Political Support and Tax Reforms: An Italian Example

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Tax reforms are at the centre of the economic and political debate in all European countries. Changes in the personal income tax schedule have been recently implemented or planned in several European and OECD countries. A general trend is to reduce the complexity of income tax rates. Between 2000 and 2005 most of the OECD countries cut the number of tax brackets, with the exception of Canada, Portugal and the US, which added one instead. Nevertheless, the effect on tax progressivity is not clear, because there has mainly been a reduction in marginal tax rates at the top of the income distribution and at the bottom, while tax rates for the middle classes have generally remained unchanged (Bernardi and Profeta 2004).

A clear example of reforms moving in this direction is Italy. Reforms of personal income tax (IRPEF) are included in the political agenda every year. In 2001 the center-right government introduced a personal income tax reform that was to be implemented in successive phases. A first phase, implemented in 2003, focused on reducing taxes for the bottom income levels. Together with a second phase, implemented in 2004, the reduction of taxes produced higher gains for low-income and high-income individuals than for those with incomes in the middle range. In 2007 the new center-left government introduced additional changes in the personal income tax design, the redistributive impact of which was mainly focused on low-income groups. Equity and efficiency arguments are often advocated to justify these changes: the reduction of bottom tax rates has been largely justified by equity arguments, and the reduction of top tax rates by incentive-efficiency arguments.[1] Financial constraints are also crucial to limiting tax rates reductions at all levels of income and prevent them from being applied to the numerically stronger income-groups.

However efficiency and redistributive issues do not exhaust all forms of motivation for taxation and tax reforms. Political constraints are also a crucial determinant of tax reforms. Many governments introduce tax reforms prior to an election as an attempt to attract votes, especially from undecided voters who may be decisive for winning elections. In this article I will argue that this motivation was crucial for the 2004 Italian personal income tax reform.

The introduction of political considerations into the economic analysis of public policy reforms may prove a successful approach. This may be particularly appropriate in the analysis of tax reforms, since taxation represents one of the hottest issues on the economic agenda and a crucial issue for voters' decisions. However, applied political economy contributions in this area are still quite limited. It is thus interesting to see how the aim of gaining political support may drive political decisions with respect to tax reforms and to understanding how this mechanism works in specific cases.

A probabilistic voting approach

The literature on political economy has provided many approaches for including political arguments into the economic analysis of redistributive public policies (see Persson and Tabellini 2000 and, for taxation, Hettich and Winer 2000). One of the main conclusions of these studies is that to be implemented and sustained, public policy reforms not only need to be economically feasible (on financial, efficiency and equity grounds) but also politically feasible, i.e., they need voters' support (for an analysis of social security, see Galasso and Profeta 2004).

Interestingly, to gain political support, politicians need not target the numerically stronger groups of voters. A possible strategy for a government to obtain political support for a reform is to attract undecided voters. In many cases their decision can have a decisive effect on the outcome of elections. The attempt to win their vote may thus prove to be more successful than trying to attract groups of voters that are numerically stronger.

This idea is appropriately captured in a probabilistic voting model (Coughlin 1992; Lindbeck and Weibull 1987) which underlines the potential role of undecided voters. This approach highlights the importance of swing voters – ideologically neutral individ-

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[1] Atkinson (2004) provides alternative models to explain the evolution of top incomes in connection with taxation.

uals – who can be easily won by either party by adopting an appropriate policy in their favour. Thus, the political success of a party depends on its ability to attract swing voters, i.e., the more mobile voters.

In Profeta (2007) I considered three groups of individuals of different size – rich, middle-income and poor – and two political parties (A and B). Before the election takes place, each party, simultaneously and independently of each other, commits to a policy platform. Each party chooses a platform that will maximize its expected number of votes. The individuals are heterogeneous with respect to their ideological preference for a party. This includes a common component measuring the general popularity of a party and an individual component representing his/her ideology. Since ideological preferences are established between the announcement of the party platforms and the election, the outcome of the elections is uncertain.

This political game determines the equilibrium between personal income tax rates for each group and the level of a general transfer financed by the taxes on personal income.[2] The budget has to be balanced.

Each group of individuals has neutral voters or "swing voters", who are indifferent to the two parties. The identity of the swing voters is crucial for the party when considering whether it should deviate from a common policy announcement or not. Suppose party A decides to decrease the taxes of group 1, which is financed by a budget-balanced increase of taxes to group 2. Party A expects a gain of votes from group 1 equal to the number of swing voters in group 1, and a loss of votes from group 2 equal to the number of swing voters in group 2. If group 1 has a higher number of swing voters than group 2, this will lead to a net gain of votes. As a consequence, each party tries to attract the more mobile voters.

I obtained the following two predictions on the average tax rate on personal income, the intuition of which is straightforward:

- Groups with a higher income will pay a higher tax rate (progressivity). A higher tax rate for richer individuals has a direct negative effect on their utility, but a larger positive effect on the utility of all groups due to an increase in the total level of transfer. Moreover, groups with a larger tax base will pay a higher tax rate. Given the budget-balanced constraint, it is more convenient to impose a higher tax on groups with a larger tax base (more numerous and/or richer). If middle-income individuals are more numerous, this tax base effect may explain why it is very difficult to decrease their tax rates in order to avoid a large loss of revenues.
- Groups with more relative political influence, i.e. containing more swing voters, will pay a lower tax rate. This is because they are more attractive for the party.

[2] Notice that policy-space is multidimensional, and a Nash equilibrium of a majoritarian voting game may fail to exist. However, a probabilistic voting approach is appropriate also for addressing this issue.

Elections in Italy

These predictions are in line with what happens in many countries when governments discuss and formulate tax reforms.

In Profeta (2007) I analyzed the 2004–05 Italian personal income tax reform implemented by the center-right government with the explicit motivation of attracting the large number of swing voters. The reform comprised a rearrangement of tax brackets, tax rates and deductions. The first step of the reform was targeted to the bottom incomes by introducing a new scheme of deductions leading to a no tax range for incomes below EUR 7,500 (for employees). Tax brackets and tax rates were also rearranged (Table). The second intervention was a deeper change in the tax schedule, as presented in the Table. The initial proposal, however, was in fact a much more radical modification of the tax design, including total exemption from taxation for individuals with income below EUR11,000 and two tax brackets only (Table). These changes produced two main results: (i) a reduction in the total level of revenues, due to lower taxes for all income groups, and (ii) higher gains for low-income (first phase of the reform) or high-income individuals (second phase) than for middle-income ones. The original proposal would have favoured the richest individuals even more.

I argue that these government choices were driven by electoral pressure. At the time of the reform, capturing the swing voters was decisive for winning the next elections and the issue of taxation was used as an instrument to reach this goal. Some interesting

Table

Irpef brackets and tax rates

Irpef 2002		First step (2003)		Second step (2004)		Initial proposal		Irpef 2007	
brackets (euro)	tax rates (%)	brackets (euro)	tax rates (%)	brackets (euro)	tax rates (%)	brackets (euro)	tax rates (%)	brackets (euro)	tax rates (%)
0–10,329	18	0–15,000	23	0– 26,000	23	0–100,000	23	0–15,000	23
10,329–15,494	24	15,000–29,000	29	26,000– 33,500	33	over 100,000	33	15,000–28,000	27
15,494–30,987	32	29,000–32,600	31	33,500–100,000	39			28,000–55,000	38
30,987–69,722	39	32,600–70,000	39	over 100,000	43			55,000–75,000	41
over 69,722	45	over 70,000	45					over 75,000	43

Source: Italian Ministry of Economics and Finance; http://www.mef.gov.it/.

survey data confirm this argument. Taxation was a crucial issue in the policy platform proposed by the government. During the electoral campaign in 2001, the centre-right coalition set taxation at the centre of its economic program, promising to the electorate to “cut taxes for everyone”. This resulted in increased trust on the part of the voters: a poll conducted by UNICAB in 2001 found the right-wing coalition to be more credible than the opposition on such issues as taxation, security and immigration. In April 2004, according to a poll conducted by ISPO, 19.6 percent of the people who voted for the winning coalition found taxation the most important issue in contrast to an average of only 11.3 percent for the total sample. However, after a few years the taxation issue led to an increased number of disappointed individuals among those voters who had supported the elected government in the 2001 elections, because the promised “tax cut” had not yet been implemented. According to an ISPO poll in February 2004, 70 percent of the Italians thought that taxes were too high and unequally distributed among citizens. Interestingly, this criticism was almost uniformly distributed across the different political parties, meaning that this was not an “ideological” issue but an issue over which voters tended to be ideologically neutral. This also suggests that it was a quite popular issue, and that it could move voters.

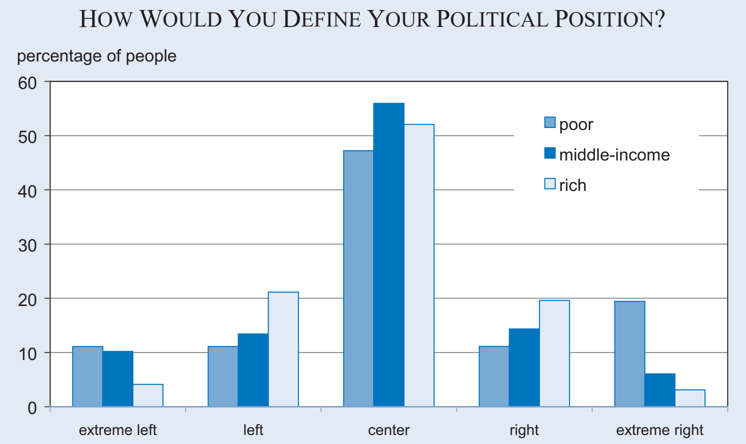
Before the 2004 reform an increasing number of voters claimed to be undecided about how they would vote at the next elections. According to ISPO polls, in October 2004, 12 percent of those who had voted for the winning party declared they were dissatisfied, while in November 2004 this percentage increased up to 17 percent. Taxation issues were responsible for much of this discontent: in November 2004, more than 40 percent of those who had voted for the winning party declared they were disappointed by the government’s decisions about taxes (ISPO, 12/11/2004). Moreover, people who had said they were undecided were generally dissatisfied (55 percent in October 2004, 59 percent in November 2004, ISPO 2/11/2004). A survey conducted by Fondazione Rodolfo De Benedetti revealed that in November 2004 about 30 percent of the total population was undecided about how they would vote in the next elections.

These survey results suggest that during 2004 the Italian government realized that the number of undecided voters was increasing and that to attract them it would be essential to win the next elections. It also realized that a crucial issue was taxation, an issue over which voters evaluated the effects of the proposals independently of their ideology. While the promise of a tax reform was able to attract votes during the electoral campaign of 2001, most of the discontent of voters towards the government in 2004 was caused by the delay in its implementation. Thus, in 2004 the government implemented tax reform as a top priority to re-attract disappointed, undecided voters.

However, survey data also show that the swing voters concentrated at the “centre” of the political spectrum were almost uniformly distributed among income classes (Figure). Thus, the specific redistributive strategy of the reform, which tended to favour high-income and low-income individuals but not the middle class, turned out not to be the best strategy to win elections. In particular, while many “swing voters” can be attracted by tax reform, no survey evidence supports the fact that, for example, the group of “rich” voters contained more swing voters than middle-income groups.

Using the answers of Italian citizens to a survey conducted by Fondazione Rodolfo de Benedetti to the

Figure



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

question, "Which party would you vote for if there were elections next Sunday?", I show in a simple multilogit analysis that the outcome "center-right coalition" had a predicted probability of 0.4488, while the outcome "center-left coalition" of 0.4037, and the outcome "undecided" of 0.1474 (Profeta 2007). This result confirms that capturing the votes of swing voters would have been decisive in winning the elections. However, while being at the centre of the political spectrum was significant in increasing the probability of undecided, and thus of being a potential swing voter, being poor or rich was not significant in affecting the probability of being undecided. Thus, the identity of the swing voters did not depend on their income.

Therefore, while personal income tax reform was an appropriate strategy to attract the undecided voters, the specific design of the reform was not entirely appropriate, since swing voters were not concentrated in the income groups that gained more from the reform.

It is interesting to note that the 2006 elections were won by the center-left coalition by a small number of votes, meaning that the electoral race was very close and undecided voters turned out to be decisive. To confirm that taxation is one of the main issues of the Italian policymakers' agenda, the new government introduced in 2007 additional changes in the personal income tax design (tax brackets, tax rates and a general shift from deductions to tax allowances, see the Table), the redistributive impact of which was mainly focused on low-income groups. This was clearly driven by political reasons, since individuals ideologically close to these groups supported the new government. However, swing voters again seem to be concentrated around the middle-class, whose recent declarations of disappointment towards tax issues should be seriously taken into account.

Conclusion

In Italy, as in many other countries, tax reforms are one of the main points in the economic agenda of the government. Their success may crucially influence the outcome of elections. The Italian center-right government realized this in 2004 and introduced a personal income tax reform. The specific design of the reform was, however, not appropriately targeted to swing voters. In 2006 the elections were won by the center-left coalition, which, in turn, immediately introduced several changes in the personal income tax design.

The applied probabilistic voting approach may help us to understand the political feasibility and success of tax reforms in many respects, such as the redistributive impact of taxation, progressivity, horizontal equity, tax complexity, tax neutrality, tax competition etc.

It is also useful to understand why, in spite of being economically desirable, structural reforms are often politically unfeasible and thus fail to be implemented, while marginal and parametric adjustments tend to prevail.

These arguments obviously apply beyond the field of tax reforms and may in general produce interesting insights for the analysis of redistributive public policies.

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