

THE REFORM OF FISCAL EQUALISATION (NFA) IN SWITZERLAND

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SUMMARY

It is first discussed why such a fiscal equalisation system is necessary for Switzerland. The reason for this are the asymmetries, mainly in size, but also in location, between the different cantons. Then, the current Swiss situation is presented, before the new system is described which effectively consists of two parts: the first one newly assigns the different tasks to the different governmental levels and organises the cooperation between the national and the cantonal governments as well as between the cantonal governments, while the second one reorganises the financial flows between the different levels. We also show the financial effects of the new system for the different cantons for the current year 2009. Whether the objectives of this new equalisation system are really reached or not is, however, still an open question, because it is in effect only since the beginning of 2008. The paper concludes, nevertheless, with a short assessment of the new system.

Keywords: Fiscal Equalisation, Asymmetric Tax Competition, Assignment of Tasks.

JEL Classification: K14, K42

1 INTRODUCTION

[1] After World War II, in many countries there was a tendency towards centralisation. Sometimes it was openly proposed, but more often it was a creeping process. More recently, however, attempts to strengthen federal structures or even introduce them in former unitary countries are observed. Even countries like the United Kingdom or Spain gave their sub-federal units (states) relative independence which sometimes is even much stronger than in traditional federal states like Germany or Austria. The successor countries of the Soviet Union have also mostly federal structures. And we also see in other continents rather a further development than a withdrawal of federal structures, as least as far as the countries can be considered as being democracies.

[2] Despite the fact that Switzerland still has a very decentralised structure and that it is still more strongly oriented towards the concept of a competitive than of a cooperative federalism, it also experienced some creeping centralisation. Some of this centralisation was objectively justified, but other parts are highly questionable and should perhaps be reversed. Thus, at the beginning of the nineties, a reform of the Swiss Federal system seemed to be appropriate. Moreover, it became more and more clear that the old fiscal equalisation system was not only rather intransparent but also provided sometimes perverse incentives. This did not only hold for the financial relations, but also for the assignment of political tasks to the different governmental levels and for the (necessary) cooperation between the cantons and the federal government as well as among the cantons. Thus, the need of a reform became more and more obvious.¹⁾ But, as not only the Swiss development teaches us, a general awareness of the necessity of a reform and its successful carrying out and finishing are two rather different things.

[3] A rather special feature of the Swiss system is the large fiscal autonomy the cantons (and, somewhat more restricted) the local communities have. There is a highly progressive federal income tax, but its amount is relatively small, and even the marginal tax rate is not above 13 percent. (The maximum average tax

¹⁾ The deficiencies of the old system are described, for example, in R FISCHER, T. BELJEAN and J. FIVAZ (2003).

rate is 11 percent.) The reason for this restraint of the federal level is the fact that the income tax is mainly a cantonal tax; apart from some antecessors a general federal income tax did not exist before the Second World War.²⁾ And the property tax is still an exclusively cantonal one. According to the tax harmonisation law there is some harmonisation of the tax base. The cantons decide on the (progressive) tax schedule and the concrete tax rates while the local communities (and in many cantons also the official churches) lay a surcharge on the cantonal taxes. Thus, there exist 26 different tax regimes in Switzerland, which implies that there is strong tax and not only expenditure competition between the cantons. As will be shown below, this results in considerable differences of the tax burdens for companies as well as individuals between, for example, low-tax cantons like Zug or Schwyz and 'tax-hells' like Jura or Valais. These discrepancies have even increased in recent years. The existing equalisation system was apparently unable to prevent this. Thus, not only from a theoretical perspective, but also from the deficiency of the actual results a reform seemed to be necessary.

[4] But why do we need a fiscal equalisation system at all? In a Tiebout-world, for example, such a system would never be necessary. But do we really live in a Tiebout-world with its symmetry assumptions? This is definitely not the case, because the cantons differ considerably, in particular with respect to their size and with respect to their locations. And this can, as will be shown below, justify the existence of such a system, but if, and only if it is effective in reaching the objective of (some) equalisation. Apparently, the old Swiss system was rather deficient in this respect.

[5] Before presenting the concept of the new Swiss fiscal equalisation system we will, therefore, first discuss why such a system is necessary for Switzerland (*Section 2*). Then, the current Swiss situation is presented (*Section 3*). *Section 4* describes the new system which effectively consists of two parts: the first one newly assigns the different tasks to the different governmental levels and organises the cooperation between the national and the cantonal governments as well as between the cantonal governments, while the second one reorganises the financial flows between the different levels. We also show the

².For the history of the federal direct income tax see, for example, C. STOCKAR (2006).

financial effects of the new system for the different cantons in 2009. Whether the objectives of this new equalisation system are really reached or not is, however, still an open question, because it is in effect only since the beginning of 2008. The paper concludes, nevertheless, with a short assessment of the new system (*Section 5*).

2 ON THE NECESSITY OF A FISCAL EQUALISATION SYSTEM IN ASYMMETRIC SITUATIONS

[6] It is debated in the literature whether fiscal competition and, in particular, tax competition, has positive or negative consequences overall. Theoretical considerations alone do not give a clear answer.³⁾ The big advantage compared to a unitary systems that has already been emphasised by A.C. TIEBOUT (1956) is that political decisions are more in line with the preferences of the citizens. The main problem is, however, that a 'race to the bottom' might occur which leads to a too low degree of government activity. This holds primarily for redistribution,⁴⁾ but might already hold for the supply of public goods, as H.W. SINN (1997, 2003) more recently emphasised. On the other hand, there is an additional positive effect that the citizens are better able to control their government and, therefore, to tame 'Leviathan'.⁵⁾ Whether the positive or the negative effects dominate is, therefore, first of all a empirical question, but it also very much depends on the design of the federal system, especially on the distribution of the tasks among the different governmental levels.

[7] When discussing this problem, nearly all theoretical models consider symmetric situations, i.e. the different governmental units have the same size and in the beginning the same amount of production factors.⁶⁾ Differences result

³⁾ A survey of the results of the theoretical models is given in L.P. FELD (2000, pp. 25ff.).

⁴⁾ See for this already G. STIGLER (1957) as well as, for example, the overview in D.E. WILDASIN (1997).

⁵⁾ See for this already G.M. BRENNAN and J.M. BUCHANNAN (1977, 1980).

⁶⁾ There are two exceptions. First, the New Economic Geography, going back to P. KRUGMAN (1991, 1991a), where the role of low taxes as compensations for the disadvantages connected with locations at the periphery (compared to locations in agglomerations) is discussed (see, for example, R.E. BALDWIN et al. (2003, pp. 365ff.)), second, there is a literature about tax heavens (see, for example, M. DESAI, C.F. FOLEY and J.R. HINES (2005) or D. DHARMAPALA and J.R.

primarily from the different preferences of the individuals, and according to these preferences the citizens sort themselves to find their optimal locations. This rather optimistic picture is, however, hardly compatible with the reality in real federal systems. Problems arise usually by disparities, i.e. in asymmetric situations, be it due to different historical conditions as, for example, in Germany, due to different endowments with natural resources as, for example, in Canada, due to different locational conditions as emphasised by the New Economic Geography, or, what is most relevant in Switzerland (but also highly relevant for international tax competition) due to the different size of the governmental units. S. BUCHOVETSKY (1991) as well as J.D. WILSON (1991) have shown that small units can have an advantage in the tax competition game compared to large units.⁷⁾ Starting from the situation of a social optimum with identical tax rates a small unit, as in Switzerland, for example, the canton Zug, can improve its situation by reducing tax rates and, therefore, attracting additional tax payers. If the large cantons like, in Switzerland, Bern or Zürich, would reduce their taxes to the same extent, nobody would win: both had still identical tax rates, but lower financial means. The large cantons will, however, not fully adjust, they will reduce their tax rates to a smaller extent than the small cantons. The logic behind this is that, by reducing tax rates, a large canton will lose quite a lot of revenue from those taxpayers already located in the canton and it will – in relative terms – not gain very much from those taxpayers moving into the canton. The opposite holds for the small canton. In the new equilibrium, both will have lower tax rates than in the beginning, but the tax rate of the smaller unit will be lower than the one of the larger unit. Moreover, despite the lower tax rate, the smaller unit will have higher public expenditure per capita, and also higher welfare compared to the larger canton, and the welfare gains of the smaller unit cannot compensate the losses of the larger one.⁸⁾ The condition that this effect occurs is that the difference in size between the small and the large canton (or country) is large enough. In principle, this results holds for all taxes which are instruments in the tax competition game, but while it relates in international tax competition mainly to corporate income taxes, it is inside

HINES (2009).). While the former has some relevance for Switzerland, because cantons at the periphery might try to attract taxpayers by low tax rates, the latter aspect is, at least for the fiscal relations inside Switzerland, totally irrelevant.

⁷⁾ See for this also A. HAUFLER (2001, pp. 74ff.).

⁸⁾ One might even say that the smaller units exploit the larger ones.

Switzerland also highly relevant for personal income taxes because one can, for example, work in the large canton Zürich and reside in the small canton Zug.

[8] If all units would (more or less) meet the symmetry conditions of the theoretical models, we would not need a fiscal equalisation system. Those areas where we would be afraid of a race to the bottom, especially redistribution and national public goods, could be assigned to the central level, and there might be competition in other areas, primarily with respect to the allocation of regional and local public goods. However, if we have tax competition between units of very unequal size, a fiscal equalisation system is necessary in order to prevent the country from breaking apart. This certainly holds for Switzerland, where the relation of the size of the population between the smallest canton, Appenzell Innerrhoden, and the largest one, Zürich, is about 1 to 84. In a democracy, this might have two consequences: the splitting up of the country in different smaller, but unitary organised countries, or the abolition of the federal structure or, at least, of tax competition. The latter one might be the Swiss solution, because, due to the existence of direct political rights, people can abolish or at least restrict tax competition between the cantons by a constitutional initiative, if the discrepancies become too large.

[9] This was an important issue in the referendum campaign for the new fiscal equalisation system in 2004. The left-wing parties argued against this system (with several arguments). They want to restrict tax competition between the cantons, to get a more harmonised system. The chances to reach this objective are the smaller the better the fiscal equalisation system reaches its goals. Thus, the other parties which were in favour of the reform pointed to the fact that, due to the increasing discrepancies between the cantons, its failure would increase the chances that a more harmonised tax system would be accepted by the Swiss electorate.

[10] The problem of any fiscal equalisation system is, however, that the incentives to keep track of the own tax basis are reduced. This holds for those governmental units which receive money from this system, but also for those which have to pay into the system. This problem can be somewhat mitigated if the distributed money stems (at least partially) from central tax revenue,

because the 'rich cantons' will still have incentives to take care of their tax basis. For the poor cantons, however, it still holds that the corresponding incentives are the lower the stronger the equalisation is. Germany is a rather negative example in this respect. The German Constitutional Court declared in several decisions that even a very far reaching equalisation is constitutional.⁹⁾ Moreover, there was a partial bailout of two smaller states, Saarland and Bremen, in 1992. This seduced some states to follow a non-sustainable policy.

3 THE SWISS SITUATION

[11] As mentioned above, in the Swiss federal system, the fiscal autonomy of the sub-national units, the cantons and local communities, is especially pronounced.¹⁰⁾ They are responsible for all tasks that are explicitly assigned in the constitution to the national level. They also have the required tax autonomy in order to raise the revenue which is necessary to fulfil these tasks. This allows every single canton and every single local community to balance and to individually fix the appropriate amount of public expenditure. This results in considerable disparities between the cantons. In 2006, for example, a married couple with two children and a gross labour income of 100'000 CHF had in Zug to pay 4'082 CHF income tax, and in Delémont in the canton Jura with 11'751 nearly three time as much. With a gross labour income of 1 Million CHF the relative difference becomes smaller, but the absolute difference with 163'441 CHF much larger.¹¹⁾ but despite the fact that the tax burden is so much higher,

⁹. See the decisions of the Constitutional Court of February 20, 1952 (1 BvF 2/51), of June 24, 1986 (2 BvF 1, 5, 6/83 und 1, 2/85; E 72, 330 II), of May 27, 1992 (2 BvF 1, 2/88, 1/89 und 1/90; E 86, 148, II) and of November 11, 1999 (2, BvF 2, 3/98 1,2/99; BverfGE 101, 158).

¹⁰. For descriptions of the Swiss federal system see, for example, V. BOGDANOR (1988) or D. STARK (1999), in comparison with Germany G. KIRCHGÄSSNER and W.W. POMERHNE (1992) as well as A. JÖRG (1998), and in comparison with other federal countries W.W. POMMERHNE (1977) or R. BIRD (1986).

¹¹. Source of the data: FEDERAL STATISTICAL OFFICE, *Steuerbelastung in der Schweiz: Kantonshauptorte, Kantonsziffern 2006*, Neuchâtel 2007, p. 21. – If we only count the burden by cantonal, local and Church taxes, i.e. without the rather progressive income tax, the tax burden is in Delémont for an income of 100'000 CHF approximately about 3.3-times as high as in Zug and for an income of 1'000'000 CHF about 2.5-times as much.

the tax revenue per capita is considerable smaller: in 2006 it was 9'880 chf in the canton zug and 6'163 chf in the canton jura.¹²⁾

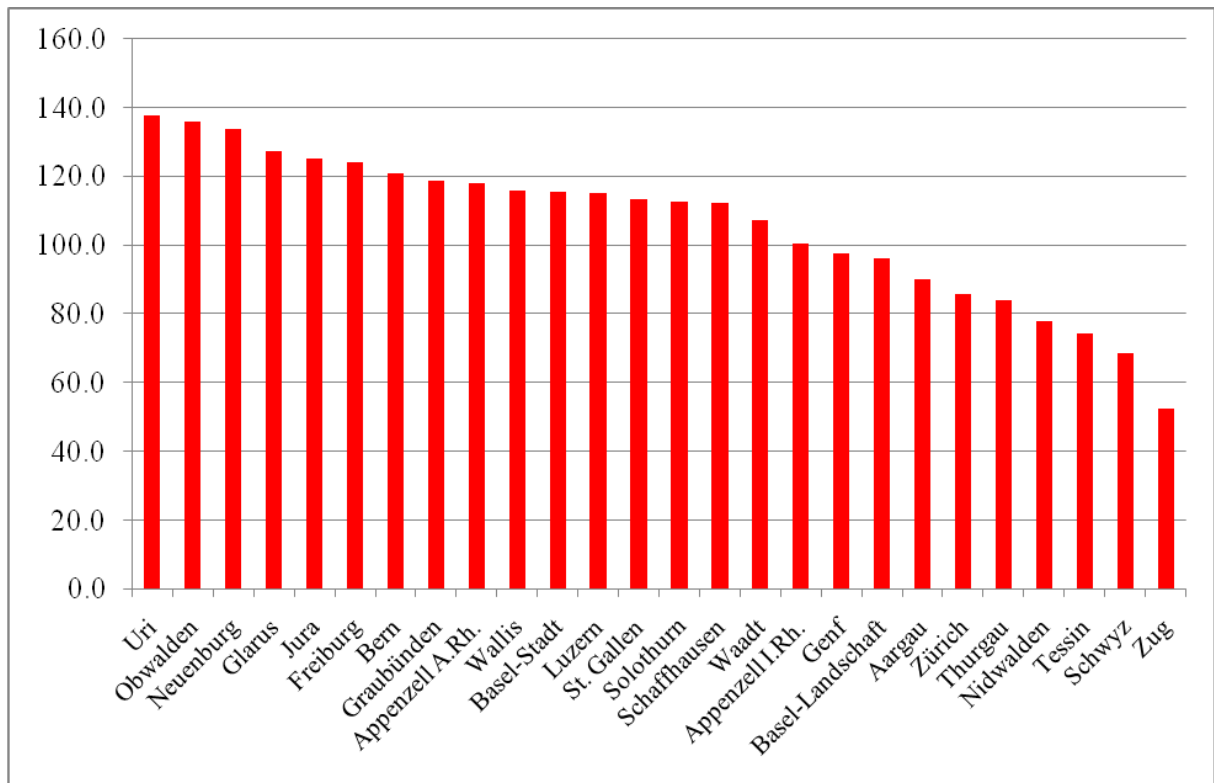


Figure 1: Index of the tax burden in the cantons, ($\bar{\varnothing}$ Switzerland = 100)

[12] The situation of the total burden by cantonal, local and Church taxes is displayed in the index of total tax burden which has been officially calculated until 2006. The values for this last year (when the old fiscal equalisation system was still in effect) are given in *Figure 1*.¹³⁾ There are huge discrepancies. In Zug, the canton with the lowest (average) burden, the index number is just above 50, whereas in Uri, the canton with the highest burden, the index is just below 140. It has also to be taken into account, that these are average figures for the

¹².Source of the data: FEDERAL STATISTICAL OFFICE, *Öffentliche Finanzen der Schweiz 2006*, Neuchâtel 2008, p. 153.

¹³.Source of the data: FEDERAL STATISTICAL OFFICE, *Statistisches Jahrbuch der Schweiz 2009* (CD-ROM) Steuerbelastung nach Kanton, Entwicklung des Gesamtindex (Tabelle. je-d-18.02.02.03.02). – This index was used for the old fiscal equalisation system. As will be explained below, the new system does no longer refer to the actual tax burden but to the revenue potential. Thus, this index is no more necessary for official purposes and these data are, therefore, no longer provided by the Federal Statistical Office.

cantons; the picture is somewhat different (and the discrepancies are even larger) if we consider single local communities. Zug, for example, has a rather strict intra-cantonal equalisation system. Thus, there are only minor differences among its local communities. Schwyz, on the other hand, has only a rather loose equalisation system. This allows some local communities in this canton like Freienbach and Wollerau to have even lower tax burdens than the local communities in the canton Zug. These low-tax and mostly rich cantons and local communities have to be contrasted with the cantons Uri, Obwalden, Neuchâtel, Glarus, Jura and Fribourg, where the tax burden is more than 120 percent of the national average. These cantons and their local communities are mostly relatively poor. Because the income of their citizens is low compared to those in other cantons, they have to have comparatively high tax rates in order to raise the revenue necessary to fulfil their constitutional tasks.

Index of Tax Burden
 Standarddeviation

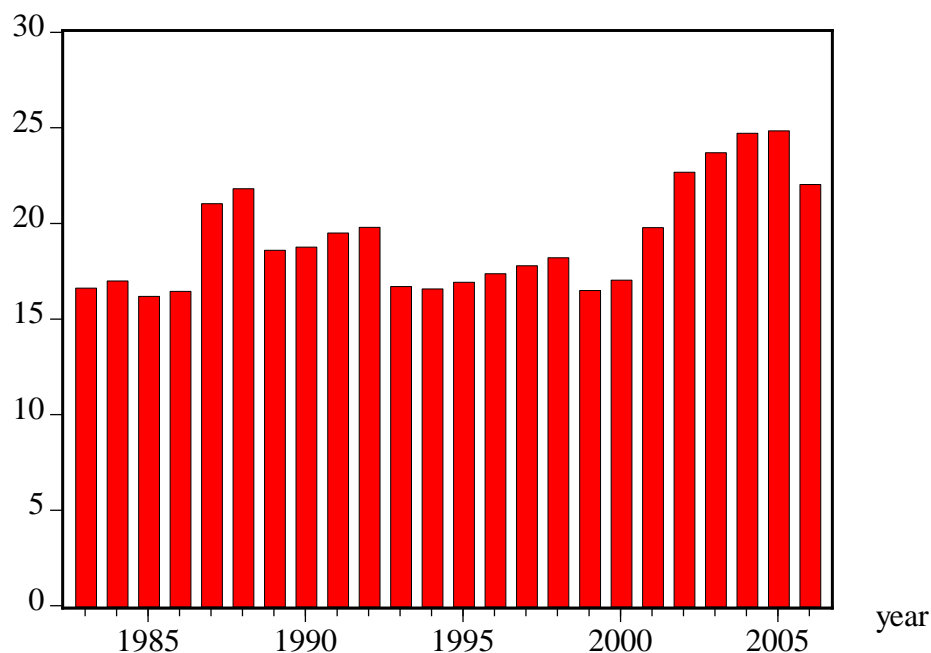


Figure 2: Development of the standard deviation of the index of tax burden

[13] If there were a race to the bottom, not only tax rates should go down but also the variance between the cantons should diminish. This is, however, not the case. Just the contrary happened: there was a steady and rapid increase since the end of the nineties which is only somewhat mitigated by the decrease in 2006. This might be taken as evidence that this hypothesis does not hold for the total tax burden, which is, however, not really surprising because we are not in the symmetric case the theory supposes.¹⁴⁾ This is, however, not necessarily good news. It rather shows that the discrepancies between the cantons recently increased which endangers the cohesion of the Swiss society and supports the demand for restricting tax competition. It is obvious that the hitherto existing Swiss system of fiscal equalisation is not capable of mitigating this development. If this objective is to be reached, the new system has to lay a higher burden on the rich cantons in order to subsidise the poorer ones. It is not surprising, therefore, that the strongest resistance against the reform came from the richest canton, Zug.

[14] There is a special feature of the Swiss tax system which encourages small cantons to reduce their tax rates. 30 percent of the federal direct income tax collected go back to the cantons. Thus, as long as lower tax rates attract additional taxpayers, part of the revenue shortfall due to reduced rates is compensated by higher grants from the federal government. The rich canton Zug got in this way by far the highest per capita transfers from the federal government; its amount was in 2006 three times as much as the national average, and it covered about 25 percent of its expenditures.

[15] Thus, contrary to Germany where there is too much equalisation, a major problem of the old Swiss system is that it does not equalise enough. Moreover, there are currently cantons like Vaud that get much more money than they should. Third, this system is not transparent; it is difficult to assess its real

¹⁴ There is, however, in recent time a race to the bottom with respect to bequest taxes. Several cantons did totally abolish them for direct offsprings in the last 15 years. This is not without problems because these taxes have – compared to other taxes – (if any at all) a relatively low excess burden and, therefore, a comparatively low negative impact on economic development. The former revenue raised with these taxes has now to be raised by other taxes which have a stronger negative impact. On the economic effects of bequest taxes see, for example, H.S. ROSEN (1999, pp. 460ff.).

effects. One of the reasons for this is that the compensatory payments are partly depending on the actual tax revenue which make them easily manipulatable by the cantons. Finally, the system restricts the autonomy of the cantons to a degree that is unnecessary. Taking all these effects together, there was no doubt that a reform was necessary. This was also undisputed in the referendum campaign. It was disputed however, to which level the different tasks, in particular the responsibility for the disabled, should be assigned as well as to what extent the rich cantons should carry burdens in order to disburden others.

4 THE DESIGN OF THE NEW FISCAL EQUALISATION SYSTEM

[16] There were two objectives that should be reached with the new fiscal equalisation system. First, following the subsidiarity principle, the tasks of the different governmental levels should be more disentangled, in particular between the national and the cantonal level. Presently, the different governmental levels share the responsibility in most policy fields and often so in a rather intransparent way. Thus, wherever common tasks are still necessary, there should be a clearer assignment of the responsibilities to the different levels as well as more transparent procedures. Second, the financial potential of the cantons should be more equalised. In order to reach this goal, the new equalisation system employs four instruments:

- (i) Disentangling of tasks and financing.
- (ii) New forms of collaboration and financing of joint tasks.
- (iii) New forms of inter-cantonal collaboration.
- (iv) The new fiscal equalisation in the strict sense, i.e. new compensation payment to and between the cantons.

In the following, we first discuss the new assignment and responsibility regulations¹⁵⁾ and second the fiscal equalisation in the strict sense.

¹⁵⁾A more detailed description of this part of the NFA is given in B. DAFFLON (2004) or in CH.A. SCHALTEGGER and R.L. FREY (2003).

4.1 THE ASSIGNMENT OF AND RESPONSIBILITY FOR TASKS

[17] 18 tasks with previous common responsibility have been entangled in the new system: seven are now solely the responsibility of the national and 11 of the cantonal level.¹⁶⁾ Among those for which the federal government is responsible are now, for example, the financing of the individual benefits of the first column of the Swiss old age pension system as well as the benefits of disabled persons (both in addition to the contributions of employers and employees) as well as the construction and maintenance of the motorways. The cantons are solely responsible, for example, for the second level education as well as grants-in-aid for the building and running costs of home and professional schools for disabled persons. Among those 17 tasks where there is still common responsibility are, among others, educational grants at the university level, subsidies to reduce health insurance premia, or public transport in agglomerations. In these areas, the federal government's task is, in principle, only the strategic leadership, while the cantons have the operative responsibility. Projects in these areas are financed by global grants from the federal government depending on the results to be achieved.¹⁷⁾

[18] Due to the fact that many of the Swiss cantons are rather small but still have – at least compared to the states in most other federal countries – rather large responsibilities, collaborations between two or more cantons are in many cases necessary. Moreover, the large agglomerations as, in particular, Zürich, Bale and Geneva provide already today services from which other cantons profit without having being forced, so far, to contribute to their financing.¹⁸⁾

¹⁶⁾ See for this also NFA Faktenblätter 2 and 9

(<http://www.efv.admin.ch/d/themen/finanzausgleich/Projektphase/Faktenblaetter/index.php> (15/10/09). – These official documents are only available in German, French and Italian, but not in English.

¹⁷⁾ See for this also NFA Faktenblatt 10.

¹⁸⁾ The low-tax local communities of the canton Schwyz are, for example, located on the border of the canton Zürich and are, therefore, able to benefit from the infrastructure of this canton.

[19] The Federal Constitution denotes nine tasks where the new system governs the collaboration between the cantons:¹⁹⁾

- (i) Planning of institutions for rehabilitation and care of disabled persons.
- (ii) Planning and division of tasks of high-tech medicine and corresponding hospitals.
- (iii) Burden sharing between university- and non-university cantons to finance the cantonal universities.
- (iv) Burden sharing to finance the cantonal universities of applied sciences.
- (v) Urban public transportation as long as more than one canton is involved.
- (vi) Prison regimes.
- (vii) Cultural Institutions of inter-cantonal importance.
- (viii) Waste disposal plants.
- (ix) Sewage purification plants.

[20] There has already been some collaboration between cantons in some of these areas so far. Moreover, there are conferences of the cantonal ministers whose decisions are effective in all cantons. These collaborations are, however, mainly optional. In particular, it was impossible to force single cantons to carry the financial burdens caused by them by other cantons. This has been changed now. The federal parliament is now able to declare general agreements or other inter-cantonal treaties as generally binding and to commit single cantons to join them. This is to assure a fair distribution of services and services in returns, or benefits and costs of public activities between the cantons. Those cantons which receive services get co-determination rights in return.

[21] This new provision allows considerable interferences into the autonomy of the cantons and represents, therefore, a massive change of the Swiss federal system. It is not for nothing that it has been attacked by professors of

¹⁹.See for this also NFA Faktenblatt 11.

constitutional law and declared as incompatible with the Swiss tradition.²⁰⁾ It is somewhat astonishing that this argument did not play a role in the referendum campaign. There, the two arguments mentioned above, the net contributions of the different cantons as well as caring for disabled persons were at the centre of the debate. On the other hand, despite the fact that the new system is now about two years in effect, there is again a debate of this point, and it is more or less the only point that is debated at the moment.²¹⁾

4.2 THE FISCAL EQUALISATION SYSTEM IN THE STRICT SENSE

[22] The new fiscal equalisation system in the strict sense consists of three elements. The first one is the resource equalisation. All cantons shall have the necessary minimum amount of fiscal means in order to be able to properly fulfil their tasks assigned to them by the constitution. The second element is the sharing of special burdens of some cantons caused by their socio-demographic situation or by the geographic and topological structure. The final element, called hardship compensation, is a compensation for temporary financial losses caused by the transition from the old to the new system.

²⁰.See, for example, R. RHINOW, Wenig autonomie- und demokratieverträglich: Staatspolitische Bedenken zur Ausgestaltung des neuen Finanzausgleichs, *Neue Zürcher Zeitung* of May 7, 2002, p. 15.

²¹.See, for example, Unterwegs zum föderalen Verwaltungsstaat, *Neue Zürcher Zeitung* No. 31 or February 7/8, 2009, p. 13..

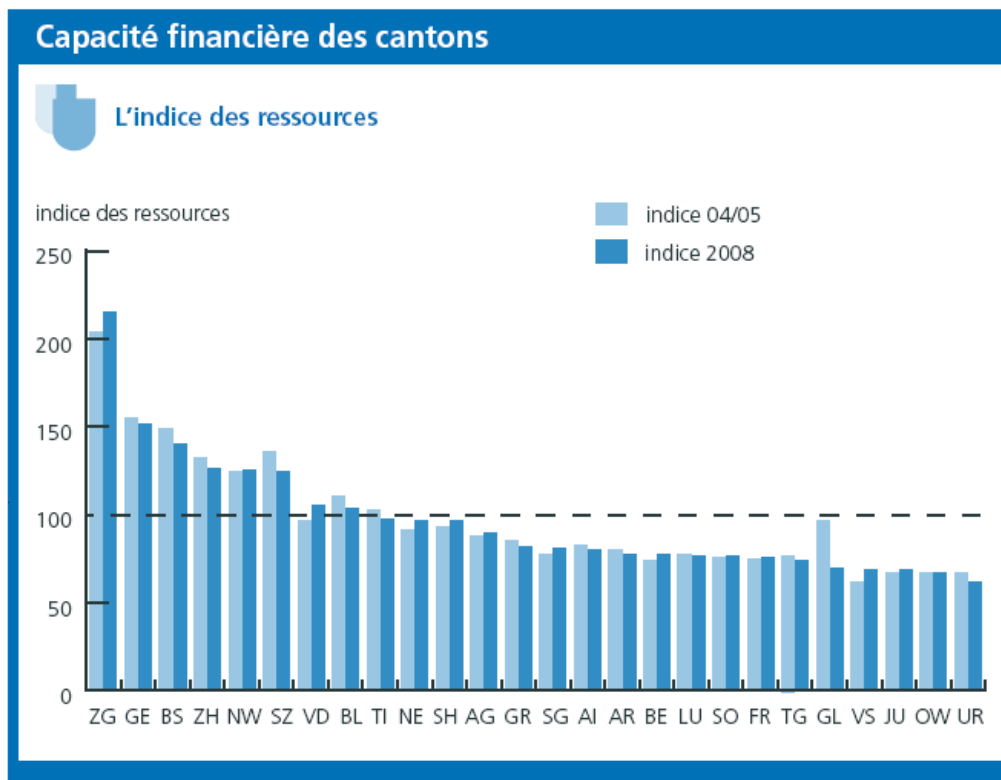


Figure 3: Resource index

[23] The core of the new equalisation system is, of course, resource equalisation. For this it is first of all necessary to assess the financial capability of every canton by a resource index.²²⁾ This index is based on the taxable income as well as the wealth of the individuals, but also on corporate profits. The weighted sum of these three elements constitutes the resource potential of the canton and, divided by the size of the population, the resource potential per capita. Comparing this with the average resource potential per capita in Switzerland which gets an index value of 100 leads to the index value of every single canton. Cantons with an index value above 100 are said to be strong with respect to resources while those with an index value below 100 are considered as being weak with respect to resources. The first group pays into the system, the second one receives revenue from the system. The payments are to be designed so that every canton has free financial means of at least 85 percent of the national average. *Figure 3* shows the values of the new index for 2008 in

²². See for this also NFA Faktenblätter 5 and 6.

comparison with those of the old index for the years 2004/05.²³⁾ The overall picture is more or less the same: most of the donor cantons remain donor cantons, and most of the receiver cantons remain receiver cantons. There will, nevertheless, be some not negligible changes because, for example, Zug will have to pay somewhat more while Glarus will receive more.

[24] The main advantage of the new system is, however, not so much that the equalisation is fairer now (what is, of course, also important), but that the incentives are different. The basis of the new index is the situation of the canton with respect to the direct federal income tax. In contrast to the old system, the level of the cantonal taxes or tax rates does no longer play any role. Thus, manipulations of the own tax revenue do not have any direct effects on the received grants. There are, of course, indirect effects; the situation of a canton in the inter-cantonal tax competition has implications for the tax base of the direct federal income tax. But these indirect effects do hardly give the cantons the possibility to manipulate the grants they receive. In particular, a reduction of the cantonal taxes will not trigger an increase of the grants; if there is an effect, it goes in the opposite direction. Insofar, the incentives for the cantons to take care of their tax basis are not affected. This is a great improvement compared to the old system.

²³ Source of Figures 3 to 6: FEDERAL DEPARTMENT OF FINANCE, Réforme de la péréquation financière et de la répartition des tâches entre la Confédération et les cantons (PRT), Berne, September 2007.

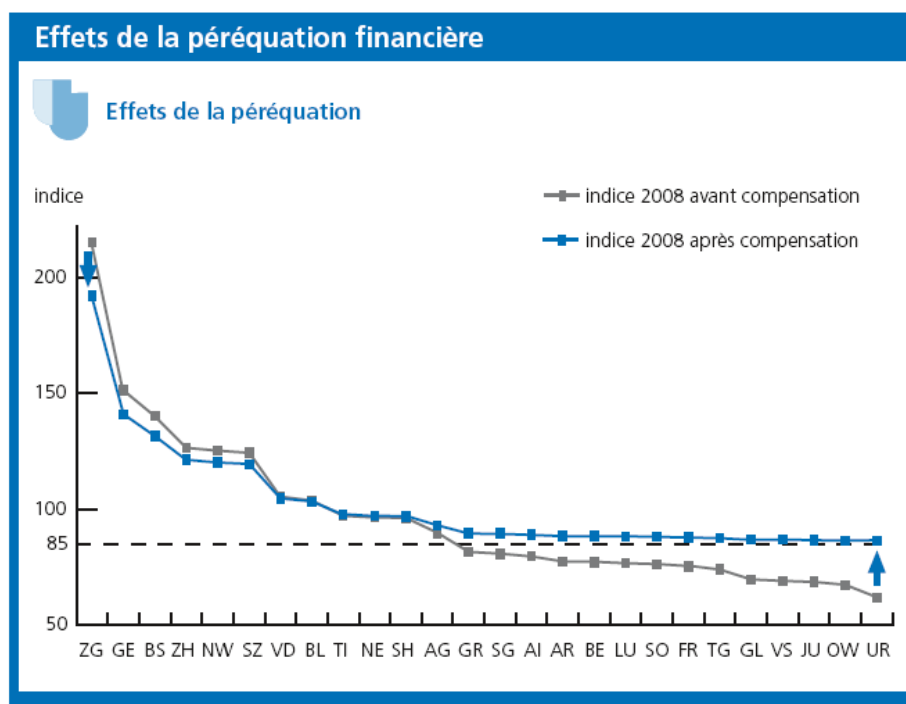


Figure 4: Effects of resource equalisation

[25] Figure 4 shows the equalising effects of the new system for the year 2008. 14 out of 26 cantons have a resource potential below the 85 percent line of the national average. Their situation will considerably be improved. One canton is between the 85 percent line and the national average; its situation will also be improved. On the other hand, 6 cantons are significantly above the national average and have to pay contributions, while the situation of the remaining 5 cantons remains more or less unchanged.

[26] This equalisation is, however, not only financed by the contributions of the donor cantons but also by the federal government. During the first four years, i.e. from 2008 to 2011, the whole amount is 3.16 Billion CHF; the federal government pays 1.8 Billion CHF and the donor cantons 1.26 Billion CHF.²⁴⁾ The contribution of the federal government is paid from the revenue of the federal direct income tax. Of the 30 percent of the revenue of this tax that goes back to the cantons only 13 percent is directly redistributed today, while the

²⁴⁾ See: Bundesbeschluss über die Festlegung der Grundbeiträge des Ressourcen- und Lastenausgleichs vom 22. Juni 2007 (613.22). (<http://www.admin.ch/ch/d/sr/6/613.22.de.pdf> (15/10/09).)

remaining 17 percent go into the equalisation system. Thus, the rich cantons will not necessarily have to pay more money to the other cantons, but they will get less money directly from the federal government. For some cantons, in particular for the canton Zug, this will result in a significant higher net contribution. Due to the financial potential of this canton, this will, however, hardly have any negative effects on this canton and even less on Switzerland as whole, as has been claimed by this canton before the referendum.²⁵⁾ It is, on the other hand, well understandable that the expected increase in the net contribution caused resistance in this canton against the reform, even if it had no effect, finally.

[27] The cantons differ, however, not only with respect to their resource potential, but also with respect to the costs for the services they have to provide, be it, that they have a considerably higher demand for some services, be it, that it is more expensive to provide these services. The first factor mainly relates to agglomerations with their social and demographic problems, the second factor to the topography of the canton. To compensate for these extra burdens, the second element 'burden sharing' or 'cost equalisation' has been included into the system.²⁶⁾

[28] To assess the additional burdens due to geological and geographic factors, i.e., to capture the effects due to mountain areas, three indicators are considered: the size of the population living in altitudes more than 800 meters above the sea level, the average altitude of the productive area of a canton above the sea level, and the share of local communities with less than 200 inhabitants. The rationale behind these three indicators is that people living in higher located communities have additional demands for public services in particular during the winter, that a higher located and, therefore, more steep area also creates higher costs, for example for forestry, and that a less dense settlement results in higher costs for infrastructure. To compensate for these burdens, the federal government pays 341 Million CHF per year to the cantons.²⁷⁾ The regional distribution of these grants is shown in *Figure 5*. As can

²⁵⁾ See for this G. KIRCHGÄSSNER and H. HAUSER (2001).

²⁶⁾ The latter term is used, for example, by B. DAFFLON (2004).

²⁷⁾ Source: See Footnote 24.

be seen from this figure, the main beneficiaries of these grants are Grisons, the two Appenzell, Uri, and, to a somewhat lesser extent, the Valais and Obwalden.

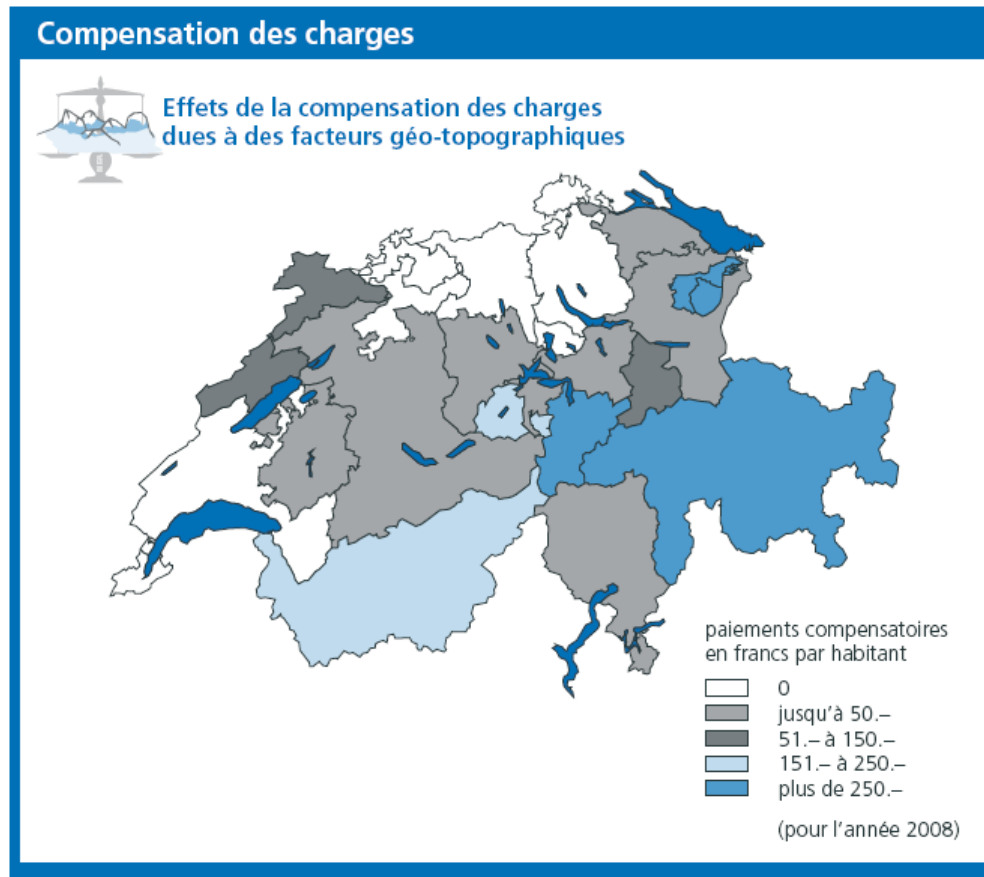


Figure 5: Effects of compensation for costs of geography and topography

[29] The same amount of money is paid by the federal government to compensate for socio-demographic burdens. This consists of two parts. The first one takes into account special problems of the population structure. The indicators used here are the share of those receiving social assistance, the share of people more than eighty years old, as well as the share of foreign people, born outside Switzerland and its neighbouring countries and living in Switzerland for less than 12 years. The second part takes into account the costs of agglomerations. There, the indicator is based on the size of the local community, the share of those employed, as well as population density. The regional distribution of these grants is shown in Figure 6. The main beneficiary

of these payments is Geneva, and somewhat smaller payments per capita go to Zürich, Vaud, Neuchâtel and Ticino.

[30] An immediate transition to the new system would have created quite a lot of losers, even among those cantons that are (according to the resource index) financially weak. The reason is that they received under the old system higher grants than they deserve under the new system. Under these conditions, the new system would hardly have had any chance in the referendum. A referendum was, however, mandatory because the introduction of the new system required a constitutional change, and in Switzerland every such change is subject to a mandatory referendum. In order to avoid this and not to risk the whole project, the hardship compensation has been added as the third element. The idea behind it is that every financially weak canton should, at least in the beginning, have some relief, whatever its position in the old system was.

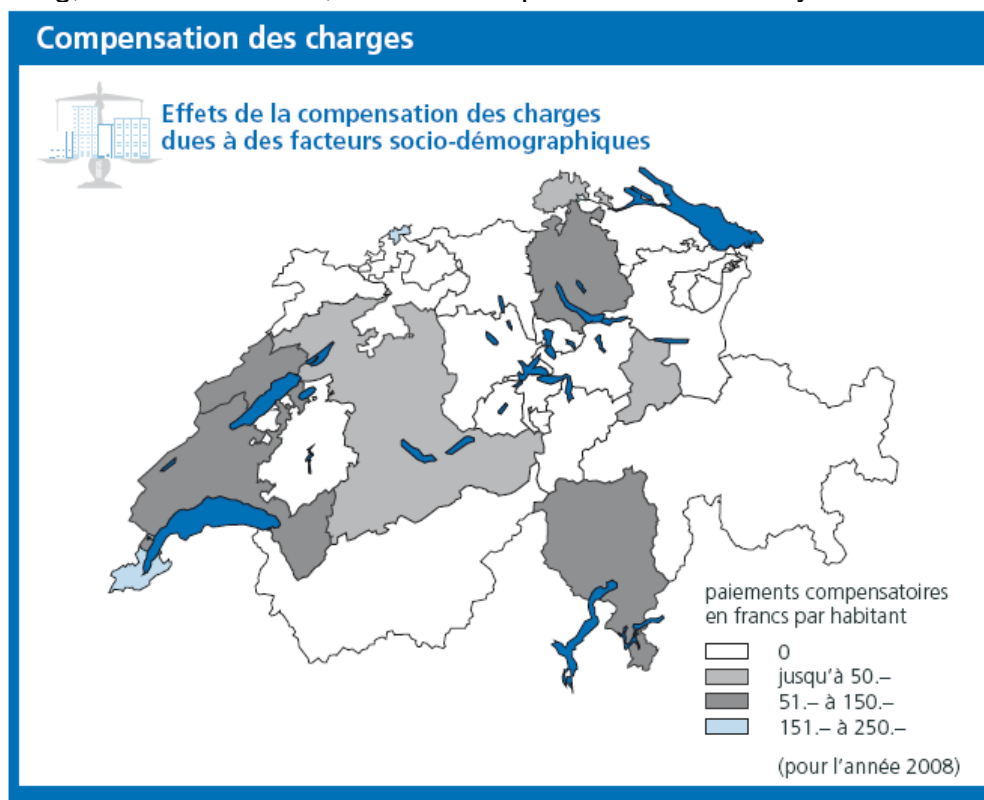


Figure 6: Effects of compensation for costs of socio-demographic factors (agglomerations)

[31] For the first eight years, the payments are fixed. The total amount is 430.5 Million CHF, 287 Million CHF are paid by the federal government and 143.5 Million CHF by the cantons. The latter are on a per capita basis with about 19.5 CHF per capita. *Figure 7* shows the distribution of the net-payments per capita among the cantons. There are two cantons, Neuchatel and Fribourg, which benefit quite a lot from these payments, three with considerable benefits, Obwalden, Jura and Glarus, and three others that benefit a little bit. However, aside from the rich cantons every canton is now better off than in the old system. This was actually the intension of this procedure.²⁸⁾ This will hold for the first eight years, i.e. until the end of 2015. Then, the amount of money for hardship compensation will be reduced by 5 percentage points every year. Thus, the new standard situation will be reached in 2035 only.

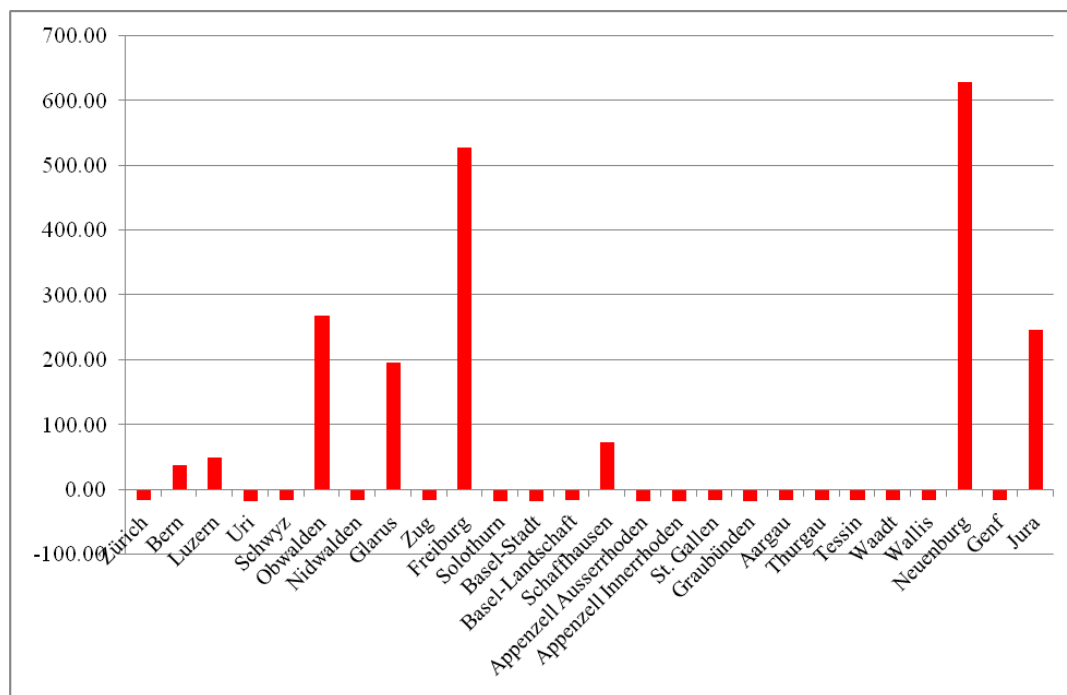


Figure 7: Payments of hardship compensation

²⁸.See, for example, P. SIEGENTHALER and G. WETTSTEIN: "no canton with a weak financial capacity, which today benefits from equalisation, should suffer from worse conditions with the new scheme.", NEUE ZÜRCHER ZEITUNG Nr. 182 of August 9, 2001, p. 13. (Translation from B. DAFFLON (2004, p. 45.)

[32] Economically, this part of the new equalisation system is the most problematic one. It is, however, a political concession to these cantons. Given the large majority in the referendum of November 28, 2004, one might ask whether these concessions have really been necessary, in particular to such a large extent. It has, however, taken into account that a rejection by the electorate would have the consequence that these cantons would have received their – from today's point of view – unjustified grants on and on and these grants might even have increased. Insofar these concessions seem to be justified in order to get a second best solution and not to endanger the whole project.

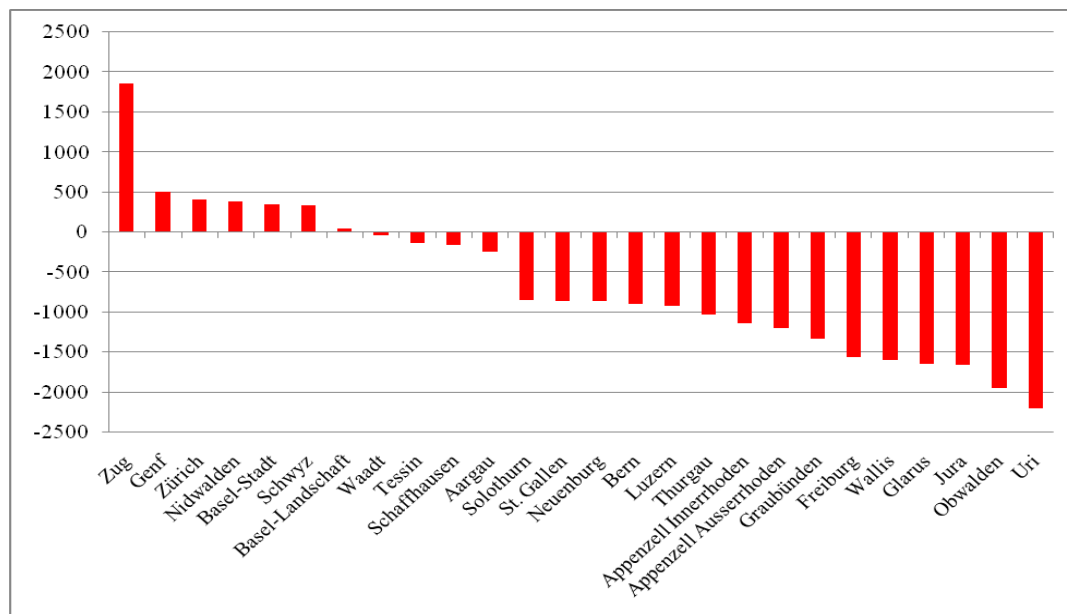


Figure 8: Net payments or contributions in 2009, respectively

[33] Figure 8 shows the net payments per capita of the sum of all three parts of the equalisation system together for all cantons for the year 2009. There are six donor cantons, two cantons have a more or less balanced situation, three cantons get some money while 15 cantons receive relatively high grants. In absolute terms, the biggest donor by far is the canton Zürich, but it is also by far the biggest canton. In per capita terms, the biggest donor is Zug, with 1'856 CHF per capita in 2009. On the other hand, Uri receives even 2'196 CHF per capita. Given the facts that 15 cantons are clear beneficiaries, 4 others get at least some money out of this system, and that, due to the hardship

compensation, all cantons of these group are better off than before, it is not surprising that the referendum showed a clear majority 64.4 percent for the reform. It is rather astonishing that only three cantons, Zug, Nidwalden and Schwyz, voted negatively. Even the canton Zürich voted with 60 percent for this reform.

5 CONCLUDING REMARKS

[34] The reform of the Swiss fiscal equalisation system was a rather long process; taking all together, it lasted about 16 years. First serious considerations and planning started in the federal finance administration in 1992. A first concrete proposal was presented in 1999. Aside from the hardship compensation, it had already the structure of the concept in effect today. As prescribed by the constitution, there was the usual consultation procedure, and the proposal with all comments was published in March 2000. The cantonal finance ministers accepted the proposal after additional discussions and the inclusion of the hardship compensation in August 2001. At this time the only negative vote came from Zug.

[35] Then, the parliamentary process started. The first step was to pass the necessary amendment of the constitution. The federal government presented its proposal in November 2001. The parliament accepted the reform with some minor revisions in October 2003. As mentioned above, there had to be referendum as for every change of the Swiss constitution. After intense public discussions, the Swiss citizens voted with a rather large majority for this reform. Thus, after about 13 years the most important part of the reform was successfully finished.

[36] The last part, which took another three years, was to pass the necessary law and the corresponding governmental and parliamentary decrees. The last but very important points, the concrete amounts of the payments, were decided in two parliamentary decrees which passed the parliament on June 22, 2007.²⁹⁾ There was the possibility for an (optional) referendum, but nobody was

²⁹⁾ SR 613.22 and SR 613.26.

collecting signatures. Thus, both decrees came into effect on January 1, 2008. Moreover, the government had decided that the law for the new equalisation system which had passed the parliament (without a referendum) already in 2003 should come into effect at the same date.

[37] One reason for the fact that it took so long is that, in order to prevent a failure of the project, the Swiss direct democracy makes it necessary to incorporate all relevant affected groups into the consultation process before a law (or a change of the constitution) passes the parliament. Thus, our direct democracy does not only lead to a delay, because after passing the parliament an acceptance of the citizens is necessary, but usually even more to a rather slow process due to the extensive incorporation of these groups into the political discussion process. The possibility of a successful referendum organised by major interest groups can hardly ever be excluded, and to avoid it the interests of relevant groups have to be considered seriously.

[38] This does, however, neither imply that major reforms are impossible, as some Swiss economists argued,³⁰⁾ nor, that it necessarily takes longer than in other countries with purely representative systems. It is, for example, common ground since several decades that a major reform of the German federal system is necessary. The basic paper by F.W. SCHARPF about the 'joint decision trap' has been published already in 1985. Nevertheless, it took rather long, before the two small reforms of the German federal system were undertaken in recent years; even together they are much less far-reaching than the Swiss reform. Moreover, the German fiscal equalisation system with its rather counterproductive incentives has not yet been touched by these reforms.

[39] Contrary to the German experience, the new Swiss fiscal equalisation system seems to be a good compromise between preserving the incentives of the cantons to take care of their taxpayers and the (partial) equalisation of the financial situation of the cantons. The two important points in this respect are that first the resource potential is measured by the tax base of the federal direct taxes. Thus, changes of the cantonal tax rates do not have direct effects on the

³⁰⁾ See, for example, S. BORNER (1997) or W. WITTMANN (2001), but also G. KIRCHGÄSSNER (2008).

grants out of the equalisation system. Second, the fixing of a minimum level of the financial resources of 85 percent of the national average and the waiving of an upper level leaves enough leeway and incentives for poor as well as rich cantons to take care of their tax base. Thus, free rider behaviour of the poor cantons can largely be excluded, and the Swiss federal system remains a competitive one.

[40] Strong evidence for this is provided by the fact that the intensity of tax competition between the cantons did not decrease after the introduction of the new system. It is not only that cantons like Zug decided on additional tax cuts, but also that those high-tax cantons which now get more money out of the equalisation system often used this money for tax cuts. To provide those cantons with this possibility was, of course, one of the objectives of this reform. Due to the current economic crises and the reduction of tax revenue connected with it, the leeway for such tax cuts will be smaller in the coming years. This does, however, not imply that this process is finished.

[41] Taking all things together, this was a long but finally successful process. Due to the fact that the transition period with the hardship compensation will last 28 years altogether, it will even take more time before the new system is fully in effect. Whether the new system of fiscal equalisation fulfils the expectations connected with it, can today not yet be decided. To have more information about this will take several additional years. There are, however, so far no indications that this will not be the case.

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