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## Tax harmonization and tax competition in the European Union: Lessons from Switzerland

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### Abstract

This paper presents empirical evidence on individual income tax competition in Switzerland. Tax competition has some influence on the spread of people with high income over the cantons, and it is partly capitalised in dwelling rents. However, it neither leads to a collapse of public good supply nor makes redistribution by the fiscal authorities impossible. Thus, if tax competition works well in Switzerland there is no reason why it should have disastrous effects in a future European Union.

*Keywords:* Tax competition; Fiscal federalism; European integration

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### 1. Introduction

Tax harmonisation, or at least tax co-ordination, has been a major topic in the European Community (EC) since the Treaty of Rome. This is revealed by various proposals by the Commission, which first aimed to maximise rather than optimise tax harmonisation. This was later followed by a strategy allowing more leeway to the individual member states with respect to their tax policy. However, even more recently, this leeway seems

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† Sadly, Professor Pommerehne died unexpectedly in October 1994. He is greatly missed.

to be rather narrow, or in the words of Cnossen and Shoup (1987, p. 82): “EC policymakers appear to believe that member states should first be forced into the strait-jacket of a uniform tax system.”

The question of whether tax competition or centralised harmonisation should be chosen, implies the application of concepts that have been discussed theoretically in the context of fiscal federalism during the last decades. During this period the main impetus of this discussion has changed. In the beginning, following Tiebout (1956), decentralised solutions were favoured for allocative reasons, disregarding negative distributional consequences (see, for example, Musgrave 1969, and Oates, 1972). More recently, the allocative inefficiencies of competitive tax systems have been discussed, especially with reference to corporate income and commodity taxes, taking negative distributional consequences as granted (see, for example, Sinn, 1990a,b). Thus, the earlier support for decentralised, competitive fiscal systems by (academic) economists has declined markedly.<sup>1</sup>

As for the results of both the decentralisation as well as the harmonisation positions, strong assumptions are employed, which do not fully hold in reality. It is theoretically open which advice politicians should follow in designing the European constitution. Fiscal autonomy with respect to taxation of the single subfederal jurisdictions could have net benefits but could also lead to detrimental effects for the citizens involved. Therefore, to evaluate the possible consequences of alternative fiscal systems it is necessary to take into account the empirical evidence. Such evidence can be drawn by analysing the allocative and distributional properties of existing federal systems. Switzerland, owing to its unique federal structure, seems to be a most promising candidate (see, for example, Cornevin-Pfeiffer and Manzini, 1992). A political European Union, if there is to be one, will certainly have a more decentralised structure than most or even all of the European nations today. Therefore, for the future fiscal constitution of a European Union there is probably more to be learned in this respect from Switzerland than from any other European country.

The paper is organised as follows. In Section 2 the main empirical results concerning tax competition in Switzerland are presented. Section 3 discusses the allocative consequences, and Section 4 discusses the distributive consequences. We conclude in Section 5 with some remarks concerning the relevance of our Swiss results for the process of European integration.

<sup>1</sup> For a somewhat broader view of intergovernmental tax competition, see Frey (1990).

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