendums constrain the size of government.<sup>1</sup> On the other hand, the effect of direct democracy on taxation in general and the tax structure in particular, has been largely neglected. The few studies on the level of taxation (using sub-national data from Switzerland and US) hint to the same fiscally conservative direction (for a survey see Matsusaka, 2004).

While regarding the structure of taxes, we are aware only of one exception. Matsusaka (2004) – in an ambitious attempt to understand whether voter initiated legislation in US states benefits the many or the few – shows that initiatives lead to higher user charges and lower share of (more broad-based) taxes in state revenues.<sup>2</sup> One important implication of this research is that direct democracy does not lead to special interest subversion.<sup>3</sup>

In this paper we exploit an institutional reform in the German state of Bavaria in 1995 of adopting direct democratic legislation at the local level to test whether the right of initiatives has had an effect on *a*) the level of municipal taxation (i.e. local tax rates), and *b*) on the choice between different municipal tax instruments (i.e. local tax-mix). By exploring these questions, we contribute to the literature in three important ways.

First, our institutional setup allows us designing clearer tests which may contribute to a better understanding of the question whether the initiative has brought about (tax) policies favored by special interests or by the majority. In particular, the tax setting autonomy of German municipalities is primarily limited to two tax instruments: property taxes on real estates and trade tax on businesses. Although the economic incidence of local taxes is not only on the remitter (Fuest

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<sup>1</sup> Some of the most prominent studies are Matsusaka (1995), Feld and Matsusaka (2003), Matsusaka (2004), Funk and Gathmann (2011), Hinnerich and Pettersson-Lidbom (2014), Funk and Gathmann (2013). One exception is Matsusaka (2000) with evidence from the first half of the twentieth century.

<sup>2</sup> Recently, Feld and Schaltegger (2012) have arrived at similar results for Swiss cantons.

<sup>3</sup> For a discussion on the impact of interest group politics in a direct democratic setting, see Gerber (1999).

et al., 2016), the perceived tax burden is strongly asymmetric: the property taxes have a very wide coverage (as these are paid either by property owners, or, in case of rented property, are directly passed over to the tenants via operating cost) while the business tax imposes a visible burden only on a very small group of the electorate (as the lion's share of the business tax revenue is generated from a small number of firms).<sup>4</sup> It is, thus, probable that unlike the property taxes, legislative decisions regarding the trade tax will be constrained by non-majoritarian special interests. Bischoff and Krabel (forthcoming) and Boehm et al. (2015), for example, present evidence that large firms use their lobby power to secure lower business tax rates in German municipalities.

The implementation of direct democracy substantially widens the scope of voters for effective opposition against special interests. Citizens now command over an additional sanction beyond the threat of punishment in the next (possibly distant) election. In contrast to the right of choosing the legislator once for a full legislative term, this sanction can be used frequently over the whole term. Instead of voting on a candidate's or party's policy package announced for the coming legislative period voters can decide on single policy issues continuously.<sup>5</sup>

Now, any strengthening of the median voter's power due to the availability of direct legislation should have consequences for local tax rates. Voters can make use of the additional channel of influence to push tax policies towards their preferred structure. Importantly in the institutional context of Germany, such influence is not necessarily conditional on the existence of comprehensive initiative power covering tax laws directly. Even though the local government code rules out initiatives that are directly related to budget variables such as tax rates or user fees ("fiscal-taboo"), direct legislation could be used to enforce the preferred tax policy.

First, initiatives can have substantial budgetary consequences despite the fiscal taboo. A large number of initiatives in Bavaria are about preventing costly projects that are favored by the local political establishment and/or special interests. In particular, projects where tax payers anticipate that they will result in property tax hikes may elicit widespread opposition, causing them to block their implementation through the initiative process. On the other hand, Bavarian citizens also extensively use initiatives to force their representatives to implement projects that require substantial local government spending. Similarly, voter initiatives may have direct consequences on local government revenues, for examples when they aim to prevent municipalities from selling or leasing municipal properties. Second, direct democracy may also affect local tax policy through non-budgetary channels. For example, Le Bihan (2016) shows theoretically how the availability of the initiative process over some policy issues may lead elected representatives to adopt policies that are in line with the median voter's preferences in areas not subject to direct legislation. The basic argument is that the availability of the initiative process decreases the relative benefits of adopting non-congruent policies in general, and thus also in areas that are not directly subject to direct legislation.

Consistent with existing theoretical arguments, this implies a clear

hypothesis: direct democracy, with its reduced political influence of minority interest groups, will shift the level of local taxes away from the preferences of the representatives and towards the preferences of the median voter. Depending on the configuration of preferences, this may entail either higher or lower spending in municipalities with more permissive direct democratic institutions. Second, direct democracy will shift the tax mix away from property taxes (and the median voter) towards business taxes (and thus the taxation of minorities).<sup>6</sup>

Our second contribution is methodological. While the results of the few studies on the role of direct democracy in shaping tax policies are suggestive, their analyses rely ultimately on regressions that are subject to selection on observables. Hence, it can be questioned whether they have identified a causal effect. In particular, the importance of direct democracy could be systematically related to tax pressure or be a consequence of an unobserved variable like citizen's fiscal preferences (Funk and Gathmann, 2013). Our study addresses this gap in the literature by developing a more credible identification strategy that relies on population thresholds for direct legislation as defined in the local government code.<sup>7</sup>

Our paper thus follows a recent strand of literature that exploits population thresholds to estimate fiscal effects of political institutions at the local level. The first paper in this literature that specifically focuses on the Bavarian context is Egger and Köthenbürger (2010). Their paper shows that council size has a positive effect on local spending using a regression discontinuity design. The authors exploit the fact that council size changes discontinuously and exogenously at population thresholds defined in the municipal code. This is an important result that sets the stage for our identification strategy below, as many of the population thresholds that determine council size are also important for the ease of initiating direct legislation. Consequently, we cannot rely on a standard regression discontinuity design to study direct legislation due to possible co-treatment with council size. Instead, we rely a combination of the 1995 reform (i.e., the introduction of direct democracy) together with the size dependent population thresholds on the number of signature and quorum requirements, which allows designing a quasi-experimental identification that is robust to co-treatment. Such an empirical design has previously been used by Asatryan et al. (2016). In this study, and consistent with our theoretical argument regarding local taxes, they find that the introduction of direct democracy led to higher local spending and revenues in Bavaria.<sup>8</sup>

Our results in the paper at hand suggest that there is a causal positive effect of the ease with which direct democratic legislation can be implemented – measured by signature and quorum requirements – on local business tax rates. We also obtain a positive estimate for the property tax, but it is insignificant and not robust across bandwidths. Overall, these results indicate that in the German institutional setting, and in contrast to evidence from countries such as Switzerland and the US, direct democracy generally may lead to more redistributive taxation.

<sup>4</sup> An additional benefit of our setting is that the institutions of direct democracy are in practice available only on the local level, thus we do not have to worry about the possibility of substitution effects with respect to state or federal programs. This is important, because earlier evidence from Switzerland and the US (e.g. Matsusaka, 2004; Feld et al., 2008; Galletta and Jametti, 2015) – where institutions of direct democracy exist both at the local and state levels – show that direct democracy leads to government decentralization.

<sup>5</sup> In contrast, a few studies exist which employ convincing identifications strategies to analyze the link between direct democracy and local expenditures (Hinnerich and Pettersson-Lidbom, 2014; Asatryan et al., 2016).

<sup>6</sup> Asatryan (2016) presents an extension of the results from Bavaria to all German municipalities as dependent variables covering both the expenditure and revenue sides of the budget as well as the deficits. With the broader sample, however, the paper relies on an instrumental variable design where the assumptions required for a causal identification arguably need to be stronger. Two further papers on German direct democracy but not directly related to public finances are Asatryan and Witte (2015) and Asatryan et al. (2015) which respectively study the effect of initiatives on local government efficiency and patterns of spatial spillovers among initiatives.

<sup>4</sup> See Section 2 for a detailed discussion on the incidence of these taxes.

<sup>5</sup> One possible concern is that wealthy interest groups will and do try to take advantage of the initiative process themselves, for example, by organizing and financing counter-campaigns or pushing for their own initiatives possibly in a more effective manner than the unorganized majority. However, even if this implies a less competitive signature collection procedure in favor of the initiatives proposed by interest groups, at the ballot only policies favored by the majority will be approved given that voters are sufficiently well informed. Such evidence is presented by Matsusaka (2004) who shows that there is no divergence between voter's preferences (measured by opinion data) and the changes brought about by the initiative. Gerber (1999) presents additional theory and evidence arguing that, contrary to popular opinion, economic interest groups are severely constrained in their ability to use direct legislation to the detriment of broader interests. Besley and Coate (2008) develop a different theoretical framework, where the right of the initiative corrects for the interest group bias in policy making through issue unbundling.

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