Tax Evasion and the Size of Decentralization: Evidence from Italy

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Abstract

Building on Acconcia et al. (2022), this project aims at a further investigation of the spatial distribution of tax evasion in Italy. By relying on the natural experiment of Italian unification and the change of province borders over time, we provide evidence consistent with the idea that increasing decentralization of tax enforcement fuels tax evasion.

1 Introduction

Building on Acconcia et al. (2022), this project aims at a further investigation of the spatial distribution of tax evasion in Italy. In that paper, we provide evidence that the process of unification of Italy in 1861 determined a large increase in the tax burden which turned out to be highly differentiated among areas of the country, due to differences in the levels of taxation among pre-unitary states. In the present paper we further explore empirically the role of the organization of monitoring and enforcement activity in shaping the heterogeneity of compliance behavior.

In Italy, the decentralization of monitoring activity and tax courts mirrors the administrative borders of provinces (first level) and regions (second level). However, borders of provinces have been changed over time, thus altering the territorial competence of the tax courts. In particular new provinces have been established in Italy after unification, both in the the period when the country was under a monarchic regime and after the establishment of the Republic in the aftermath of the II world war. The split of large provinces into smaller ones has taken place as the outcome of a political-administrative process independent from the way tax collection is organized. Therefore, we argue that the territorial split can be safely considered as an exogenous shock to the geographic scope of local units of the national agency of tax collection and of the tax courts. This split reduces the distance between taxpayers residence and the location of the authority in charge for the enforcement of the fiscal law.

Theoretically, a reduction in the distance between the taxpayer and the tax officials has two effects: on the one hand, it facilitate information gathering by tax official and fiscal judges thus increasing the strength of enforcement; on the other hand, it facilitates capture of tax officials at local level by taxpayers.[1] Therefore, because of these two countervailing effects of distance on the equilibrium level of deterrence, whether an exogenous reduction in the distance between the tax officials and the taxpayer increases or reduces the equilibrium level of compliance, has to be settled on empirical grounds.

By exploiting data at province level, we provide evidence consistent with the idea that increasing decentralization—through the split of provinces which implies an exogenous reduction in the distance between tax officials and taxpayers—fuels tax evasion.

References

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Allingham, Michael G. and Agnar Sandmo, "Income tax evasion: a theoretical analysis," *Journal of Public Economics*, 1972, *1* (3-4), 323–338.

[1]This idea is formalized in a standard setting (Allingham and Sandmo, 1972) extended to the case in which the deterrence effect of the a given probability of apprehension for misreporting is diluted by the possibility of a collusive agreement. In other words, the probability of apprehension is decreasing in the distance, along with the probability of a collusive agreement between the taxpayer and the tax official.