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In search of yardstick competition: a spatial analysis of Italian municipality property tax setting

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Abstract

This paper uses Italian local government data to test for fiscal interaction arising from yardstick competition. To discriminate yardstick competition from competing theories of strategic interaction, we account for the incentives and constraints generated by the electoral system, in particular for the presence of term limits and the size of the majorities supporting the mayors. Estimation of a local property tax setting equation uncovers positive spatial auto-correlation in local tax rates of jurisdictions where the mayors run for re-election in uncertain contests, while interaction is absent where either mayors face a term limit or are backed by large majorities.

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1. Introduction

One of the most interesting recent developments in empirical local public finance is the growing evidence of strategic interaction in tax and public spending determination.[1]

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[1] Ladd [26], Case [21], Case et al. [22], Kelejian and Robinson [25], Murdoch et al. [27], Besley and Case [5], Shroder [34], Bivand and Szymanski [10,11], Buettner [20], Heyndels and Vuchelen [24], Brueckner [17], Brueckner and Saavedra [19], Figlio et al. [23], Brett and Pinkse [16], Saavedra [32], Revelli [29–31], and Sole-

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Unfortunately, such empirical evidence might be consistent with different competing theories of local government behavior.

For example, the fact that local tax rates tend to be correlated across neighboring jurisdictions has been variably interpreted as arising from public expenditure spill-overs, tax competition or yardstick competition.[2] Worse than that, these theories may have very different, indeed contrasting, normative implications, so that the observer is left without solid grounds to judge this evidence.

As usual in empirical analyses, the above indeterminacy arises from one (or both) of the following reasons. Either alternative theories may be observationally equivalent, or the available data set may not be rich enough to allow discrimination among their different predictions. Consequently, solving these problems requires one either to carefully re-examine the implications of the theories to be tested, or to build a better data set.

In this paper, we follow both strategies, looking for evidence of yardstick competition across local governments in Italy. We focus on this theory for a number of reasons. First, as forcefully argued by Salmon [33], yardstick competition theory may provide new and powerful insights on the structure of government in democratic countries. If it were really the case that citizens made comparative performance evaluation across governments in order to understand the quality or the competence of their politicians, a new approach to key issues of fiscal federalism would follow. For example, if this evaluation is beneficial to citizens, one would then want to organize, say, the allocation of functions and resources to local governments so as to maximize this behavior, possibly in contrast with the suggestions of traditional theory (as summarised, for example, by Oates [28] or Wildasin [38]).

A second motivation is that the interest in these issues is not purely academic. Indeed, several European countries—where one would expect other forms of competition across governments, such as the celebrated Tiebout [37] 'voting by feet' to be less relevant than, say, in the United States—are actually involved in deeply reforming their local government structure.[3] Knowing if yardstick competition is a true phenomenon may then help them in designing a better institutional framework.

In order to investigate the presence of yardstick competition, one has to find specific empirical implications of the theory. As we argue in Section 2, the key insight of yardstick competition theory is that tax setting behavior and the features of the electoral system should be considered at once in the empirical analysis. Consequently, we test the theory on a sample of Lombardian municipalities, by estimating a property tax setting equation that fully exploits both the institutional structure of the Italian system of local government and the techniques developed within the spatial econometrics literature (Anselin [1], Anselin and Florax [3], Anselin et al. [2]). As argued below, careful spatial econometric testing,

Olle [35], all found evidence of interdependence in local government fiscal choices, using a variety of data sets and estimation techniques.

[2] See Wilson [39] and Brueckner [18] for recent reviews.

[3] In Italy, for example, the idea that decentralization and the ensuing competition across local governments may enhance efficiency in the production of local services has been determinant in shaping the 1997 tax reform and the subsequent constitutional reform (October 2001).