Local governments reaction to central government’s spending cuts. An analysis of the fiscal adjustment behaviour of Italian municipalities

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Abstract

The reaction of local authorities to central governments’ spending cuts has been only marginally explored so far both by the theoretical and empirical literature. This paper aims at closing some of the literature gaps providing a theoretical framework and an empirical analysis that show how local authorities react to central government’s spending cuts resulting in a contraction of intergovernmental grants. The theoretical framework shows under which conditions local authorities are more prone to increase local taxes rather than reducing local expenditure to cope with the grants contraction. The model’s predictions of the local fiscal adjustment have been tested using a new and unique dataset of Italian municipalities over a period of six years from 2007 to 2012. Italy provides a good laboratory for the empirical analysis thanks to the intense program of inter-governmental grants reduction implemented since 2008 (8 billions of inter-governmental cuts up to 2015). Moreover, Italian data are particularly useful because of the presence of a discontinuity in the rule of determining the grants contraction produced by the permanent exemption of municipalities below 5000 inhabitants from the spending cuts of 2.5 billion implemented by the central government in 2010 (Legislative decree 78/2010). Our identification strategy allows us to obtain standard difference in discontinuities estimates of the fiscal adjustment behaviour of Italian municipalities providing a good measure of the causal relationship between central and local fiscal decisions. Final results show that Italian municipalities reacted to the contraction of inter-governmental grants mainly by increasing local taxes rather than by reducing local expenditure; some heterogeneity emerges in relation to the level of the fiscal effort, the electoral cycle and the degree of electoral competition.

Keywords: local fiscal adjustment; inter-governmental grants; regression discontinuity, spending cuts