



Political cycle and reported labour incomes in Italy: Quasi-experimental evidence on tax evasion

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ABSTRACT

Tax evasion is a complex phenomenon affected by many factors and shaped by policymakers' and citizens' behaviours. Distinct claims about the acceptability of tax evasion between centre-right and centre-left coalitions have clearly emerged in Italy in the last decades. According to the ruling coalition, these different attitudes could have influenced tax compliance, affecting reported incomes of the self-employed, who have much more room to engage in tax avoidance or evasion strategies than employees. Using a longitudinal administrative dataset recording the entire working life of the sampled individuals, we focus on the period 1996–2005 (the only period when a complete bi-partisan political cycle took place in Italy) and, following a difference in differences design and carrying out fixed effects estimates, we test whether self-employed earnings, compared to employees earnings, significantly changed after the change in the ruling coalition. We find a clear reduction in self-employed reported earnings when the centre-right coalition ruled.

"Il prelievo fiscale corretto si aggira intorno a un terzo del reddito, se invece le tasse sono tra il 50 e 60% è troppo e così è giustificato mettere in atto l'elusione o l'evasione".

"The correct tax burden is about one third of the income; it is too much if the tax burden is approximately 50 or 60%, thus it is justified to resort to tax avoidance or evasion."

Silvio Berlusconi, speech during the electoral campaign, April 2008.

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1. Introduction

The economic literature shows that the self-employed and employees strongly differ with respect to their tax compliance (e.g., Andreoni et al., 1998; Bruce, 2000; Slemrod, 2007). In most countries, employees usually get taxes paid on their behalf by the employer, whereas the self-employed directly deduct taxes from their gross income, giving them greater opportunities to underreport labour income (e.g., artificially reducing proceeds or increasing production costs).

Weak party positions on combating tax avoidance and evasion may attract the self-employed's votes; likewise, different party attitudes towards the self-employed and tax evasion may affect the self-employed's propensity to correctly report labour incomes, affecting determinants of tax compliance and tax morale. On the one hand, different policies (e.g., measures easing tax avoidance or affecting the probability of receiving an audit) may be implemented by differently oriented parties, thus affecting the propensity of citizens to underreport their incomes. On the other hand, when a pro-self-employment party is ruling, the self-employed may feel that the political atmosphere is more favourable to their wishes—and this feeling may be strengthened by explicit politician claims or by the introduction of tax amnesties—thus leading the self-employed to expect fewer controls and risks in the case of inaccurate tax files.

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Disentangling the determinants of tax evasion is a crucial issue for Italy, which has one of the highest levels of tax evasion of any developed country (Schneider and Enste, 2000). Distinct claims about the acceptability of tax evasion between centre-right and centre-left coalitions have clearly emerged in Italy since the 1990s (Livadiotti, 2014). The centre-left coalition has often stressed that fighting against tax evasion is a priority, whereas Silvio Berlusconi, the leader of the centre-right coalition since 1994, has repeatedly stated that evading excessively high taxes is justifiable.

As confirmed by the analyses of elections carried out by political scientists (Caciagli and Corbetta, 2002; Diamanti and Lello, 2005), the self-employed—who represent a large share of the Italian workforce¹—are the strongest political constituency of centre-right parties, whereas the majority of private and public employees support centre-left parties. Therefore, right-wing parties should pay more attention to the needs and requests of the self-employed, who frequently ask for a large reduction in their tax burden and consider the centre-left coalition as “tax lovers” (Mastro Paolo, 2009).

However, it is very difficult to examine the effect of political cycles on tax compliance in Italy because Governments are usually in power for short periods and the Centre Catholic party *Democrazia Cristiana* had the relative majority of votes and was in control of the Government (in a coalition with other smaller parties) from 1946 until 1994. The only completely bipartisan political cycle took place in the decade 1996–2005, when the centre-left coalition was in control of the Government for a 5-year period (April 1996–April 2001) and, afterwards, the centre-right coalition ruled from May 2001 to March 2006.

The literature on political economy has extensively studied the effects on the economic variables due to the interactions among voters and politicians; however, to the best of our knowledge, no emphasis has been placed on examining the effects on citizens' tax compliance due to parties' attitudes towards different groups of workers and towards contrasting tax avoidance and evasion.

The original contribution of this paper is thus to inquire whether the Government change from centre-left to centre-right leadership affected self-employed tax compliance in Italy in the decade 1996–2005. Assuming that relative changes in reported incomes between self-employed and employees can be considered a good proxy of changing tax evasion, we aim to test whether the supposed different attitudes of the two ruling coalitions towards the self-employed and tax evasion (in addition to influencing the votes of self-employed and employees) led to an effective change in self-employed reported incomes—compared with employees' reported incomes—when the coalition in control of the Government changed.

We have at our disposal neither data on actual incomes earned by the self-employed and employees (hidden information) nor data on the amount of individual tax evasion found by the fiscal administration. Using a longitudinal administrative dataset where a person's entire working life and annual gross earnings reported to the public administration are recorded, we carry out panel fixed effects estimates and follow a difference in differences (DID) design, considering private employees (whose chances to underreport earnings are very limited) as the control group and two types of self-employed—craftsmen and merchants (i.e., the shopkeepers, both trader and retailer), the typologies of self-employed tracked in the administrative sample—as the treatment group and consider the coalition change in 2001 as the shock. Then, controlling for individual characteristics, business cycle and time trends, we carry out panel estimates to measure whether the self-employed reported earnings significantly changed compared with employees' reported earnings from 1996–2000 to 2001–2005.

Note that our strategy does not allow us to compute the share of real earnings that is underreported by the self-employed and employees. Instead, focusing on reported labour income, our strategy allows us to identify the change in income underreporting that follows a change of the ruling coalition, which we can interpret as a “marginal” effect of the Government change on tax evasion.

The paper is organised as follows. We briefly review the literature on tax compliance and political cycles (Section 2) and the main measures affecting tax evasion implemented in Italy in the period 1996–2005 (Section 3). Then, after having presented the characteristics of the dataset (Section 4), we use descriptive evidence provided by our dataset and other data sources about the living standards of self-employed and employees in the period 1996–2005 to corroborate our assumption that changes of reported incomes could be interpreted as changing tax evasion behaviours (Section 5). Afterwards, we present the empirical strategy (Section 6) and show our findings (Section 7). Section 8 concludes, summing up the main evidence.

2. Political cycle, tax compliance and its determinants: related literature

According to the seminal model of Allingham and Sandmo (1972), the rational taxpayer chooses the amount of the income to report and the quantity to evade when he/she fills in his/her income tax file. The decision is affected by the probability of being detected by the tax authority in case of underreporting and by the penalty in case of detection. Following this approach, tax compliance depends on the tax rates, audit frequencies and fines.

However, in the last two decades, the empirical research has shown that tax compliance is not fully explained by these variables because it also depends on individuals' “civic duty” (Orviska and Hudson, 2003) or “tax morale”, which can be defined as the intrinsic motivation to pay taxes and is affected by the moral regret or guilt over cheating on taxes (Torgler, 2005). Therefore, the choices of taxpayers depend both on rationality and on other factors such as the subjective perception of the beliefs and the behaviours of other members of the community (Kirchler, 2007; Erard and Feinstein, 1994; Fortin et al., 2004).

Investigating the determinants of tax morale, Lago-Peñas and Lago-Peñas (2010) notice that a high tax burden makes the taxpayers feel entitled to evade, and Feld and Frey (2007) argue that tax compliance is affected by a sort of “psychological tax contract” that citizens sign with the State on the basis of the fiscal exchange (public services versus taxes), the personal relationship between

¹ According to EUROSTAT data the share of the self-employed, representing about 10 million voters, is much higher in Italy than in other EU countries (in the last decade around 23% in Italy vs. an average share of about 14% in EU28 and EU15).

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