

To harmonize or to compete? That's not the question

Bruno S. Frey, Reiner Eichenberger

*Institute for Empirical Economic Research, University of Zurich, Blümlisalpstr. 10,
CH-8006 Zurich, Switzerland*

Abstract

Neoclassical public economists stress economic distortions induced by differential taxation and therefore favour harmonization; political economists focus on political distortions and therefore reject harmonization. However, policy choices on the possibility frontier between economic and political distortions tend to be biased: economic advisers, politicians and interest groups typically favour harmonization. Harmonization is, moreover, undermined by incentives to re-establish tax differences. Both activities prevent the possibility frontier from being simply a menu of choice. Popular referenda and functional, overlapping, competing jurisdictions (FOCJs) are institutions able to reduce political distortions and to shift the possibility frontier.

Keywords: Tax harmonization; Direct democracy; Federalism

1. Introduction

Tax harmonization is normally advocated because it reduces economic distortions, and tax competition because it reduces political distortions. Thus, there exists a conflict between harmonization and competition, and we are tempted to formulate the implied trade-off by a possibility frontier relating economic and political distortions.

In this paper we carry out the following.

(1) We analyse the nature of the relationship between economic and political distortions.

* Corresponding author. Tel.: +41-1-257-3731; fax: +41-1-364-0366.

(2) We argue that it is not possible to choose a socially optimal position on this possibility frontier. Rather, endogenous politico-economic forces determine a position on the frontier. In contrast, institutional conditions, or the ‘rules of the game’, can be chosen such that an inward shift of the possibility frontier is induced.

(3) We suggest that popular referenda and competitive federalism are effective institutions to reduce both economic and political distortions.

Section 2 characterizes economic and political distortions and analyses the resulting possibility frontier. Section 3 argues that the politico-economic forces engaged in economic policy-making (tax policy) lead to a biased position on the possibility frontier. Section 4 discusses institutional changes to reduce distortions by introducing popular referenda and functional fiscal federalism. Section 5 offers concluding remarks.

2. Determinants of distortions

2.1. Economic distortions

In a social-welfare-optimizing allocation of resources, the intervention of government via taxation distorts this optimal allocation as (in the case of commodity taxes) a wedge is driven between producer and consumer prices and (in the case of income taxes) between the wage paid and received. The welfare-optimizing equality between marginal benefits and marginal cost no longer obtains. The distortions introduced by taxation are particularly strong when the same good or activity is taxed at different rates and according to different principles, as is often the case in international trade. As a consequence, welfare theory demands the imposition of harmonized taxes, which means that producers and consumers are to carry the same tax burden for the same economic activities. In particular, in a union aspiring to free trade, such as the European Union, the goods produced in any country should be burdened with the same tax rates in order to allow suppliers to produce the goods where the real resource costs are lowest. Harmonization thus favours economic competition by easing the mobility of firms and workers across jurisdictions.

According to the neoclassical theory of optimal taxation (see Stern, 1987) the allocation of resources is the more strongly distorted by (commodity) taxation, the larger is the price elasticities of demand: a given tax differential then leads to a larger deviation from allocational efficiency at zero taxes. While the extent of the demand price elasticities for the various commodities can be econometrically estimated, the formal theory offers little indication of the factors determining the size of the price elasticities. Nevertheless, it may be expected that the elasticities of demand for goods

and services, as well as for factors of production, are the larger in absolute terms, the higher the potential mobility. On reasonably open markets, capital is generally more mobile than labour. The mobility of the latter is constrained by a multitude of governmental restrictions, both for leaving and entering a jurisdiction, which tends to reduce available alternatives and price elasticities. Also, it is empirically well confirmed that elasticities are greater in the long than in the short run, because adaptation to new prices or taxes requires time. Elasticities may also systematically vary between persons; thus, it has been observed that, compared with male, female labour supply elasticities are greater. There is no need to go into the many other possible determinants of economic distortions at this point.

2.2. Political distortions

Politicians pursue their own goals (such as realizing their ideology, social prestige and material gain), which may deviate from the preferences of the citizens. The resulting deviations of government policy and individual preferences may be called ‘political distortions’.¹ They are particularly prominent in dictatorships, but also exist in democracies where the politicians and parties tend to form a coalition against the voters, or where the competition between the parties is incomplete due, for instance, to entry barriers or asymmetric party financing. In particular, governments seize the opportunity to exploit voters by imposing high and uniform taxes between jurisdictions in order to restrict individuals’ and firms’ possibility of exit to a governmental unit with lower taxes. The politicians’ behaviour thus also leads to distortions in the welfare-maximizing allocation of resources. As a consequence, *competition* between governments is called for: each unit should have the option to set taxes according to the preferences of its citizens. The competitive process between jurisdictions via the mobility of labour and capital gives politicians an incentive to take account of individuals’ preferences, to provide an efficient combination of taxes and public services and, therefore, to optimize the allocation of resources.²

The size of welfare losses due to politicians not following individuals’ preferences depends on the political institutions that shape the citizens’ perception, as well as their possibilities and incentives to engage in voice and to take up their exit options. When individuals do not fully perceive the

¹ The cost of deviating from individual preferences for various decision-making rules is analysed, for example, in Buchanan and Tullock (1962). For a survey of various manifestations and empirical evidence, see Lott and Reed (1989).

² Harmonized taxes do not produce (avoidable) political distortions if they are the result of a voluntary agreement among the citizens of the various countries, e.g. when sanctioned by referenda and subject to revision.

extent to which the politicians in parliament and government exploit them by imposing taxes, they do not respond adequately by negatively sanctioning politicians, e.g. by not re-electing them in a democracy. The extent of such limited perception – often called ‘tax illusion’ (see, for example, Pommerhne and Schneider, 1978; Oates, 1988) – correlates with the type of taxation. Relevant factors are, for instance:

- implicit taxes (e.g. turnover taxes included in selling prices) are less perceived than explicit taxes (where the buyers are always forced to add the tax to the posted price);
- an inflation tax is less visible than a tax based on an explicit law;
- the more complex the tax system, the less the burden of taxation is perceived.

Perception also depends on the type of actor involved. Large corporations with specialized tax economists and tax lawyers are more familiar with taxes and the ways to avoid them than smaller firms or individuals.

Political distortions are the smaller, the more democratic is a political system. Essential elements are the extent of competition between political parties, as well as the participation rights of the citizens via elections and referenda, but also via legitimate protest in the form of appeals, demonstrations and grass-root movements. Harmonization weakens the individuals’ incentives to raise voice against increases in taxation, as voice will be the more costly, the more centralized is the political process. Moreover, as interest groups (e.g. the producers) are harmed more by higher relative taxes (their taxes compared with those of their competitors) than by absolute taxation, they reduce their opposition against tax increases once taxes are harmonized. Together, this widens the politicians’ leeway to increase taxes and to serve their own interests.

In addition to voice (Hirschman, 1970), exit constitutes another important mechanism to force politicians to respect citizens’ preferences. Thus, the freedom to leave the country if one is dissatisfied with its performance is an essential feature of a democracy (whereas dictatorships often prohibit exit). To make exit a binding constraint to politicians, dissatisfied citizens must be able to leave their country, state or region without incurring high cost, and they must have favourable opportunities available elsewhere. However, harmonization makes exit options shrink.

In this section the underlying institutional conditions that determine the extent of economic or political distortions, and therewith the location of the relationship between the two, have been discussed. The next section takes the institutions as given and looks at systematic tendencies in economic policy-making that favour harmonization or favour competition. While institutions can be chosen (at the level of the basic consensus; see Buchanan, 1977; Frey, 1983), these policy-making processes are endogenous to the model and cannot be influenced from outside.

3. A bias towards harmonization

As a result of the working of politico-economic interactions, each society is, at a given point in time, characterized by a specific combination of harmonization and competition and hence by a specific position on the possibility frontier between economic and political distortions. It is useful to distinguish between the fundamental *policy choice* (Subsection 3.1) and the *outcome of the social process* leading to deviations from these policy choices (Subsection 3.2).

3.1. Policy choices between harmonization and competition

3.1.1. The view of economic theory

Parts of economic theory hold the notion of a social-welfare-maximizing government, thus implicitly assuming democracy to work so well that no political distortions arise. While modern political economy or public choice has grown strongly in importance and become an accepted scientific view, the area of international tax policy has remained singularly unreceptive:³ the literature on inter-governmental taxation is dominated by scholars who assume that governments basically maximize social welfare. As a consequence, the view that taxes should be harmonized between jurisdictions prevails in the scientific literature (compare the references given in Cnossen, 1987).

3.1.2. Economic advising: Amicable agreement

When it comes to practical advising in public (tax) commissions, *all* economists realize that political realities have to be taken into account. This, however, does not necessarily mean that the tax harmonization view is less dominant in public advising commissions.

First of all, there is a *selection effect* working in favour of economists who propose that taxes should be harmonized. Parliaments, governments and the public service, being interested in curbing political competition (see below), choose the members of a scientific commission on taxation in such a way that the likely outcome corresponds to their own wishes, i.e. to harmonize the taxes. This selection bias is strengthened by the unequal incentives for joining such a commission. Economists who favour harmonization have come to their conclusion because they believe that their normative advice has some effect on politics, i.e. they adhere at least to some extent to a technocratic view of society. They are, therefore, more willing to become members of such planning commissions. This is even more so as they hope to be included in the following harmonization negotiations promising

³ As always, there are exceptions, e.g. Hettich and Winer (1988).

potential rents. Political economists who favour tax competition, however, are more reluctant to do so because they believe that such commissions are ineffective, and therefore prefer to offer their advice at the level of constitutional rules.

Once the members of public (tax) commissions have been selected, they are strongly motivated to get along reasonably well. Suggesting that taxes should be harmonized is a much more suitable proposal than making an adversarial suggestion, namely embarking on possibly stiff competition between jurisdictions that the commission members represent or are attached to. Under most circumstances, the point of a meeting or a commission is to find a harmonious solution. Only if the commission were dissolved immediately thereafter would it be acceptable to fight each other. Paraphrasing Adam Smith, one may state that people rarely meet in commissions to stimulate competition, but rather to suppress it by harmonizing tax policy, and government policy more generally.

There is another reason why (tax) commissions tend to favour harmonization over competition. Equal tax rates on commodities and production factors across jurisdictions can be planned and organized, and the outcome is reasonably predictable, including the resulting distribution of rents. In contrast, competition cannot simply be established by voluntary action (von Hayek, 1960). At best, the preconditions allowing competition can be set, but even then it is uncertain to what extent competition actually emerges and who receives the rents produced. Therefore, the members of commissions representing particular economic interests (e.g. sectors in the economy) are reluctant to propose competition, since they are uncertain whether or not in the end their group will benefit.

3.1.3. Politicians' interests

Members of government as well as of parliament (or the 'classe politique') have an interest in harmonization: it allows them to buttress the (implicit) cartel formed against the general population and the firms. When taxes are equalized between jurisdictions, exit does not help and protest (voice) is less attractive because everyone is affected equally, so that a tax payer does not feel that his or her relative position has worsened.

Harmonization of taxes is an effective means to raise the tax level and therefore to cement the importance and power of the politicians' cartel. A striking example is provided by the EC council of ministers which, in June 1991, reached a preliminary agreement that from 1993 onward the rate of VAT should be *no less* than 15% in all member countries. Consequently, three member nations (Germany, Spain and Luxembourg) were forced to raise their tax rates. The choice of a minimum instead of a maximum rate is revealing. The suppression of exit and voice has been identified as a major threat to the citizens' welfare in public choice theory (see, for example,

Mueller, 1989, ch. 9). While the politicians in power benefit most from the rents created by harmonization, the politicians in opposition may also appropriate part of this rent (the sizeable privileges received by *all* members of parliament are identified, for example, for the German Bundestag by von Arnim, 1991).

3.1.4. Influence by pressure groups

Organized interests generally favour harmonization of government policies and, in particular, taxes, because the potential benefits for a specific group are easily identifiable, while the costs in terms of policies less in line with citizens' preferences are either irrelevant or distributed so broadly that they are of little consequence to them. However, competition tends to undermine the influence of interest groups, because the market instead of managed trade takes over. Above all, the advantages from competition tend not to be attributed to those who helped create the appropriate conditions. The managers of interest groups, therefore, prefer to harmonize the rent distribution, which they are able to influence by taking part in the bargaining process. In the case when they are successful, they prove their importance to the members of their interest group.

3.2. Undermining harmonization

The previous subsection has argued that economists, experts at the advising stage, politicians and interest groups have a bias in favour of harmonizing policies. This does not mean that once the official decision to harmonize taxes has been taken, all influential actors will be satisfied. Harmonizing taxes *also* means that some tax advantages that certain groups have enjoyed so far may be lost, creating an incentive to undermine the harmonized taxes as far as possible. The possibilities for avoiding, evading or cheating will hence be exploited (see Cowell, 1990; Thomas, 1992). The same holds for politicians and governments of individual jurisdictions who gain from leaving the 'harmonization cartel' as long as such action promises high rents and cannot be sanctioned or remains undetected by the other members of the politicians' cartel. As a result, taxes will *de facto* be less harmonized than *de jure* and some competition between jurisdictions is thereby reinstalled.

Interest groups, as well as single actors whose rents are curtailed by the harmonization of some taxes, will look for ways and means to re-establish differentials in their favour regarding *other* taxes. If all taxes were harmonized between jurisdictions – which appears imaginable only in a fully centralized state – then the rent-seekers would turn to subsidies or regulations (which are a kind of tax; see, for example, Posner, 1971). If, for example, environmental taxes were harmonized in the European Union,

then it can be expected that differences in formal, and even more so in effective, regulations between nations would emerge. Short of a completely effective monitoring and judicial system by the European Union, such a development cannot be prevented. Reality is thus characterized by a combination of official harmonization with (mostly unofficial) disharmonization of government policy. The ‘ideal’ world projected by formal economic models of harmonized taxes (e.g., Sinn, 1990) disregards the incentives created by the very fact of harmonization to re-establish differences in taxation and regulation.

4. Shifting the possibility frontier

From the traditional optimization perspective there exists a dilemma between economic and political distortions: the former can only be reduced by increasing the latter and by introducing new inefficiencies. However, there are strong forces in official policy pushing towards tax harmonization. This policy not only leads to political distortions, but also tends to be undermined by the taxpayers affected, as well as by politicians themselves. The result is a mixture of official harmonization and unofficial disharmonization, which may vary from one area to the other depending on the possibilities and incentives to monitor and control taxpayers’ behaviour. As constitutional political economy has taught us, there is little point in advising governments to behave differently and, for example, to harmonize taxes so that economic externalities are internalized (this is suggested by traditional welfare theory, including optimal taxation). What can be done is to change the institutional conditions under which people act; that is, to change ‘the rules of the game’. This allows them to evade the dilemma by adopting a new perspective: economic and political distortions can be reduced by setting appropriate constitutional rules.

The literature discusses many possibilities that, at the constitutional level, induce actors to reduce the economic distortions. For instance, one is to introduce the equivalence principle for taxation. A further step would mean setting, at the constitutional level, explicit prices for publicly supplied goods, e.g. distributing vouchers for the use of schools and hospitals, introducing road pricing or environmental taxes on emissions, or imposing an ‘ecological tax system’ as a substitute for the present taxation. If such prices for public services are set according to the marginal benefits created, at least part of the economic externalities between jurisdictions produced by the present taxes can be avoided and, from the point of view of traditional welfare theory, there is less need for the harmonization of taxes.

Constitutional provisions can also serve to reduce the politicians’ tendency to deviate from voters’ preferences. As with *economic* distortions, there also

exists an extensive literature (public choice) on how to reduce *political* distortions. One possibility would be to strengthen party competition by opening access to new parties and reducing established parties’ grip on the public purse for financing elections. Instead of repeating these well-known proposals, we want to discuss two institutions that are very effective in reducing political and economic distortions, but that have been little considered in the literature, and have been used even more rarely in reality. They are popular referenda (Subsection 4.1) and functional, overlapping, competing jurisdictions (Subsection 4.2).

4.1. Popular referenda

A referendum in which all the citizens have the possibility to participate gives decision power to people *outside* the politicians’ cartel. Groups that, in a parliamentary democracy, are not at all or only weakly represented, can better express their preferences; this applies, in particular, to the unorganized taxpayers and consumers as well as to newly emerging demands. Since these individuals are not integrated into the *classe politique*, they can evade being controlled by politicians. In an *initiative*, the demands are explicitly directed against the political establishment represented in parliament and government. *Optional* and *obligatory* referenda have more of a controlling function, as they overrule, if successful, the decision taken by the executive and legislative.⁴ The influence of referenda on political outcomes is strengthened by the low informational requirement for the citizens. Compared with elections, where the parties’ programmes contain a mixture of many different issues, and, moreover, are vaguely formulated (for the reasons expounded by Downs, 1957), referenda are single-issue votes with pros and cons highlighted in the referendum process. It is possible to have a referendum on aspects of tax harmonization. Indeed, in Switzerland, there have been several such nation-wide popular votes. The citizens can, for example, be asked whether they want to have a unified income tax or value added tax in contrast to federal units having the power to determine their own tax levels.

A popular referendum (in the broad sense) can only serve its purpose if the *classe politique* cannot block it. In many countries, the supreme court has the power to decide whether a referendum is admissible – legally, the criteria are purely formal, but, in fact, the members of the court who form part of the *classe politique* have considerable incentives to forbid referenda

⁴ For referenda in general, see Cronin (1989); for a discussion from an economic point of view and in a comparative perspective, see Frey (1994). It turns out that most deficiencies attributed to direct democracy equally (if not more strongly) apply to representative democracies.

threatening the position of the politicians' cartel, often using vague concepts of what they consider to be the 'raison d'état'. In other countries, such as Switzerland, the supreme court may not interfere in this, and issues meeting an almost unanimous opposition by the politicians are therefore brought to the vote. Empirical evidence suggests that referenda are indeed able to break the cartel among politicians and thus reduce political distortions (see Blankart, 1992). This is only possible if referenda are binding for political decision-makers and do not take the form of plebiscites, which are used as a vote of confidence for the reigning government or president.

To understand the role of referenda for reducing political distortions, it is useful to distinguish the stages before, during, and after referendum.

4.1.1. The pre-referendum process

An important feature of a referendum is the discussion process stimulated among the population as well as between politicians and voters. The pre-referendum discussion may be interpreted as an exchange of arguments among equal citizens taking place under well-defined rules. This institutionalized discussion satisfies various conditions of the 'ideal discourse process' as envisaged by Habermas (1992), but it also has various advantages over this rather academic (seminar-style) discussion type. Referenda bring social issues on to the public agenda; they focus the deliberation process on a specific proposal, and they naturally end the discourse by the vote. The discussion induced by a referendum not only improves information but makes voters aware of issues and alternatives they may not have considered before; thus, it enlarges their cognitive decision set. This means that all forms of 'electronic' or 'instant' voting are mistaken. The same holds if the citizens have to decide simultaneously on a large number of propositions as is the case in California (see Eule, 1990).

Referenda are possible and should be constitutionally allowed at all levels of government: communities, regions, counties, states, nations and the supra-national (e.g. European Union) level. Today's constitutional law and practice transforms referenda all too often into plebiscites. In contrast, a referendum democracy invites agenda-setting from outside the politicians' cartel, especially if a relatively low number of signatures for launching an initiative or optional referendum is required, and if all issues, including taxation, are admissible (except the most fundamental human rights).

4.1.2. The referendum vote

It is often claimed that for a referendum to be valid there should be a minimum participation rate in order to provide legitimacy to the decision (see, for example, Cronin, 1989, p. 11). Such a provision is unfounded as it does not take into account citizens' rational behaviour. They only participate if their subjective benefit and cost calculation induces them to do so.

Many issues are of little relevance to particular individuals, so that voting makes no sense to them. However, what matters is that participation rates vary according to the perceived importance of the issue at stake (in Switzerland, for instance, the participation rate is sometimes as low as 25%, but sometimes jumps up to 75%). Such variations override the much discussed 'paradox of voting'. An important prerequisite for inducing citizens to participate is that the outcomes are binding to government and parliament.

Many people are concerned about the high administrative cost referenda are claimed to cause. In reality, these costs are rather low, provided that the citizens are involved in conducting the vote. In addition to reducing (at least budgetary) cost, this strengthens the voters' feeling for co-determination, which in turn raises their commitment to the community they live in.

4.1.3. The post-referendum process

In a referendum, a political decision is formally taken that conforms to the preferences of the majority of the citizens participating. This does not necessarily mean that the politicians and the public administration take the appropriate action to implement it. The more legitimate the population takes the constitution to be, the higher are the costs of not following it. In addition, the politicians are induced to act according to the referendum by the threat of otherwise not being re-elected by the voters.

Identifying the majority is not the only thing that matters in a referendum. A referendum also clearly reveals how the population feels and where and how large the minorities are. Groups dissenting from the majority are identified, and their preferences become visible. In representative democracies it is often not revealed that there is a sizeable dissatisfied minority or even a majority among citizens, and where the population is not asked, even large discrepancies between politicians' decisions and the voters' preferences do not become visible. Only when a referendum is taken in such countries are these discrepancies being revealed, as, for instance, in France in 1992, when the Maastricht Treaty was accepted by an overwhelming margin in parliament but only by slightly more than 50% of the voters in a referendum. For this reason, even consultative referenda may have a significant impact on political outcomes. Popular referenda make the preferences of (sizeable) minorities become part of the political process. Parties in search of additional votes adjust their political demands by partly or wholly integrating the minority's preferences.

There is strong empirical evidence (see Pommerehne, 1990; Schneider, 1992; Steunenberg, 1992; and Eichenberger, 1994) that referenda are an effective mechanism to significantly reduce deviations of political decisions from individual preferences. An econometric comparison of Swiss communes with different degrees of institutionalized forms of participation in

political decisions reveals that the outcomes correspond more closely to the voters' preferences, the more direct-democratically they are reached. The growth of public expenditure is more strongly determined by demand factors (i.e. the citizens' willingness to pay) than by supply factors (in particular, by the politicians' and bureaucrats' own interest). Moreover, public supply is less costly, the more direct are the democratic institutions. There is also evidence from surveys that citizens are more satisfied in a referendum democracy (Cronin, 1989, pp. 78) and that land prices are higher because people are attracted to such communes (Santerre, 1986). The members of the *classe politique* overwhelmingly reject the institution of referenda with all sorts of arguments (e.g. that citizens are uninformed, do not understand the issues or are manipulated by interest groups), which, however, are not convincing because they to a large degree also apply to voters and even to members of parliament in representative democracies.

4.2. *Functional, overlapping, competing jurisdictions*

The competition between suppliers of public services can be intensified by allowing groups of individuals to establish jurisdictions, each of which offers functions such as electricity and water, police protection and education or refuse collection at a tax price (see Frey and Eichenberger, 1995). Several such jurisdictions may exist in the same geographic area, so that residents are free to get the services from the unit with the most favourable combination of quality and tax price. Parents are, for example, free to send their children to a school that promises the best education for the education tax charged. This arrangement introduces competition among jurisdictions, giving them an incentive to respond to the preferences of the citizens and to offer their services at the lowest price possible. Such functional, overlapping, competing jurisdictions (FOCJs) come close to a private provision of such services, and it is conceivable that they exist along with private suppliers (e.g. there may exist both public and private schools for primary education). FOCJ constitute an effective way of providing 'public' services when for one reason or another the citizens do not want to fully privatize them, but do still not wish to be prone to the often inefficient public monopoly. FOCJ exist to a limited extent on the local level in both Europe and America (see Casella and Frey, 1992). The Swiss canton Thurgau with its roughly 250 000 residents is, for example, composed of several thousand overlapping communes for water, refuse collection, police, church and schools.

The overlap between jurisdictions may also extend to a governmental service not mentioned so far; namely, the provision of law. Each individual or firm has the freedom to choose which law it wants to apply to its respective transactions, thus inducing competition among different forms of

law. The possibility to choose one's law already exists in various areas of international transactions, and there is quite often competition with privately established 'laws' administered, in particular, by private courts (see Posner's 1986 concept of privately produced law). This allows individuals or firms to choose the law that most efficiently regulates their issue and that implies the lowest costs if a conflict between parties should arise. A German firm wishing to produce under Portuguese law thus does not need to go to Portugal, but can adopt the Portuguese law while staying in Germany. This does, of course, completely eliminate the origin principle of international trade applied by the European Union. Such FOCJs extending to laws may be interpreted as the 'Cassis de Dijon' reading by the European Court, stating that the law regulating the introduction of a good in one member country may be applied to any other if so decided by the participants.

5. Concluding remarks

Societies face two kinds of distortions that reduce the welfare of individuals: economic distortions are induced by differential taxation, and political distortions (which consist in politicians deviating from the citizens' preferences) are induced by harmonized taxes. Choices by the various economic and political actors on the resulting possibility frontier between economic and political distortions tend to be biased. Policy proposals based on social-welfare-maximizing economic theory, and brought forward by economic advisers, tend to favour harmonization. The personal interests of politicians and the influence of interest groups work in the same direction. However, this policy choice is at least partly undermined by the incentives created to re-establish differences in taxation. The position arrived at on the possibility frontier is an endogenous result of the current politico-economic process. It can, therefore, not simply be chosen from outside. This paper argues that economists should instead propose changes in institutions – or in the underlying constitution – which shifts the relationship between economic and political distortions inside. While the possibilities for reducing economic distortions have been extensively discussed in the literature, reducing political distortions has received less attention. Popular referenda and FOCJ are discussed as important and practically relevant institutions for reducing political distortions.

Acknowledgements

We are grateful for helpful comments to the formal discussants, Ewald Nowotny and Anne Case, as well as to the other participants at the ISPE

conference in Linz, and to Iris Bohnet, Angel Serna and to Jürg de Spindler.

References

- Arnim, H.H., 1991, Die Partei, der Abgeordnete, und das Geld (von Hase & Koehler, Mainz).
- Blankart, C.B., 1992, Bewirken Referenden und Volksinitiativen einen Unterschied in der Politik? *Staatswissenschaften und Staatspraxis* 3, 509–524.
- Buchanan, J.M., 1977, *Freedom in constitutional contract. Perspectives of a political economist* (Texas A&M University Press, College Station, TX).
- Buchanan, J.M. and G. Tullock, 1962, *The calculus of consent. Logical foundations of constitutional democracy* (University of Michigan Press, Ann Arbor, MI).
- Casella, A. and B.S. Frey, 1992, Federalism and clubs. Towards an economic theory of overlapping political jurisdictions, *European Economic Review* 36, 639–646.
- Cnossen, S., ed., 1987, *Tax coordination in the European Community* (Kluwer, Boston, MA).
- Cowell, F.A., 1990, *Cheating the government. The economics of evasion* (MIT Press, Cambridge, MA).
- Cronin, T.A., 1989, *Direct democracy. The politics of initiative, referendum and recall* (Harvard University Press, Cambridge, MA).
- Downs, A., 1957, *An economic theory of democracy* (Harper and Row, New York).
- Eichenberger, R., 1994, The benefits of federalism and the risk of overcentralization, *Kyklos* 47, 403–420.
- Eule, J.N., 1990, Judicial review of direct democracy, *Yale Law Journal* 99, 1503–1590.
- Frey, B.S., 1983, *Democratic economic policy* (Blackwell, Oxford).
- Frey, B.S., 1994, Direct democracy: Politico-economic lessons from Switzerland, *American Economic Review* 84, 338–342.
- Frey, B.S. and R. Eichenberger, 1995, Competition among jurisdictions. The idea of FOCJ, in: L. Gerken, ed., *Competition among institutions* (Macmillan, London) 209–229.
- Habermas, J., 1992, *Faktizität und Geltung. Beiträge zur Diskurstheorie des Rechts und des demokratischen Rechtsstaats* (Suhrkamp, Frankfurt).
- von Hayek, F.A., 1960, *The Constitution of Liberty* (Routledge, London).
- Hettrich, W. and S.L. Winer, 1988, Economic and political foundations of tax structure, *American Economic Review* 78, 701–712.
- Hirschman, A.O., 1970, *Exit, voice and loyalty* (Harvard University Press, Cambridge, MA).
- Lott, J.R. and W.R. Reed, 1989, Shirking and sorting in a political market with finite-lived politicians, *Public Choice* 61, 75–96.
- Mueller, D.C., 1989, *Public choice II*, 2nd edn. (Cambridge University Press, Cambridge).
- Oates, W.E., 1988, On the nature on measurement of fiscal illusion: A survey, in: G. Brennan et al., eds., *Taxation and fiscal federalism: Essays in honour of Russell Mathews* (Australian National University Press, Canberra) 65–82.
- Pommerehne, W.W., 1990, The empirical relevance of comparative institutional analysis, *European Economic Review* 34, 458–469.
- Pommerehne, W.W. and F. Schneider, 1978, Fiscal illusion, political institutions and local public spending, *Kyklos* 31, 381–408.
- Posner, R.A., 1971, Taxation by regulation, *Bell Journal of Economics and Management* 2, 22–50.
- Posner, R.A., 1986, *The economic analysis of law*, 3rd edn. (Little, Brown, Boston, MA).
- Santerre, R.E., 1986, Representative versus direct democracy: A Tiebout test of relative performance, *Public Choice* 48, 55–63.

- Schneider, F., 1992, The federal and fiscal structures of representative and direct democracies as models for a European Federal Union? Some thoughts on the public choice approach, Mimeo, University of Linz.
- Sinn, H.-W., 1990, Tax harmonization or tax competition in Europe, *European Economic Review* 34, 489–504.
- Stern, N.H., 1987, Optimal taxation, in: J. Eatwell, M. Milgate and P. Newman, eds., *The new Palgrave*, Vol. 3 (Macmillan, London) 734–738.
- Steunenberg, B., 1992, Referendum, initiative, and veto power: Budgetary decision making in local government, *Kyklos* 45, 501–529.
- Thomas, J.J., 1992, *Informal economic activity* (Harvester Wheatsheaf, New York).