

# Political support and tax reforms in Italy

Paola Profeta  
Università Bocconi

ECFIN Taxation Workshop "Political economy of tax reforms"  
Brussels, 19 October 2015

# Outline

BOCCONI

- Introduction: Tax reforms and political constraints
- The political process shapes taxation
  - Some results on Europe
- Tax reforms as an attempt to attract votes
  - Case study on Italy
- Tax reforms as a response to political constraints
- The present
- Conclusions

# Tax reforms

Bocconi

- Debate on tax design and tax reforms
    - Complexity
    - Progressivity
    - Efficiency (top rates)
    - Tax mix
    - Optimality *versus* actual tax design and reform:  
Why there is often a gap between the efficiency and fairness prescriptions based on standard economic theory and actual tax systems?
- ➔ The debate is particularly strong in Italy

# Political constraints

- Political constraints
  - Tax reforms as an attempt to attract votes
  - Tax reforms as a response to political constraints
  - Overall political feasibility of tax reforms

# The political process shapes taxation

Bocconi

- It is important to understand which reforms can be implemented
- And how to reform
  - Gradualism or Big Bang?
    - How reforms are bundled and sequenced
    - To circumvent the status quo bias
  - Targeted or Broad?
    - Group-specific or general
  - Type of government
    - Number of parties in a coalition
  - Timing during the electoral cycle
    - Political business electoral cycles: first (before election) reforms which produce the more certain gains

Castanheira, M., Nicodème, G. and Profeta, P. (2012) “On the Political economics of tax reforms: survey and empirical assessment” *International Tax and Public Finance*.

# Reforms in Europe

LABREF database: 27 EU Member States, Years 2000-2007

**Bocconi**

Labor tax reforms: more visible and concern voters directly

Table (1): Reforms of labor income taxation in the European Union

Reforms	Total number	Of which, at least one reform is targeted
PIT, SSCe, SSCr	9	7
PIT, SSCe	5	5
PIT, SSCr	15	10
SSCe, SSCr	6	0
PIT only	57	31
SSCe only	3	3
SSCr only	22	15
<b>Total</b>	<b>117</b>	<b>77</b>

Source: LABREF and own calculations. PIT, SSCe and SSCr represent personal income tax, social security contribution of employees and social security contribution of employers, respectively.

# Regression technique

- Logit approach for all reforms and for targeted reforms:
  - We focus on the effect of political variables on the *probability* of reforms
  - We control for standard economic and socio-economic variables
  - We focus on personal income tax and social security contributions

# Results: All reforms Political variables

**BOCCONI**

Many political variables are significant



Political variables matter, not only economic ones

All Reforms	(1) Base regression
execoalition	0.450*** (0.136) [0.111]
herfgov	1.850** (0.875) [0.457]
herfopp	2.050** (0.959) [0.506]
maj	4.358* (2.542) [1.077]
left	-0.983** (0.466) [-0.241]
right	-1.239*** (0.450) [-0.300]
govspec	0.460 (0.507) [0.111]
parlyterm	-0.328 (0.563) [-0.081]
parliamentterm	-1.223*** (0.450) [-0.302]



# Results

## Targeted reforms

### Political variables

BOCCONI

Many political variables cease to be significant



Unlike general reforms that necessitate broad political support, targeted reforms might be political acts targeting specific constituencies.

Targeted Reforms	(1) Base regression
execoalition	0.414*** (0.128) [0.093]
herfgov	1.472 (0.918) [0.329]
herfopp	2.075** (0.897) [0.465]
maj	3.178 (2.217) [0.711]
left	0.302 (0.521) [0.068]
right	0.033 (0.501) [0.008]
govspec	0.457 (0.465) [0.106]
parlyterm	-0.370 (0.582) [-0.083]
parliamentterm	-0.772* (0.460) [-0.173]

# Tax reforms as an attempt to attract votes

BOCCONI

- Most reforms are targeted.
- Policymakers may have an incentive to introduce targeted reforms, even when broad reforms may be more efficient
- Why targeted reform?
- Theory: Probabilistic voting
  - The crucial voters to gain the elections are the “swing voters”, ideologically neutral, indifferent between the 2 main parties, easily captured with a policy in their favor.

# Probabilistic voting framework /1

• BOCCONI

- Consider different groups in population
  - Each group is characterized by:
    - its size (number of voters)
    - its “political mobility”, function of party offers
    - its “income elasticity”, function of implicit tax rates
- Efficient taxation
  - Tax rates inversely proportional to the group’s “income elasticity” (Ramsey rule)
- Assume that voters do not only look at policy proposals. They also consider other factors: a random term (charisma, political mood...)
  - The expected number of votes received by either party becomes a smooth function of the proposed tax rates.

# Probabilistic voting framework /2

Bocconi

- Assume each party maximizes vote share
  - The parties seek to please the more mobile voters. If the number of swing voters is the same in all groups it is a maximization of the average voter's utility, if groups are different in how easily their votes can be swayed, the group with more swing voters is more responsive to policy and gets a higher weight.
- To maximize vote share, party offers must be more generous to “politically mobile” groups (regions, age groups, ...)
  - Thus: in a political equilibrium, taxation is distortionary
  - Flip side: Reducing distortions can be politically costly

# Italy: Main features of taxation

	Italy	EU-28
Total receipts from taxes and social contributions (including imputed social contributions) after deduction of amounts assessed but unlikely to be collected	43,3	39,9
Total tax receipts	30,0	26,5
Taxes on products and taxes and duties on imports, excluding VAT	5,5	4,0
Value added type taxes (VAT) and other taxes on production	9,3	9,3
Taxes on individual or household income including holding gains	11,9	9,4
Taxes on the income or profits of corporations including holding gains	2,5	2,5
Other current taxes	0,5	1,0
Capital taxes	0,3	0,3
Net social contributions	13,3	13,5

Source: Eurostat, 2013

Taxes received by general government (central + local), expressed as % of GDP

# Italy: General features

*(past and present)*

• **BOCCONI**

- In Italy many voters are uncertain about next elections (“swing”), in particular among those who claim to be at the center of the political spectrum.
- The issue of taxation is able to capture many of these uncertain voters.
- To capture the vote of these uncertain voters is decisive to win next elections and the government knows that it can try to do it through the tax reform.

# Case study: The personal income tax reform in Italy (2006)

IRPEF BRACKETS AND TAX RATES: 2002 AND REFORMS							
Irpef 2002		First step		Second step		Initial proposal	
Brackets (euro)	tax rates	brackets	tax rates	brackets	tax rates	brackets	tax rates
0-10329	18%	0-15000	23%	0-26000	23%	0-100000	23%
10329-15494	24%	15000-29000	29%	26000-33500	33%	over 100000	33%
15494-30987	32%	29000-32600	31%	33500-100000	39%		
30987-69722	39%	32600-70000	39%	over 100000*	43%		
over 69722	45%	over 70000	45%				
*(at least for 2005)							

Profeta, P. (2007) "Political Support and tax reforms with an application to Italy" *Public Choice*.

# Effects of the reform

The reform:

- **BOCCONI** • reduces the total level of revenues (reduces taxes for all income groups)
- the first step is a gain for the lowest incomes (“no tax area”), while the second step redistributes in favor of the highest incomes (over 70000 euro). Smaller gains are provided to middle-income groups.

2 outcomes:

- Reduction of the level of taxes
- Targeting the poor and the rich



May political electoral reasons explain this strategy of reform?



# Taxes and swing voters /1

Survey evidence shows that

• **BOCCONI**

- Taxation is a crucial issue in the policy platform proposed by the government (ISPO polls)
  - attracted credibility to the government during the electoral campaign
  - 19.6% of people who voted for the winning coalition found taxation the most important issue, April 2004 (11.3% total sample)
  - The delay of the tax reform creates the disappointment of many voters.
  - It is a non ideological issue: 70% of the Italians think that taxes are too high and this criticism is almost uniformly distributed across the different political parties (ideologically neutral)



Taxation is a policy that can move swing voters.

## Taxes and swing voters /2

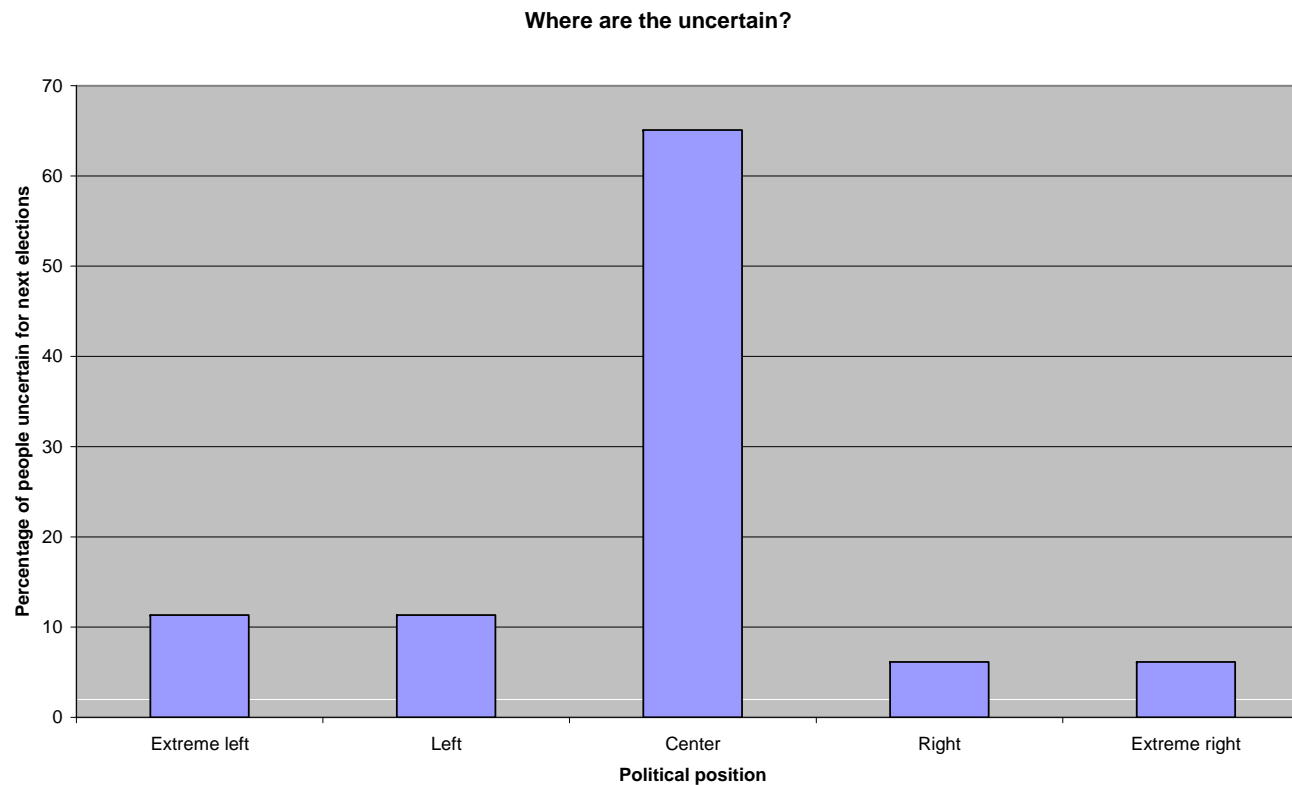
Bocconi

- An increasing number of voters claim to be uncertain about their vote at next elections
  - Taxation is responsible for much of this discontent: more than 40% of the government's electorate declares to be disappointed by the government decisions about taxes
  - 30% of the total population is uncertain about his vote at next elections

# Where are the swing voters? /1

- Uncertain voters are at the center of the political spectrum (67%)

Bocconi



Source: Author's calculations on Fondazione Rodolfo De Benedetti data (2004)

## Where are the swing voters? /2

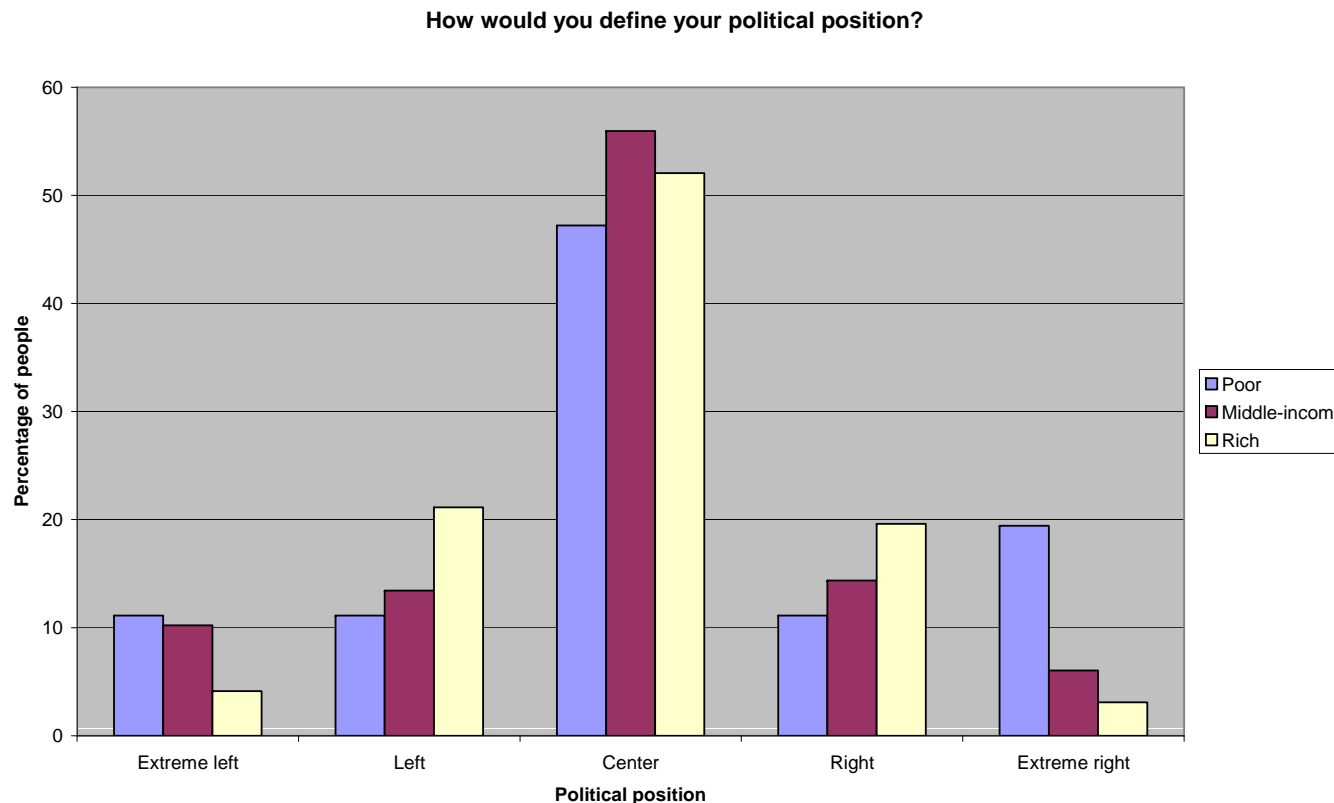
• **Bocconi**

- The more mobile voters are at the center: according to an ISPO poll, 38% of voters at the center declare to plan to change their vote at the previous election, only 19% at the two extremes
- More swing voters at the center of the political spectrum. Target these voters!

# Swing voters by income levels

- Rich individuals concentrate around the center (54.5%), less polarized at the extreme. However also middle-income!

Bocconi



Source: Author's calculations on Fondazione Rodolfo De Benedetti data (2004)

# Specific strategy of the reform

- Will a reform targeted on low and high income groups capture individuals at the center of the political spectrum, i.e. where there are more swing voters?
  - 19% of the poor uncertain about their vote at next election
  - 14% of the middle
  - Only 10% of the rich

# A simple empirical exercise

- Multilogit regression based on individual survey data
  - Which party would you vote if next Sunday there would be political elections?
    - Center-right, center-left, uncertain
  - Results: predicted probability of each outcome
    - Center-right: 0.4488
    - Center-left: 0.4037
    - Uncertain: 0.1474
- Attracting the uncertain is decisive to win the elections!

# The uncertain voters

Outcome 3: uncertain

Probability (Party=uncertain)=0.1473

Variable	dy/dx	Std.Err.	Significance
Rich	0.0337	0.0664	
Poor	0.1487	0.2451	
Center	0.1356	0.0564	*
Right	-0.0751	0.071	
Left	0.1316	0.1438	
Female	-0.0177	0.0479	
Elementary	-0.0106	0.1462	
University	-0.119	0.0399	**
Self-employed	0.0148	0.0609	
Union	-0.083	0.0483	*
Old	-0.155	0.028	***
Young	0.2	0.142	
North-East	0.1187	0.0834	
Center	-0.0559	0.0169	
South	0.0009	0.056	



# Results

• **Bocconi**

- The identity of the uncertain- swing voters does not seem to depend on their income
- The only crucial feature of uncertain voters is their identification with a central political position
- General cut of taxes is approved, but not a specific redistribution in favor of low and high income
- Better to target middle-income individuals, the “true” uncertain?

# Tax Reforms as a response to political constraints

•  
Bocconi

- Example: Italian property tax at local level
  - Salience
  - Paid lump sum on annual basis
- Bracco, Porcelli, Redoano (2015)
  - When political competition is tight and elected politicians can rely on more tax instruments, they will substitute salient taxes with less salient ones, which are not necessarily preferable.
  - If competition is low, since the incumbent does not face a real threat to lose elections, she decides the mix of taxes irrespective of their degree of salience

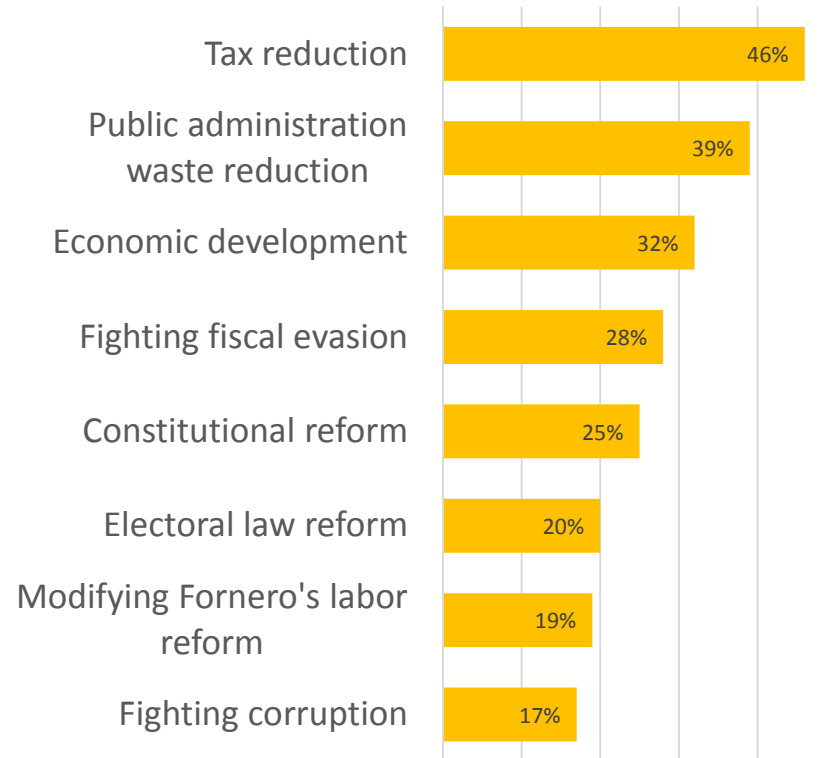
# Example: local property tax

BOCCONI

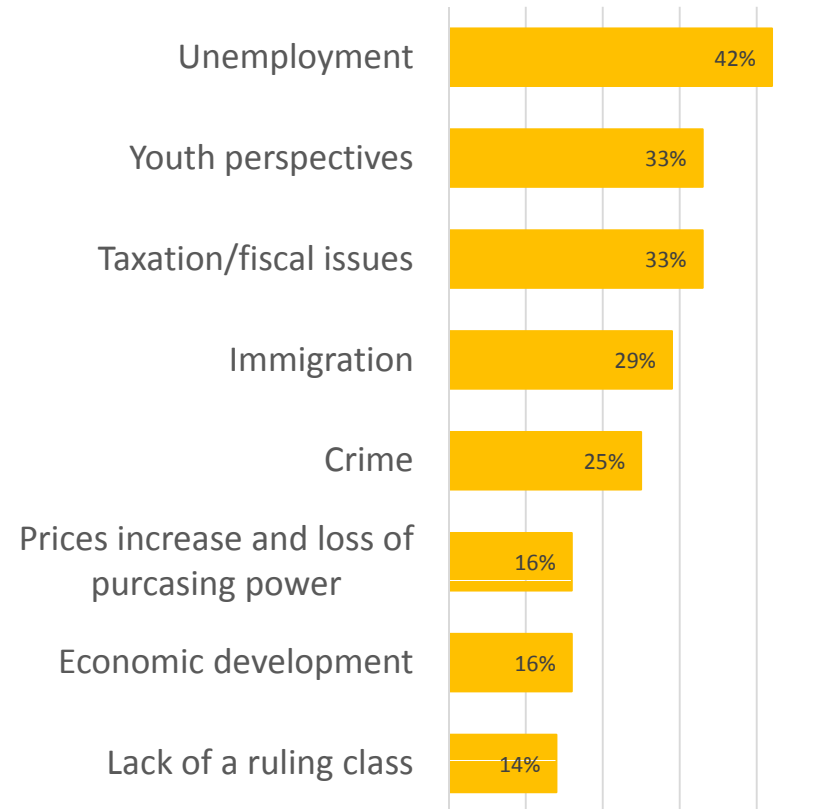
- In Italy property taxes are the more salient local taxes.
- ICI municipality tax on property in the period 1998-2008. 33% of municipality fiscal revenue
- More competition, less “salient” taxes
- Results: when the distance between the elected mayor and her opponent shrinks by 1%, the per capita tax revenue from ICI drops by 0.80 Euros but, at the same time, revenue raised from fees for general and other services, in per-capita terms, increases respectively by 0.64 and 0.28 Euro

# The present /1

MARCH 2014: If you were a party leader at this point in time, on which of the following issues would you focus your efforts?



APRIL 2015: Among the following issues, which ones worry you the most at this point in time?

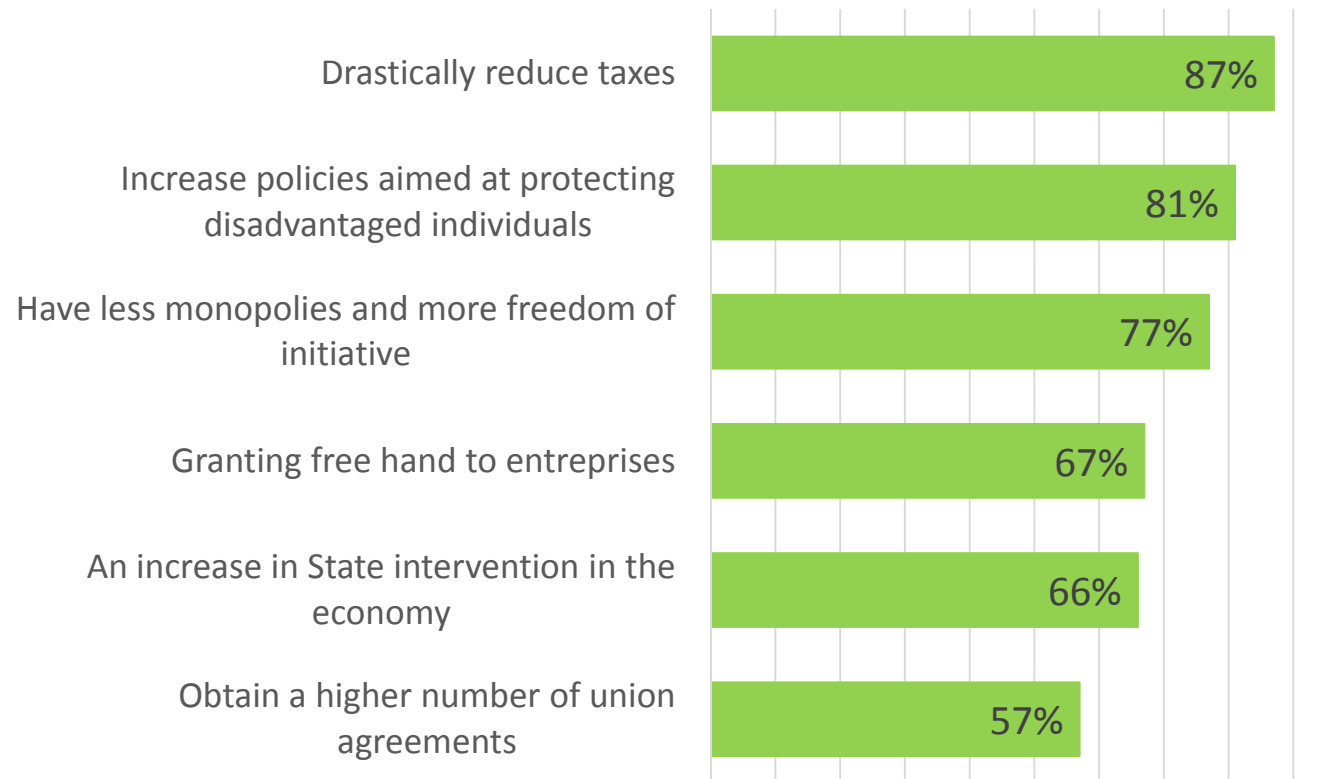


*data source: SWG; multiple answers allowed  
CAWI survey on a national representative sample of 1000 adults*

# The present /2

In order to guarantee the country's development,  
how important do you think it is to:

**Bocconi**



*data source: SWG; multiple answers allowed*

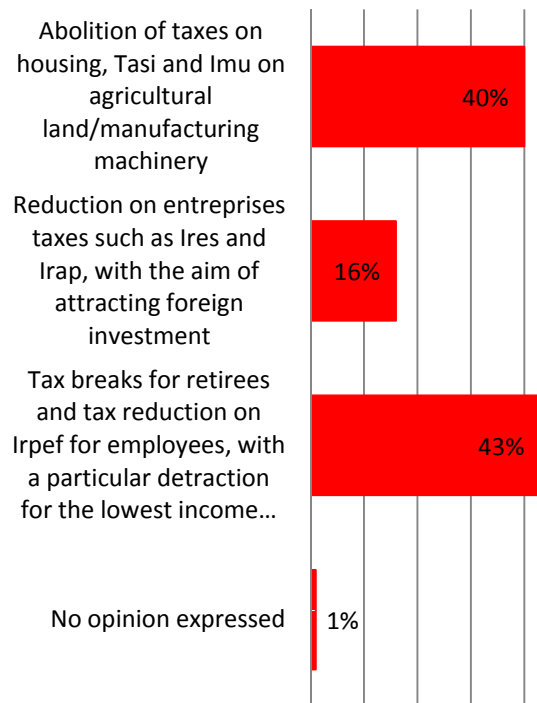
*CAWI survey on a national representative sample of 1000 adults, June 29 - July 1 2015*

# The present /3

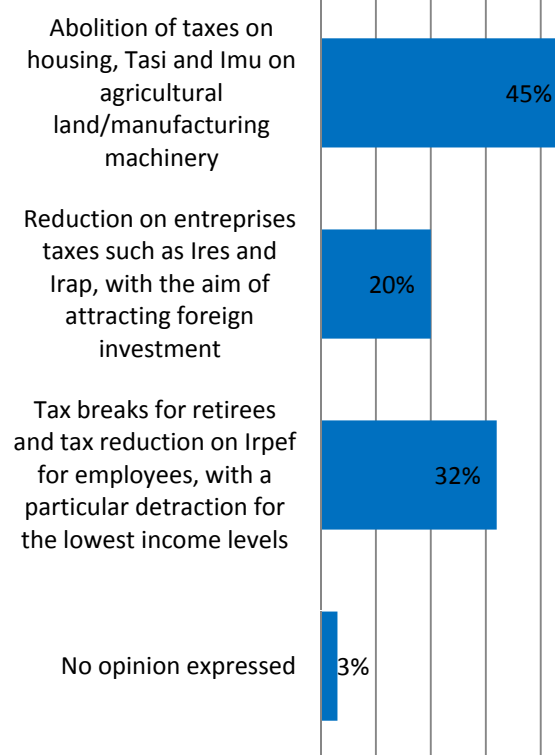
In summer, the Italian prime minister announced a tax reduction plan for 50 billion Euros to be implemented in the next 5 years

**Among the following 3 intervention areas, which is the one you would mostly like to be implemented? (According to political orientation)**

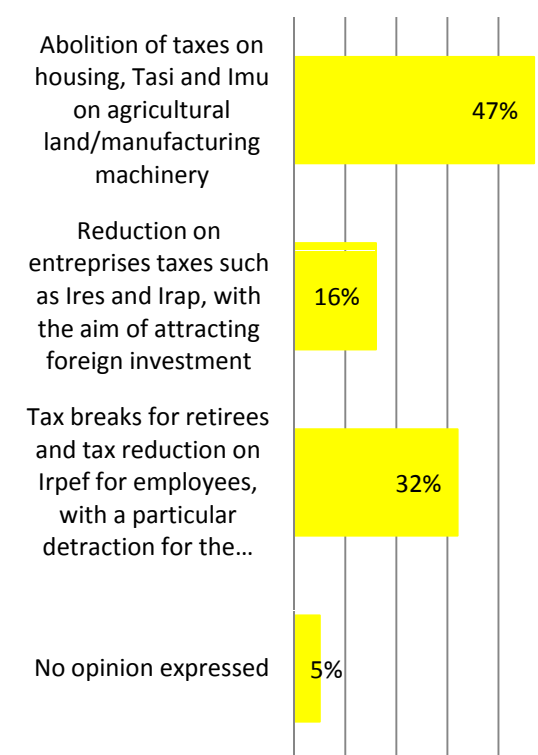
## Centre-Left



## Centre-Right



## 5 Stars Movement



*data source: Piepoli, July 2015*

# Conclusions

- Tax reforms are a highly debated issue
- Actual tax systems are different from optimality
- Most reforms are targeted
- Political factors matter in Italy:
  - Tax reforms as an attempt to attract votes
  - Tax reforms as a response to political constraints