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TAX COMPETITION AND FISCAL FEDERALISM IN ITALY

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Tax Competition and Fiscal Federalism in Italy

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1 Introduction

The aim of this paper is to discuss tax competition in Italy, in particular at the subcentral levels of government – namely Regions and Communes – in the recent years, as a part of the more general framework of the government to achieve a large fiscal and tax decentralization process. In the second paragraph, after a very brief review of the main outcomes of the literature on tax competition, we discuss the economic meaning of tax competition and how it works theoretically and practically, and whether we can assume that this form of special competition to attract tax bases and revenue is always welfare worsening. In the third paragraph, we try to define more completely the meaning of tax competition, since empirical evidence shows that states tend to compete not only on the base of tax factor but also by using expenditure, regulation, land rules and so on. In the fourth paragraph, we provide a snapshot of the recent Italian situation. We try to account how much tax competition does exist in Italy. First we describe the degree of tax and spending decentralization currently existing in Italy and then, by observing the changes in the main SGCs tax rates, we show the relatively low degree of tax competition that characterizes the current Italian fiscal federalism. In particular, we analyse the case of Regions and especially the three main taxes available for them, IRAP (the Regions' tax on value added-income type), the surtax on the central income tax (RSIrpef) and the Regional tax on vehicles (RTV). We therefore try to clarify the possible factors which may explain the limited scope of tax competition in Italy and whether an increase in tax competition may be beneficial for the Italian fiscal federalism experience. The last section concludes.

2 What does tax competition mean and how it works?

In the economic literature there are now many works on the topic of tax competition. Perhaps the first and most famous academic work on competition between jurisdictions, similar to that of firms in the market, is the Tiebout (1956) model of a voting-by-feet mechanism. People tend to move across jurisdictions and try to settle down where the supply of public goods matches their preferences. People reveal their preference, and therefore 'vote', by moving their residence across the different jurisdictions.

In his seminal work on fiscal federalism, W. Oates (1972) states this problem as follows: "*The result of tax competition may well be a tendency toward less than efficient levels of output of local services. In an attempt to keep taxes low to attract business investment, local* *officials may hold spending below those levels for which marginal benefits equal marginal costs, particularly for those programs that do not offer direct benefits to local business*."[1]

Therefore, since the onset of this approach, the emphasis is on the possible negative spillovers that may derive from tax competition on efficiency through a suboptimal level of public expenditure. Local governments might find themselves involved in a tax war and be forced to reduce the tax rates in order to attract tax bases, namely, firms, taxpayers and consumers. By using tax rates and strategic adjustments of the tax bases, in order to attract tax revenue, states and regions may absorb a more or less relevant share of tax revenue of their neighbouring level of government.

However, as it is quite obvious, strategic tax movements tend to produce a more or less symmetric reaction by other SCGs. They may react to the first mover and follow it with a similar reduction of tax rates, like the move in a leader-follower (Stackelberg) game. Obviously and more realistically, by using their Leviathan power, SCGs may also try to collude and find an *ex ante* agreement, in order to avoid a possible tax war. However, the information mechanisms and the transaction costs needed to achieve this collusive mechanism are far from being assured and some non-cooperative (free rider) behaviour is in most cases possible. Some models explore the context and possible conditions under which a similar mechanism may emerge.

What are the supposed advantages and benefits of tax competition? What then the possible costs? It is worthwhile to stress that in this domain of economic literature, competition tends to assume a rather special value and meaning. In fact, in economic theory and normative models, competition is the key variable of the working of the market mechanism, ensuring the efficiency of economic activity and so an efficient allocation. Differently, in a tax strategic setting, when some form of competition between governments is at work, an inefficient allocation may be the final outcome[2].

Different jurisdictions tend to attract tax bases through the mobility of firms and consumers. As a consequences of this mobility, tax bases will reallocate across states and regions, looking for tax advantages, special treatments or differences in the 'quality and quantity' of public expenditure – benefits in term of infrastructure, services, etc. Firms and consumers will try to exploit the possible existing tax arbitrage simply by moving across the territory into the more convenient regions. The loss of the tax base by one

1 See for early models on tax competition, based on interaction due to benefits spillovers, Williams (1966), Pauly (1970), Oates (1972) and Boskin (1973); for other models exploring the effects of tax–base mobility, Beck (1983), Wilson (1986) and Zodrow-Mieszkowski (1986).

2 See on this Hindrick-Myles (2002).

jurisdiction will however become a gain for another. Therefore, the mobility will cause a tax externality between jurisdictions[3]. Some forms of harmful tax competition would probably occur in the end, since a 'race to the bottom' will result, as a final outcome, in an under provision of public goods. The OECD and the EU have both shown concern about this race to the bottom and in various recent reports and initiatives they have identified different forms of harmful tax competition on business taxation[4].

The game theoretical models of tax competition show that under certain assumptions the final Nash equilibrium is inefficient. In fact, when taxes are inefficiently low, we have that some fiscal externalities may characterize the equilibrium. The attempt by the various countries to attract the mobile capital – the "race to the bottom" and the process of fiscal competition – may prevent to achieve the efficiency[5].

In the economic literature we have several models on capital taxation that show that when countries use source-based taxes on capital income to finance their public expenditure, and that when tax base is mobile among jurisdictions, tax competition tends to raise. In particular, Wilson (1986) and Zodrow-Mieszkowski (1986) show that, in similar contexts, a possible effect of tax competition is to lead jurisdictions to under-provide" public goods – that is to say that, a tax reduction in one jurisdiction imposes a negative externality on other jurisdictions, by reducing their tax bases.

In the same way, when jurisdictions are financed by a source-based tax on capital which is perfectly mobile among jurisdictions, and when jurisdictions are somewhat identical, then there is too little public expenditure in any symmetric Nash equilibrium. Therefore, all residents of the nation 'would be better if each jurisdiction raised its capital tax rate by a small amount, starting from the Nash equilibrium'. In addition, some other policies may be envisaged which may lead to a Pareto superior outcome – i.e., jurisdictions could agree to introduce a national capital tax with the proceeds to be distributed equally among all jurisdictions.

[3] Hindricks (2004) states "What is the role of competition between governments? If competition is the fundamental force of efficient economic performance in the private sector, why should it be different for the public sector? Why cannot the same disciplining effect of competition be applied to the public sector as well? In the private sector competition will promote efficiency because firms which best satisfy consumers' preferences will survive and prosper, while others will lose customers and fail. Extending this argument to the public sector, competition among governments and jurisdictions should induce them to best serve the will of their residents. If they fail to do so, residents will vote out their incumbent or still worse they can leave for other jurisdictions which offer a better deal".

[4] See for example the OECD 1998 Report and the EU Code of Conduct.

[5] Hindricks-Myles (2002).

Models of tax competition have been applied to any mobile tax base. While most of the theoretical literature deals with the issue of capital taxation, some studies have addressed this topic to commodity taxation, when there is cross-border shopping[6] - physical or not physical consumers' movements. When the origin principle is applied (taxes are levied in the country of production), some cross-border shopping is possible if tax rates diverge; while with the destination principle, with the zero rate on exports, taxation in the country where final consumption takes place prevents cross-border shopping – even if it requires to maintain some forms of borders. Being borders inconsistent with a single-market in a federation, most of the European debate on VAT has focussed on possible solutions to get a true single market in Europe without any physical borders at custom posts.

However even if one accepts the general conclusion of the race to the bottom models and of a harmful tax competition which may considerably reduce welfare, "a positive role for intergovernmental competition in general, and tax competition in particular can be found. There are two main ways for it. First, the role for intergovernmental competition can be compared to an auction mechanism to get resources allocated to their best possible uses. Another possibility is that there is an agency problem in government which tends to make the public sector inefficient and possibly too large"[7]. Therefore in some circumstances, and if we take a public choice perspective, inter-governmental competition can be welfare enhancing, and so the case of some 'efficient tax competition' may really exist.

It is important to highlight that, quite obviously, models show that 'size matters', in the sense that the dimension of the level of government may affect the intensity of competition – we may have some leader (or 'first mover') in the tax rates change – but also that asymmetries in technology may lead countries to set different taxes. For example, the outflow of capital is in general less severe for the largest countries for any tax increase, and therefore largest countries or regions set higher tax rates.

Another interesting case in the literature of tax competition has been studied in relation to the vertical dimension of governments. Keen (2002) showed that, especially when some tax overlapping applies – higher and lower levels of government share the same tax base – the issue of vertical fiscal coordination and competition become crucial – we have to address not only horizontal fiscal externality but also vertical tax externality. An increase in the tax by the higher level of government tends to reduce the tax base of the lower ones – and this is the opposite effect to the case of horizontal externality between regions.

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[6] See on commodity tax competition, among others, Behrens-Hamilton–Ottaviano-Thisse (2009), Knight- Schiff (2010).

[7] Hindricks (2004).

Another key issue is to understand whether perfect or imperfect mobility tends to exist in real world. There are in fact many factors which may hamper – apart from the elegance of formal theoretical model... – the mobility of firms, capital and tax bases. If on one hand, perfect mobility forces homogeneity of jurisdictions, since rich would move to escape redistributive taxation, on the other, this fact may prevent regions from implementing any redistributive policy that is more redistributive than that of the other regions. For that reason, in the literature of fiscal federalism, the function of redistribution is in general assigned to the central government which is in the best place to deliver the purpose of the redistribution of income.

3 The definition of tax competition

But what does tax competition mean in reality is not always clear and it has to be better defined. The issue of definition of what really constitutes tax competition is not an easy task. In fact, in models the reduction of tax rates is usually interpreted as the signal of the existence of some forms of tax competition. In general a movement of tax rates by one or more jurisdictions may result in a tax competition process. But, the reduction in tax rates, per se, is not enough to affirm that tax competition is really at work. To assert so some shifting of the tax bases need to be found out; and in the end, a certain reduction in the tax revenue should be generated as well, to be sure that a fiscal externality has been produced and that some effects on general welfare may occur.

It is important to stress also that competition across levels of government takes place not only by changes in tax factors but also by manoeuvring goods and services supply, both in terms of quantity and quality, as well as with the use of the other forms of benefit taxation – such as charges and prices of local government.

In the same way, by looking for a reduction of the burden on capital taxation and other mobile firms, the process of tax competition may trigger some tax shifting on other bases and taxpayers, which in the end may result in some externalities on other tax bases – tax competition on one base may be ‘exported’ to another one.

4 Some empirical evidence on tax competition

4.1 Among countries

We can get the best and easiest example of tax competition probably by looking at what happened to the corporate tax rates in the EU in the last two decades. In figure 1, the evolution of nominal corporate tax rates in the European Union have been pointed out, while figure 2 show the situation also for some selected OECD countries[8] (see also table 1). If we identify tax competition with the process of corporate tax rates reduction, then the EU in the last 15 years has proved to be as a perfect case of tax competition among countries. From 1995 onwards, tax rates have considerably declined as a result of competition, given the high mobility of tax bases associated to capital and firms.

In figure 2 we see however that while this process after 2003 went to a halt for the non-EU OECD countries, it continued for the EU15 and particularly for the EU10 countries. The average tax rates lessened from 38,57% in 1993 to 28.64% in 2007 for EU15 and to a less than 20% for EU10. A possible explanation of this trend is that the entry of new member states in the EU in 2005 – these countries were already characterized at that time by a relatively reduced rates on corporations – exacerbated the process of intense competition already existing within the old Europe[9].

Even if it seems obvious that these movements in the tax rates on corporations give clear evidence to the process of tax competition that took place within the EU in the last two decades, we are left with a surprising puzzle since 'corporate tax revenues have remained remarkably stable over time" notwithstanding this considerable reduction in rates[10]. The fiscal externality associated with the tax competition should be reflected to some extent in a reduction of tax revenue, which would make more difficult the supply of public good. But in the end, if the tax revenue remained substantially unchanged, it is not clear what might be the fiscal externality of tax competition, leaving aside any possible distributive consideration that may follow from a modification of the tax mix. Of course, the simplest possible explanation to this puzzle is that EU countries have compensated the decline in tax rates with the broadening of the tax bases – changes in the rule allowing interest deductibility, fiscal depreciation and losses offset, a reduction of the investment tax credits, etc. – that allowed them to leave partially unchanged the corporate tax revenue.

[8] See EEAG Report (2008) of the CESIFO and Crabbé-Vandenbussche (2008).
[9] See the discussion in Crabbé-Vandenbussche (2008).
[10] See Mooij-Nicodeme (2008).

A recent study[11] however suggests an original alternative explanation: that the revenue implications of corporate tax competition do not show up in lower corporate tax revenue but in lower personal tax revenue. In fact, if there exist a positive differential between the average tax rate levied with the personal income tax and that set on corporations, then it is easy to understand that, at the time of choosing the legal form of doing business, entrepreneurs would obtain a considerable benefit from shifting partially or totally their legal form towards incorporation. This will be reflected in a partial reduction of the tax revenue coming out from the personal tax system – given the difference in the average rates. Therefore, what really matters in the end is the process of income shifting from personal income to corporate taxes, that will affect not only the distributive consequences of the tax system but also the incidence of taxes on the economy – as well as the total tax revenue, since the revenue gain from the corporate tax will be partially or completely offset by the decline in the personal tax revenue.

4.2 Among SCGs

Moving to the experience of some countries, in recent years, many studies have been carried out on Switzerland and now there is a large empirical evidence on tax competition in this country. Some evidences[12] have shown that "for individual income taxes and for corporate income taxes, fiscally induced mobility at the Swiss cantonal and local levels is relatively important. In particular high income earners and firms with high rates of return on capital reside or locate in places where taxes are low in relative terms"[13]. Therefore, the existence of strategic tax setting of Swiss sub-federal jurisdictions could hence prove the existence of tax competition in Switzerland.

In a recent paper Feld-Reulier (2005) show that the Swiss Cantons have been characterized in the '80 and '90 by a process on intense tax competition: that Swiss taxpayers reside where income taxes are low; and that if the income tax rate is low, is low also the one of the bordering cantons. Figure 3 and 4 – taken from Feld-Reulier (2005) – show cantonal local income tax rates for certain range of taxable income and there is a clear evidence of a large reduction in tax rates across the various Swiss Cantons – even if there are some surprising results for the high income taxpayers: in fact, in this case, even if we may safely assume that this group of people are more mobile and therefore more sensitive to total rates differentials, the reduction of income tax rates by Swiss cantons on these brackets have been quite modest, if any. Another work by Schaltegger-Somogy-

[11] Mooij-Nicodeme (2008).

[12] See among others, Pommerehne (1996), Pommerehne-Kirchgassner-Feld (1996), Feld (2000a, 2000b), Feld- Kirchgassner (2001) and Schmidheiny (2003), Feld-Kirchgassner (2003), Brueckner (2003).

[13] See Feld-Reulier (2005).

Sturm (2009) provides evidence of the influence of income taxes on the choice of residence of taxpayers at the local level. In particular, from 1991 to 2003, for the 171 communities in the Swiss canton of Zurich, they find relevant evidence of the existence of income sorting.

Another work by Riedl-Rocha-Akis (2009) by using a panel of annual data from 17 OECD countries, during the period between 1982 and 2005, explore the elasticity of tax bases. They find significant international fiscal externalities in the form of CIT–induced resource flows. The magnitude, however, indicates that the extent of international corporate tax base mobility is rather modest.

Gérard-Jayet-Paty (2009) test the existence of strategic interactions among municipalities using a panel of Belgian local tax rates from 1985 to 2004 with a special emphasis on the role of the language spoken in the various municipalities. They find that Belgian municipalities interact with each other over the two main local tax rates, the local surcharge on the labor income tax rate and the local surcharge on the property tax: in particular, municipalities are sensitive to tax rates set by their close neighbors only and that language does matter: the intensity of tax interactions is lower between municipalities speaking different languages than between municipalities speaking the same language. Along the same line, Vandenbussche-Crabb-Janssen (2005) test the existence of tax competition at the firm level in the three regions of Belgium and find the existence of a lower effective tax rate in the peripheral region of Wallonia than in Flanders.

Some studies of strategic tax setting have been carried out also for other countries: in particular, Besley-Case (1995) provide panel evidence for U.S. states; Ladd (1992) analyses tax mimicking at the U.S. county level; Heyndels-Vuchelen (1998) deal with the Belgian municipalities, Buttner (2001) with the German local jurisdictions, Solé-Ollé (2003) the Spanish communities and Feld-Josselin-Rocaboy (2003) analyze a panel of French regions. In particular, Brueckner-Saavedra (2001) try to verify at the city level – the Boston metropolitan area – the existence of strategic tax interaction and tax competition in the setting of the property tax rates and do they find a positive response.

On the Italian case, Bordignon-Cerniglia-Revelli (2003) address spatial tax competition on ICI – the Italian property tax – within the Italian municipalities and find positive evidence; Ermini-Santolini (2006) address the issue of public spending interdependence among some Italian local councils and find a significant positive interaction between spending of neighboring local councils both at the level of total expenditure and for different sub-categories; Santolini (2007) investigates tax interactions and tax setting of Italian local government and the case for tax mimicking in some local governments; she finds that, especially in the Marche Region, tax setting is driven by political trends.

An interesting recent paper (Piatkowski-Jarmuzek (2008)) show that the recent (2008) decision of Moldova to reduce to zero the tax rate on corporate income tax may exacerbated the process of tax competition within the other countries of Eastern Europe – and therefore in the end also with respect to the old member of the EU, that, as we have seen above, have already suffered from this tax interactions in the recent two decades.

Finally two very recent papers – Goolsbee-Lovenheim-Slemrod (2009) and Knight-Schiff (2010) – address some special cases of tax interactions in the US: a) tax competition in the selling of cigarettes by internet, where the rise of internet as a source of state-tax-free cigarettes has considerably affected the taxed sales elasticity and therefore reduced the potential revenue from tobacco taxation; b) tax competition between jurisdictions in cross-border shopping for state lottery tickets – per resident sales are more responsive to prices in small states with densely populated borders, than in large states with sparsely populated borders.

5 A snapshot of the Italian situation

5.1 The decentralization of expenditure…

By considering the total government expenditure, net of the interests spending on the public debt and pensions expenditure, we have that in 2005 Regions manage 29.5% of total consolidated expenditure. If we consider also the 22.9% of the total expenditure managed by local governments, the degree of expenditure decentralization on the whole in Italy is currently at 52.4% – see figure 5 – of total government expenditure, a substantial percentage especially if compared to the 44.1% of 1996 (by including the spending for interests and pensions, the 2005 level goes down to 30%).

On one hand, we have certain sectors – like defense, education, industry and social welfare – where the role of central government is still preponderant; on the other, we have some functions for which subcentral governments play a key role in the management of expenditure but also in decision making, such as health, transports, tourism and agriculture, roads maintenance, territory. It is important to stress that the highest degree of decentralization is achieved in public health spending: in fact, health spending of the central government amounts to a limited 5% of total health outlays[14].

Figure 6 and 7 consider, respectively, the local and regional budgets and show the distribution of the total expenditure by functions. In Provinces' and Municipalities' budgets, the most important functions in terms of share of total outlays are: general administration, (mainly remunerations of public employees), territory (community amenities and environmental protection – with a high quota allocated to waste management), roads, public assistance and public transports. Public education represents also an important sector in which local governments show relatively high shares of budget spending, mainly devoted to the maintenance of schools, to new investments and to the payments of non-teaching staff.

Social and health sectors represent the main spending functions in regional balance sheets, with a share on total outlays near to 80%. Health care spending is managed at the regional level through the Local Health Authorities with the specific aim to guarantee, over the national territory, the essential levels of treatment (national standards), which are determined by the central government in close cooperation with regions.

5.2 … and of taxing powers

[14] In the education sector, compensations of employees are still paid by the central government with the only exception of some special regions.

During the 90s, Italy has experienced a significant process of tax decentralization towards regions and local governments. The key steps of this process are the following:

- in 1992, the CG decided to fully regionalize the tax on vehicles;
- in 1993, Central Government decided the setting up of a communal tax on dwellings, housing and real estate (ICI);
- in 1996, in the same way, a Regional business tax (IRAP) and a regional surcharge on the central government income tax (RSIRPEF) have been introduced;
- from 1999, the possibility to introduce a surcharge on the central government income tax (MSIRPEF) has been attributed to Communes;
- in 2002, the tax sharing to the revenue of the central income tax has been provided to Communes.

This process has given rise to a significant increase in the tax revenue of the SCGs. In 1996, the share of SCGs' tax revenue was only the 12% of the total national tax revenue (net of social security contributions), while in 2001 this share raised to 20.2% and in 2007 to 22%.

It should be emphasized that the process of tax decentralization implemented in Italy has essentially entailed the attribution of own taxes to the SCGs, own taxes in the sense that at least the tax rate can be chosen by SCGs, also if in a range fixed by CG. Hence, in this period the weight of the revenue from taxes has increased, as well as the tax autonomy of the SCGs. If we appraise the degree of tax autonomy as the ratio between the revenue from own taxes and the total current revenue, at present this is nearly equal to 46% for ordinary Regions and to 36% for Local governments. Tax autonomy is much lower, around 18%, for Special Regions, since for them most of the tax revenue comes not from own taxes but from tax sharing to national taxes (Income tax, VAT, etc.) (figure 8).

5.3 SCGs main taxes

We will focus on the main own taxes of ordinary Regions and Municipalities, the most important levels of sub-national authorities.

For the regions, the main own taxes are (table 2):

- The regional tax on productive activities (Irap) (73.7% of total tax revenue)
- The regional surcharge on the Central Government Income Tax (RSIrpef) (14.6%)
- The regional tax on vehicles (RTV) (8.9%).

These taxes are responsible of 97.2% of the total own tax revenue of all the regions, and the situation is not significantly different between ordinary and special regions. Moreover these taxes provide 37.3% of total current revenue. This percentage rises to 44.6, if only the ordinary regions are considered (in special regions, given the importance of shared taxes, the revenue of own taxes is only 15.1% of total current revenue).

With respect to IRAP, it has to be noted that it is a tax on business – mainly, firms and companies – and on Public Administrations – in this last case, the tax is based on wages paid to employees[15]. There is therefore a private IRAP and a public one. Relating to the private component of IRAP, a few remarks can be done on its merits and drawbacks:

- Given the huge tax base – roughly, the total value added net of depreciation and some other small minor items – this tax can provide a very significant tax revenue with a relative small rate;
- the compliance of the tax is quite simple and not costly;
- it does not foster accountability, being paid at a first stage only by firms and companies, as well as by individual taxpayers running a productive activity on a permanent basis, hence by a limited number of residents and voters;
- by taxing the remuneration of productive factors (profits, as well as interests and wages), it produces a procyclical revenue, with adverse effects in downturns;
- the regional distribution of revenue is highly uneven, requiring large financial transfers in favor of less developed regions to restore equity;
- it presents difficulties in the regional definition of its revenue, when it refers to firms with operating plants located in different regions of the country.

With the public component of IRAP, the main problem is that this is a central government tax on which regions have no real taxing power (the fixed tax rate is the same for all regions). Hence, it should be considered as a form of tax sharing rather than a genuine own local tax. For Southern regions – where the public component has the highest share (with peaks over 40% in some cases) – this represents a significant reduction in their taxing power.

As regards the regional surcharge on the central government income tax (RSIrpef), the main difficulty relies on the fact that the tax base is the same as that of the central government Irpef. Hence, regional revenues will vary – positively, or negatively – according to changes of the tax base as introduced by the central government. Moreover, the additional tax creates inequalities between individuals with income levels lower than the minimum taxable threshold and individuals with income levels immediately higher than the minimum: the former are exempted from the additional tax while the latter are taxed on the overall tax base. Finally, the different rates set by Regions inevitably end to

[15] The definition of value added used in the case of IRAP is that of the income-type, not the consumption-type such that used with VAT.

interfere with the scale of progressivity of the central personal income tax, creating problems, spillovers and negative undesired effects.

For the communes, the main own taxes are:

- The municipal property tax (ICI) (62.8% of total own tax revenue)[16]
- The Municipal Surcharge on the Central government Income Tax (MSIrpef) (11.0%).

As Table 3 demonstrates, these taxes, for all the communes, are responsible of 74% of the total own taxes revenue.

The incidence on total current revenue is instead not very high (28.5%), but this is mainly due to the importance, in the communal budgets, of the revenue coming from the tax sharing to Irpef and from other own sources of revenue, as fines and sanctions (most of all on vehicles!), and tariffs on services.

Despite the fact that the property tax is recognized, also from a theoretical perspective, as being the most adequate local tax, it has to be noted that in Italy there exist other taxes on housing levied by the central government, some referring to the value of the house itself, others referred to the transfer of property. This contributes to increase the overall tax burden related to housing properties. Also for this reason, in deciding how to cope with the last international economic crisis, the then just elected new CG decided in 2008 to abolish ICI on the first dwelling to help families (at least those possessing a dwelling) but also for political reasons, being the ICI one of the most controversial and unpopular tax in Italy.

The municipal additional tax on IRPEF, is structured on the model of the regional additional on the central personal income tax and for which the same considerations and drawbacks apply.

Another important municipal tax relies on waste management. The tax has to be paid by the user of the house (proprietor or renter) and the amount to pay is linked to the square meters and also to the number of residents – for these reasons it can turn out to be regressive. According to the existing laws, this tax should be transformed in a charge paid on the basis of the amount of waste produced. Until now, this transformation has not been

[16] In May 2008, the Italian Government has decided to abolish this tax on the owner and occupants of the ‘first house’, while leaving it unchanged on secondary house and luxury residences.

completely implemented, but in any case, it should be considered as a tariff, given that the tax revenue cannot exceed the cost of the service, and that in many cases it is paid out directly to the firms which manage the service.

5.4 SCGs range of taxing powers

The range of powers attributed to SCGs on the taxes we have mentioned is summarized in table 4, where we have considered the following elements:

1) The possibility for SCGs to not levy the tax. First of all, this is true for the municipal surcharge on Irpef (MSIrpef). Others SCGs optional taxes are the municipal earmarked tax for public works (introduced by CG in 2007) and the regional tax on gasoline (RTG, max. 0,025 euro/litre). Until now, the RTG has been introduced by 4 regions and the earmarked tax for public works by less of 20 communes. For this reason and also because the tax revenue is very limited they are not considered in this paper.

2) The possibility to choose the tax rate: it is the basic element for a tax to be considered "own" and it is always present. The choice can always be done within a range (min. and max.) fixed by CG. The only exception is for the regional tax on vehicles: indeed, the tax rate can be modified up to 10% each year.

3) The possibility to vary the tax rate for specific categories of taxpayers (or tax bases, in the case of ICI and RTV). This is true for all the taxes here considered, Irap and, from 2007, MSIRPEF included

For the purpose of evaluating the degree of taxing powers and autonomy of the SCGs, it is also important to stress that:

- with the only exception of the surcharge on income tax (regional and communal), SCGs can always decide on many aspects of the management of the taxes (i.e., tax compliance, collection, etc.);
- all the mentioned regional and communal own taxes are disciplined in general terms by CG laws. These laws can always be modified autonomously by the CG. For example, this has occurred in the last years for Irap and Ici. CG, at least in theory, can also abolish some of these taxes, of course providing SCGs with an equivalent amount of revenue[17];

[17] This is what is happening with the abolition of ICI on 'first house', decided in 2008.

- CG can oblige SCGs with budget deficits to apply the mentioned regional and municipal taxes at the maximum rate. At present, this is true for 4 regions with relevant budget deficit in the health sector.

5.5 Do Italian SCGs make use of their taxing power?

The answer is definitely affirmative. For the Regions, figure 9, this is true for all the taxes here considered:

- for the Irap, 95% of the Regions (100% in the North and in the Centre) use their fiscal power. That means that the tax rate is almost always different from the ordinary one and that in many cases the tax rate is differentiated for specific categories of taxpayers. For example, 85.7% of the regions apply the minimum tax rate to promote special kind of firms (i.e. firms managed by youths or by women, or which are considered virtuous according to parameters fixed in regional laws). 47.6% give total exemption to the non profit sector.
- for the RSIrpef, 62% make use of their fiscal power, with negligible differences between North-Centre and South. This means that 57% apply tax rates higher than the ordinary one (62% in the South) and that 38% differentiate the tax rate according to the taxpayer's revenue (54% in the North).
- Finally, more than 40% of regions apply the RTV using a tax rate higher than the ordinary one. Moreover, many regions are planning to introduce or have introduced special facilities for vehicles considered less pollutant.

Also the communes appear very in favour of using their fiscal power:

- for the ICI, which has been introduced by CG in 1993, almost all of them apply tax rates higher than the ordinary one and introduced facilities for specific types of housing and properties or taxpayers (i.e., according to the revenue or the family composition).
- For the MSIrpef, it is important to stress the percentage of communes which levy this "optional" tax, introduced by CG in 1999. Among the 7,469 communes considered by the Ministry of Interior[18], 72% now apply the tax (almost 80% in the North-Centre) and also in 2002 the tax was very widespread (figure 10).

It is also interesting to consider the level of the tax rate chosen by communes for the MSIrpef. As figure 11 demonstrates, in 2006 less than 10% have adopted a very low tax rate (less than 0.2%) and 29% the maximum tax rate then possible. As we have said, from

[18] The total number of Communes is around 8.100.

2007 it is possible to apply a tax rate of 0.8%, and some communes have already made use of this possibility (for example, the town of Trieste). From 2007, it also possible to differentiate the tax rate according to the level of taxpayers' revenue and the data of the Ministry of Economy show that 678 communes have already made use of this power.

6 The use of SCGs fiscal power and the tax competition. A case study of the Italian Regions

If we want to analyze tax competition at the subcentral level, we need obviously to address the tax and spending behavior of the various bodies of the same level of government. But then when can we assume that some form of tax competition is at work?

By limiting to the tax factor, at least one specific condition seems crucial for that purpose: in a certain year, at least one or more regions should have levied a given (own) tax with a rate lower than the standard one. This may mean in fact that we are experiencing some form of tax competition, perhaps at its initial stage, or somewhat near to its final outcome, where the same level of government compete over the same tax base by manoeuvring the tax rates. Moreover, even in the case where only a single body (regions, provinces, etc.) is levying a rate lower than those charged by the other levels of government, we may assume that we are in a context of tax competition, where other subcentral governments will be forced soon to follow the 'leader', by lowering the rates themselves.

The reduction of tax pressure by a single body of government may be however explained also by looking at other factors, like for example, the achievement of a sound budget situation which would free some financial resources for taxpayers or the will to follow the electoral cycle by lowering the tax burden on local residents in the immediacy of ~~the~~ local elections.

Our analysis of the Italian case will essentially be made by referring to the main regional taxes, in view of the fact that these taxes are the most suitable candidate for the purpose of playing some form of tax competition. In fact, RSIRPEF and Irap tax bases could have a potentially high mobility in response to tax rate adjustments[19].

6.1 The situation of IRAP

It is important to remember that Regions have two possibilities on the manoeuvrability of IRAP rates. To modify the standard rate set by the CG – 4,25% of the tax base until to 2008, when this central limit has been reduced to 3,92% – by a range of +/- 1% for:

[19] Here we do not consider the public component of IRAP.

- All the productive activities that operates in the regions' territory;
- Only some specific categories of productive activities.

As shown in the figure 12, only the second option is quite common between regions, but this has little to do with tax competition at least for two main reasons. First, when a change in rates has regarded some important economic sectors – the banking and the financial sector, for example – this has always meant a rate increase with the aim to raise the tax revenue. Second, it is true that some reductions were introduced and that they are quite differentiated between regions, but they are so limited in the scope that one may safely assume that they do not symbolize any form of tax competition. In general, these reductions have concerned the promotion of specific forms of business activities – firms run by young people, women or with a cooperative and nonprofit legal status – or with the aim to support employment or protect the environment (i.e. by subsidizing the development of alternative energy).

The first option – to lessen or increase the standard rate for all the productive activities – is of course much more interesting since it is the type of change that could determine some form of tax competition and turn out in movements of the tax base between regions. However, as shown in figure 12, no regions have so far introduced some remarkable reductions of the standard rate, therefore no attempts have been tried to compete by attracting tax base from their neighboring level of government. On the contrary, the regions of Liguria, Lazio and all the Regions of the South – with the exception of Sardinia and Basilicata – have decided some general increases of the standard rate up to the ceiling set by the CG.

One may wonder why right in the South, i.e., in the area that would need most to attract tax bases, the tax rates are the highest? The answer is that these regions are characterized by huge budget deficits, given the excessive costs of the health care sector. In order to consolidate the public budget, they have been forced by the CG to increase the tax revenue by levying the maximum rate allowed for IRAP and, as we will see in a moment, the regional surcharge on central income tax.

There are however some situations in which we may think that some sort of a free rider behavior is at work, in particular for regions of Basilicata and Sardinia. In fact, just by levying the standard rate (4.25%), they were able to grant some relative tax advantages to firms and business located in their regions, given that their neighboring regions were forced to use the maximum rate of 5.25% – with the possibility therefore to compete and get more revenue even without levying the reduced rate of 3.25%.

Of course, if Basilicata, Sardinia and all the regions of the Centre-North had adopted the lowest rate (3,25%) their tax competition would have been even stronger. But this did not happen and we may suggest, between others, three main possible explanations:

a) for choosing the location of a firm, other factors seem more relevant than the Irap tax rate: the supply and the quality of infrastructures, the social capital, the compliance with property rights, the situation of safety and public order, the quality of public administration.

b) the system of allocating the IRAP tax base. In fact, for firms with plants in more regions, the tax base – and consequently the tax revenue – is assigned to the regions where plants are located —on the base of the number of employees for each plant – and not according to the legal residence of the firm. Consequently a firm, to take advantage of a low tax rate in one region, has to move its plants, a rather complex and burdensome task.

c) the structure of state transfers from the CG to fund the cost of the health expenditure. This structure has been designed to cover in each region the difference between: the standard tax revenue from IRAP and RSIrpef; and the very rigid expenditure necessary in each region, according to CG estimates, to guarantee some national standard levels of health care. The revenue loss due to a possible tax rates reduction below the standard rate, would therefore endanger the accomplishment of a balanced budget.

6.2 The situation of RSIrpef

Also in this case it is useful to briefly recall the power of regions to change autonomously their specific rate of the surcharge on the national personal income tax. The compulsory minimum rate is 0.9%. Regions may increase this rate up to a maximum of 1.5% and they may differentiate this increase for different tax revenue brackets, altering in this way the progressivity of the income tax – otherwise, the regional rate would only be proportional. According to the different rates levied, Regions can be distinguished in some groups (see figure 13):

a) regions using exclusively the minimum rate. In this group there are three Northern regions (Valle d'Aosta, Trentino Alto Adige, Friuli Venezia Giulia) one from the Center (Tuscany) and three regions of the South (Puglia, Basilicata and Sardinia);

b) regions which levy only the maximum rate or a rate higher than the minimum: like the Centre region Lazio, and five from the South (Abruzzo, Molise, Campania, Calabria and Sicilia), all with a remarkable health deficit;

c) regions which set differentiated rates on the tax brackets of the personal income tax. In this group, there are 5 Northern regions (Piemonte, Lombardia, Veneto, Liguria, and Emilia Romagna) and two centre regions (Umbria and Marche).

On the whole, the situation is quite variegated, even within the same geographic area; The only element of uniformity is the maximum rate applied in the regions with relevant deficits in the health sector (group b), but in almost all of these regions this is due to CG directives, as for Irap. In any case this situation doesn't seem to be the outcome of some form of tax competition because the limited range of rates manoeuvrability it is not sufficient to induce taxpayers to change their residence.

In Italy, the decision where to reside appears based more on factors such as the labor market conditions, the employment outlook, the residential home market, the family value, the quality of some local services – transports, education, health care – the cost of living.

6.3 The situation of the regional vehicle tax (RVT)

The vehicle tax is, in theory, very interesting from the point of view of tax competition, being one of the most "own" taxes of the ordinary regions (and of the two special provinces of Trento and Bolzano). Regions not only are completely responsible for the management of the tax but there is not a maximum rate set by CG: starting from the standard rate set by CG, Regions can increase or decrease this rate up or down to 10% each year. If this power were used, the tax rates could be very differentiated among the regions. Nevertheless, only the Province of Trento uses a tax rate lower (of 11%) than the standard one. Of the remaining 17 cases, where the RVT is regional, 10 use the standard tax rate and 7 a higher tax rate (3 of which, Campania, Calabria and Abruzzo, have a considerable budget deficit in the health sector) (fig. 14).

Why tax competition on RVT is so limited? Two reasons may provide some explanations:

- The tax must be paid to the regions where the vehicle owner has his residence;
- The movement of taxpayers across the regions, given the other additional costs needed to change the physical residence, cannot be justified only by accounting the relatively limited amount of the tax paid, even if the tax rate in some specific regions were much below the standard level.

Of course, car renting companies could be interested to locate their headquarters where the tax rate is lower, given the huge number of vehicles they have. But for these firms other factors may be more important than the RVT rate: for example, the amount they have to pay for the public-liability insurance of their vehicles, amount which is very different across regions, given the risk level as assessed by insurance companies.

7 Why in Italy tax competition is so small?

There are many factors that may partially explain why in Italy tax competition is so low:

a) the aim of the CG to achieve a fiscal consolidation of its budget has imposed on all regional budgets many constraints and tensions. In addition, the public finance of some SCGs is largely unbalanced and requires some special efforts to comply with the Domestic and Stability Pact. The yield of regional main taxes must be devoted to finance the health care, where the expenditure requirement is very demanding and inelastic because each region has to guarantee some essential levels of health care services set by the CG. Therefore, in the end the room to reduce the tax rates is very little, also in the rich regions of the North. Moreover a similar situation is valid also for the local governments, but their budget is more flexible, at least because they have more possibilities to finance the cost of their services through tariffs and fines (most of all on users of vehicles);

b) In Italy, perhaps more than in other countries, there is a large room of manoeuvre to reduce the unproductive public expenditure. So the CG is promoting a competition between SCG in this field, more than on the tax competition.

c) the structure of the equalization system does not raise incentives for tax competition, being targeted on the revenue yield applying taxes at the standard level;

d) the most suitable tax for tax competition is Irap; the range of rates manoeuvrability allowed to regions in theory could be significant for the choice of a firm's location. But this does not happen because:

- in the choice of a firm's location, other factors seem in the end more important (the social capital of each region, the level of infrastructure and services – as telecommunications and transport – the efficiency of public administration, other incentives granted by CG, the EU and the regions);
- tax base and tax revenue are given to the region where is located the production and not only the legal site of the firms.

e) Also for the RSIrpef, the range of manoeuvrability allowed to the regions is in theory significant, but not sufficient to convince people to "vote by the feet". The region of residence is chosen taking account of other more important factors like the work availability, the cost of apartments, the level of house rents, the proximity with the family, the cost of living, the level of the public services (health and education)…

f) The fact that many South regions are obliged by CG to apply Irap and RSIrpef at the maximum rate to cope with their unbalanced budget situation, prevents the use of the tax competition exactly where it could be more useful – i.e. in poorer regions, obviously keen to attract tax base from richest regions. Moreover, this constraint pushes the other regions unintentionally in a situation of free rider: it is possible to ensure some fiscal advantages to their citizens and firms, also by applying IRAP and RSIrpef at the standard rate.

We have then to conclude that fiscal autonomy in Italy is useless, just because it does not permit a significant tax competition?

We believe this is not the case. In fact, fiscal autonomy seems to be however a very crucial factor since:

- it gives to the region an essential tool to cope with budget deficits by using ordinary sources of revenue and reducing the need for indebtedness;
- the manoeuvrability of Irap can help the regions to promote productive sectors believed virtuous;
- the manoeuvrability of RSIrpef makes possible for the regions to reduce the weight of the tax on poor families;
- the fiscal autonomy is in any case an important factor for improving the accountability, at least when the performance of specific regions is very poor.

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Table 1

Corporation tax rate reductions in the EU for retained earnings, 2003–06[a)]

	Reduction (percent)	Year of reform
Austria	34 to 25	2005
Belgium	39 to 33	2003
Cyprus	25 to 15 to 10	2003, 2005
Czech Republic	31 to 28 to 26 to 24	2004, 2005, 2006
Denmark	30 to 28	2005
Estonia	26 to 24 to 23	2005, 2006
France	35.4 to 34.9 to 34.4	2005, 2006
Germany	32 to 30.5	2004
Greece	35 to 32 to 29	2005, 2006
Hungary	18 to 16	2004
Italy	36 to 34 to 33	2003, 2004
Latvia	22 to 19 to 15	2003, 2004
Netherlands	34.5 to 31.5 to 29.6	2005, 2006
Poland	28 to 27 to 19	2003, 2004
Portugal	30 to 25	2004
Slovak Republic	25 to 19	2004

[a)] Reductions shown are for national tax rates only. The diagrams also include local taxes on profit.

Table 2 - Regions' main own taxes

Own taxes	IRAP	RSIrpef	RTV	Total
All the Regions				
tax revenue 2007	37,744	7,455	4,569	49,768
% of total own tax revenue	73.7	14.6	8.9	97.2
% of total current revenue	28.3	5.6	3.4	37.3
Ordinary Regions				
tax revenue 2007	33,580	6,762	4,464	44,805
% of total own tax revenue	73.3	14.8	9.7	97.8
% of total current revenue	33.4	6.7	4.4	44.6
Special Regions				
tax revenue 2007	4,164	693	106	4,963
% of total own tax revenue	77.3	12.9	2.0	92.2
% of total current revenue	12.6	2.1	0.3	15.1

Source:based on data ISSiRFA-CNR

Table 3 - Main own taxes of Communes

Own taxes	ICI	MSIrpef	Total
All the Communes			
tax revenue 2007	12,778	2,240	15,018
% of total own tax revenue	62.8	11.0	73.9
% of total current revenue	24.3	4.3	28.5

Source: National Accounts

Table 4 - Range of taxing powers attributed to SCGs on principal own taxes

Range of powers	Regions			Communes	
	IRAP	RSIrpef	RTV	ICI(*****)	MSIrpef
Possibility not to levy the tax	no	no	no	no	Yes
Possibility to choose the tax rate (inside a range determined by CG)	yes	yes	yes	yes	yes
General tax rate at which the tax must be levied if SCGs do not choose a different one	4.25% of the value of the tax base (*)	0.9% of the value of the tax base	2.80 euro/Kw (**)	0.004% of the value of the tax base	–
Permitted range of tax rates	3.25% - 5.25%	up to 1.4%	10% each year, up and down	up to 0.007%	up to 0.2% (of the value of the tax base) each year. Max 0.5%(***)
Possibility to vary the tax rate for specific categories of tax payers	yes	yes	yes	yes	no (****)
Possibility to decide some aspects of the tax management	yes	no	yes	yes	no
Possibility for CG to oblige SCGs with budget deficits to apply the tax at the maximum rate	yes	yes	yes	yes	Yes
Possibility for CG to change autonomously the discipline of the tax or to abolish the tax	yes	yes	yes	yes	Yes

(*) 3.90% from 2008. The range of rate variability is +/- 1%.

(**) tax rate for cars in the pollution class euro 2, with no more than 100 kw

(***) From 2007, the upper limit is 0.8% and the 0,2% limit for the yearly increase has been abolished

(****) Yes from 2007

(*****) Ici on the first dwelling abolished in 2008

Figure 1

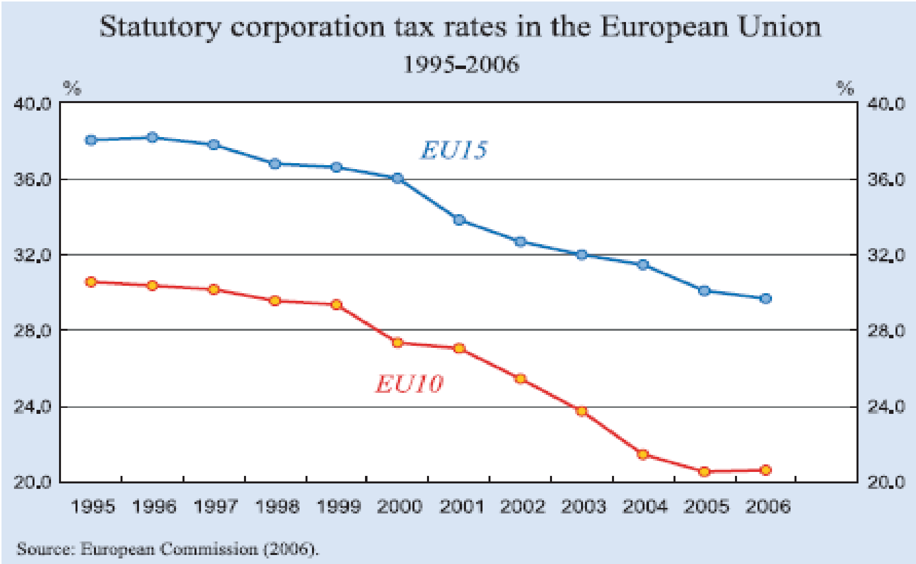


Figure 2: the evolution of corporate tax rates in OECD and EU, 1995-2006

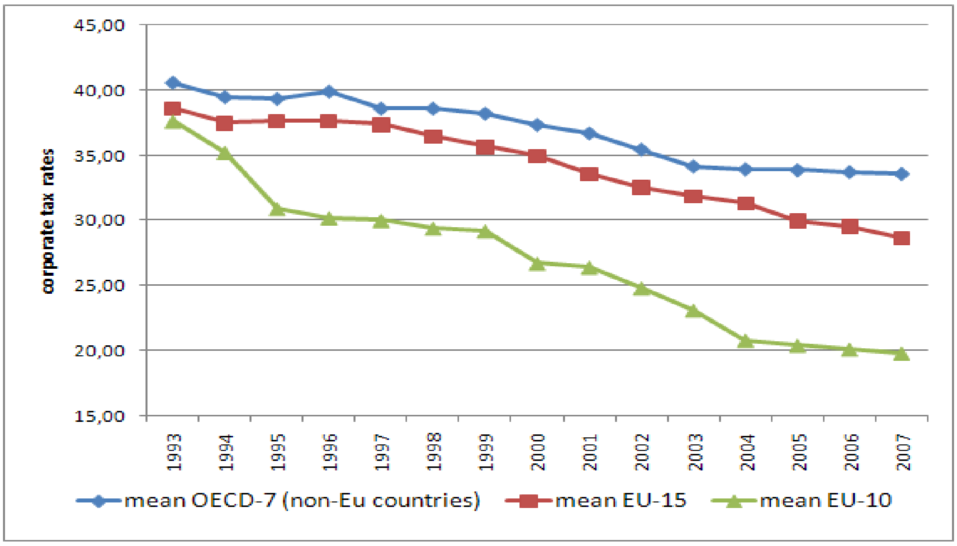


Figure 3

Cantonal and (Weighted) Local Individual Income Tax Rates (in %) on Annual Taxable Income of Less than Sfr 30'000, 1983 – 1999

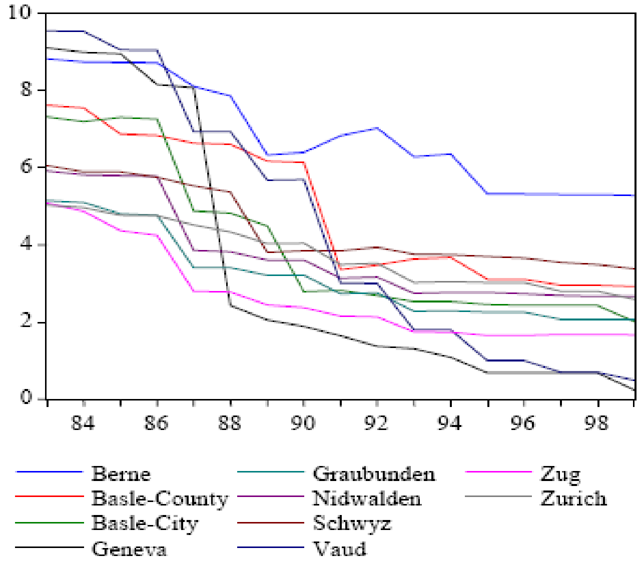


Figure 4

Cantonal and (Weighted) Local Individual Income Tax Rates (in %) on Annual Taxable Income of Sfr 80'000 to 100'000, 1983 – 1999

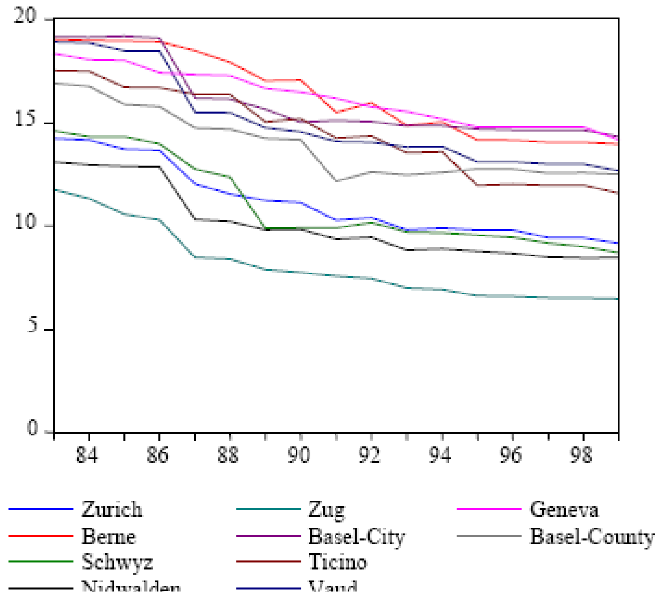
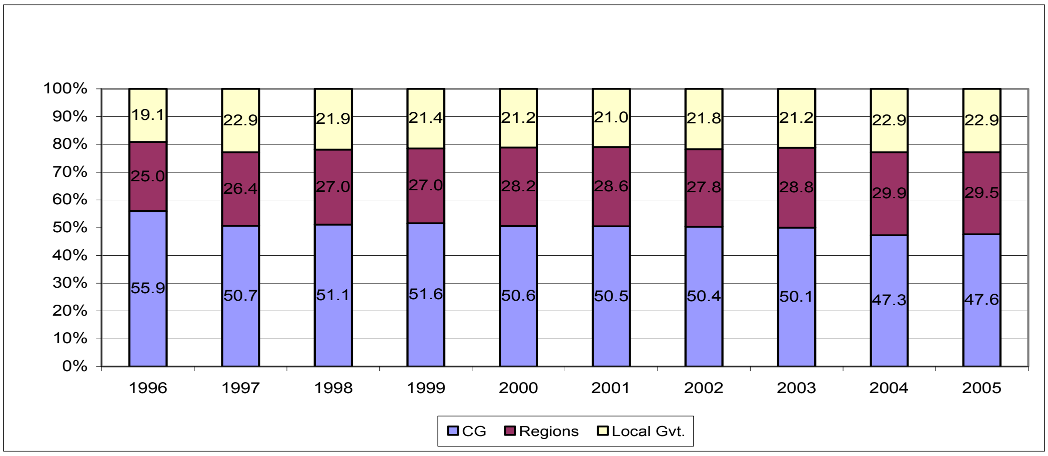
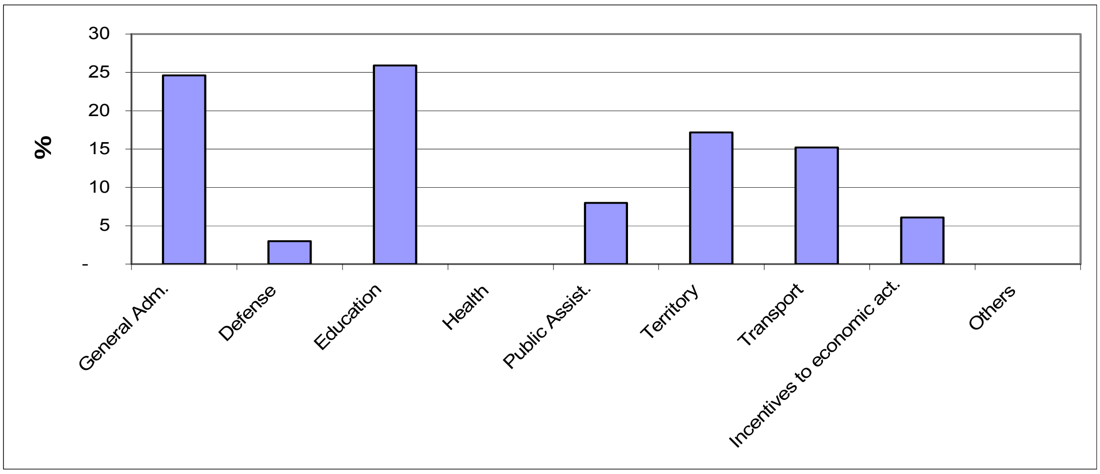


Figure 5 - Total final public expenditure by level of government in Italy



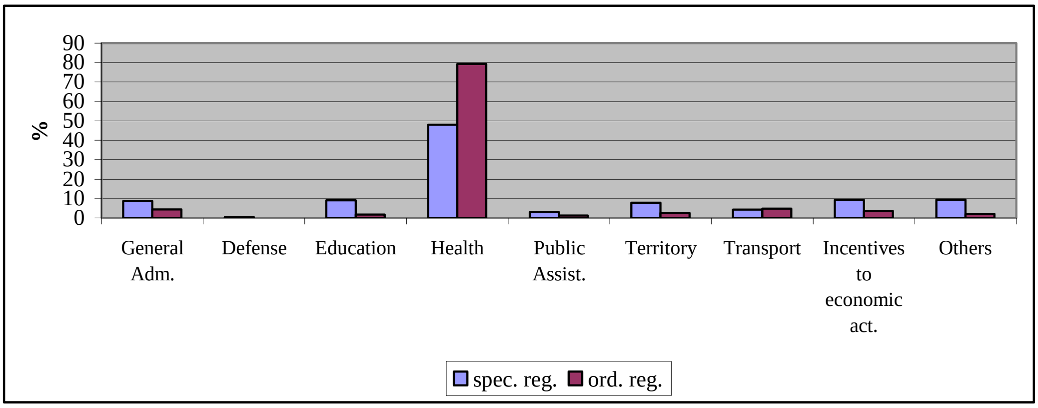
Source: based on data of Ministry ef Economy - Dpt. for development policies

Figure 6 - Total expenditure of Local Govt. by function (%) - Year 2007



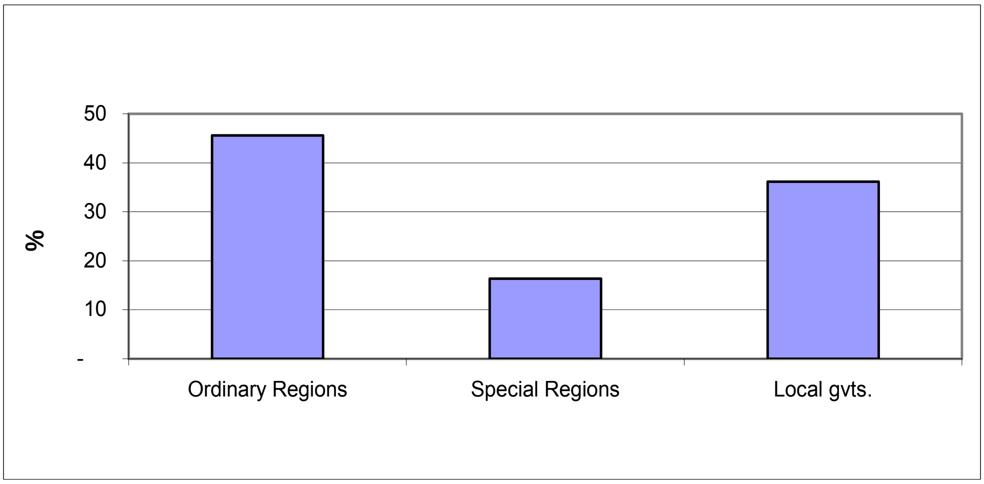
Source: based on data of Ministry ef Economy - Dpt. for development policies

Figure 7 - Total expenditure of Regions by function (%) - Year 2007



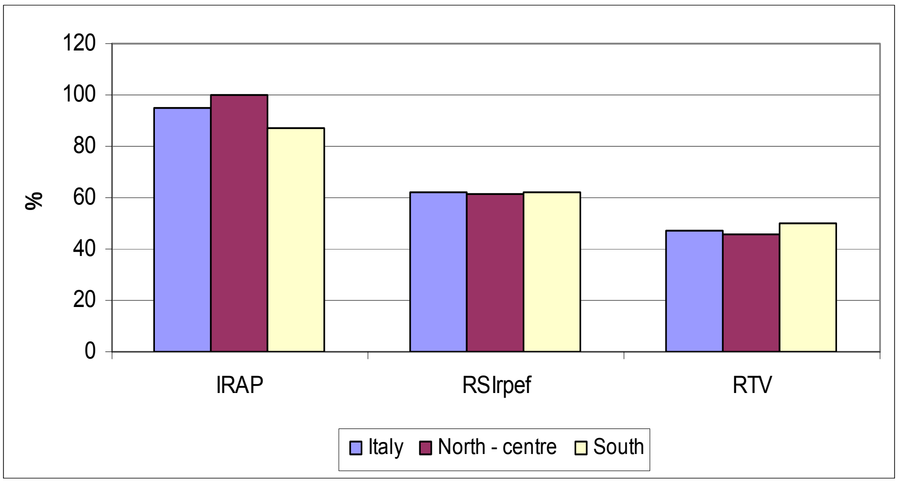
Source: based on data of Ministry ef Economy - Dpt. for development policies

Figure 8 Level of fiscal autonomy (1) for Ordinary Regions, Special Regions and local Gvt. - Year 2007



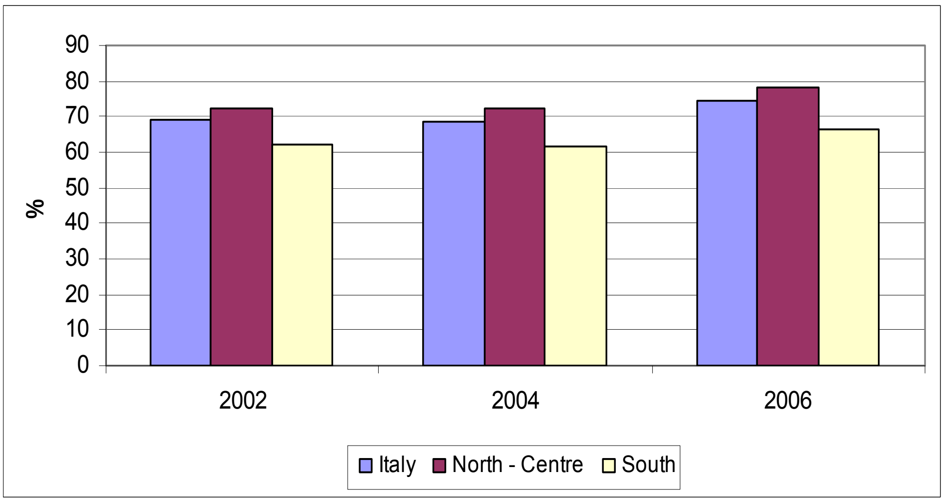
(1) Own tax revenue / total current revenue
Source: based on data of Ministry ef Economy - Dpt. for development policies and on data Issirfa-cnr

Figure 9 - % of Regions using their tax power (main regional taxes) - Year 2007



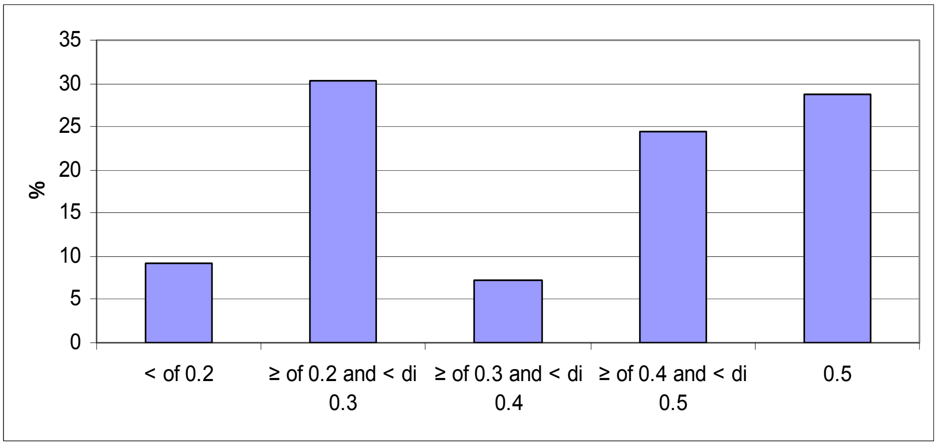
Source: based on data of Corte dei Conti, Relazione sulla gestione finanziaria delle regioni
Roma 2007

Figure 10 - % of Communes which apply the MSIrpef - Years 2002, 2004, 2006



Source: Ministero dell'interno, Dipartimento per gli affari interni e territoriali, Relazione annuale sullo stato di attuazione della addizionale comunale all'Irpef

Figure 11 - Communes which apply the MSIrpef - % distribution by level of tax rate - year 2006



Source: Ministero dell'interno, Dipartimento per gli affari interni e territoriali, Relazione annuale sullo stato di attuazione della addizionale comunale all'Irpef

Figure 12 – Irap –Rates applied by each region – Year 2007

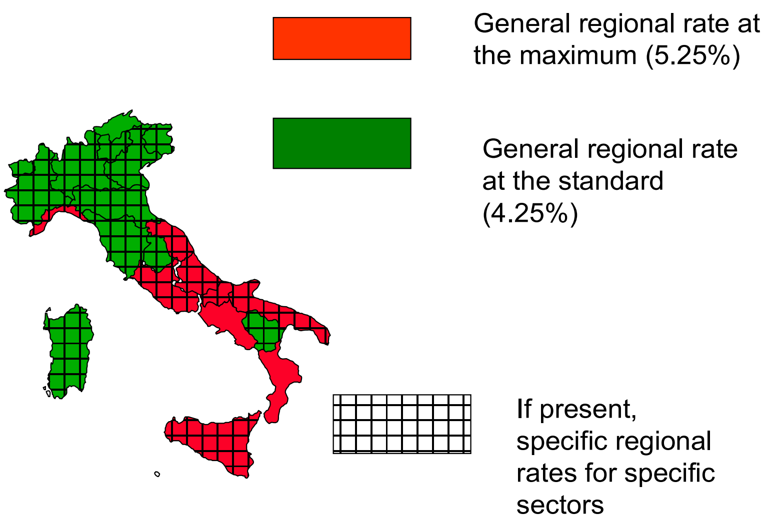


Figure 13 – RSIrpef – Rates applied by each region – Year 2007

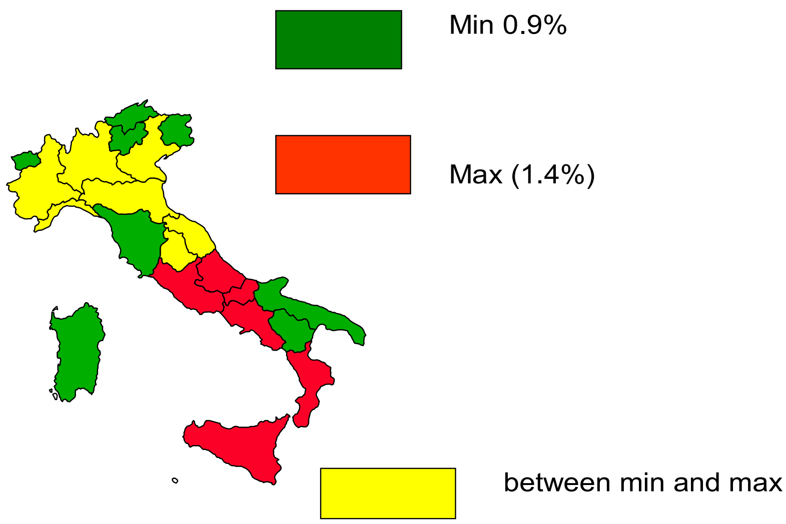


Figure 14 – RTV – Rates applied by each region (euro 2, up to 100Kw) – Year 2007