Swiss cantons still compete for taxpayers

Fiscal equalization does not compensate for all differences among cantons.

BY *LARS P. FELD*

Tiny Switzerland has surprising news for its critics: instead of the usual slowness in political reform, Swiss federalism has recently undergone significant changes in a short time. To bring the different income taxes for each canton more in line with one another, a federal law on cantonal tax harmonization was enacted in 1993 that gave the cantons until 2001 to adapt their income and profit tax bases to certain minimum standards. Despite a wide interpretation by the Swiss federal (supreme) court, the tax harmonization law did not aim at complete tax harmonization, as tax rates and large parts of tax bases have remained cantonal responsibility.

In a referendum in 2004, Swiss citizens accepted a package of reforms of the fiscal equalization system. The old system had almost exclusively involved transfers from the confederation to the cantons and municipalities – what economists call "vertical transfers," or transfers of funds from the central authority to the constituent units. Up to now, the cantons got 30 percent of the federal income tax as unconditional grants, and received additional matching grants. The unconditional grants comprised about a quarter and the conditional (matching) grants the other three quarters of total transfers to the cantons. Moreover, the cantons contributed to the federal social security schemes. All in all, total transfers amounted to about 15.5 billion Swiss Francs (about $12.425 billion U.S. dollars).

But beginning in 2008, these transfers, which were for the most part paid as matching grants, will be replaced by a new system combining both vertical and horizontal transfers (transfer payments among entities of the same order), and based on unconditional grants. The new transfer system will consist of a so-called resource equalization scheme and a plan to equalize particular cantonal burdens. The federal government will contribute the funds for the equalization of specific burdens with a sum of 688 million Swiss francs per year. These transfers are paid to compensate for the burdens associated with living in mountainous and urban areas.

Not compensating for everything

The resource equalization scheme is funded by the federal government with about 1.8 billion Swiss Francs (about $1.44 billion U.S.) and the eight resource rich cantons with about 1.3 billion Swiss Francs (about $1.12 billion U.S). This money is distributed to the 18 resource poor cantons according to their position on a resource index that is derived from their aggregated (income and wealth) tax bases.

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Photo: Konrad Busslinger

Zurich: no place for millionaires? An unmarried taxpayer in Zurich with a taxable income of a million Swiss francs pays cantonal and local income taxes of 25.1 per cent. One hour away in Wollerau, in the canton of Zug, that person would pay only 7.9 per cent.

Fiscal equalization will compensate for differences in economic resources, instead of financial strength. In other words, a canton cannot get extra transfer payments simply because it chooses to keep its tax rates below those of other cantons. The reform package also contains a new assignment of tasks to the cantons and the federal level. However, what could amount to more than half of today's matching grants to the cantons will not be replaced by unconditional grants, but abolished as the federal government will take over the corresponding responsibilities and assume the cost of this expenditure. The new fiscal equalization system is also being created in order to compensate for the effects of tax competition between the cantons.

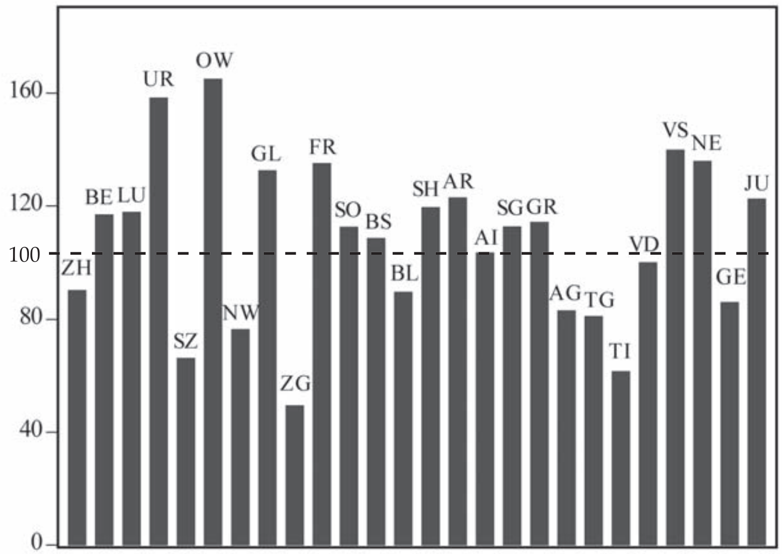
As if this was not enough, the Swiss Social Democrats announced in late 2006 a popular initiative calling for a referendum on their proposal to essentially harmonize cantonal taxes with fully harmonized tax bases as well as minimum tax rates. The initiative awaits its official launch, which requires the collection of a legally specified number of signatures to hold a referendum. As this initiative has gained additional attention after several cantons have recently introduced regressive income tax schedules, observers expect the Social Democrats to aim at using this political momentum to increase their voting share in the federal parliamentary elections in 2007.

Those not familiar with Swiss federalism might raise their eyebrows and wonder what is going on. Swiss citizens will have to ask themselves whether tax competition is sufficiently important to cause such political turmoil, and whether tax competition really affects their well-being.

The Swiss fiscal constitution

The Swiss fiscal constitution is unique among the classical federations as it results in a stronger decentralization of direct taxes than in any other federation. While the Canadian provinces or the U.S. states rely to a considerable extent on indirect taxes, the Swiss cantons have the basic

Figure 1: **AVERAGE TAXES BY SWISS CANTON IN 2005:**
Index of the cantonal and (weighted) local income and wealth (property) tax burden.



Some cantons, such as Zug (ZG) and Schwyz (SZ) have a tax burden far below the average index of 100. Others, such as Freiburg (FR) and Obwald (OW) have much higher taxes.

Cantons: Zurich (ZH), Bern (BE), Lucerne (LU), Uri (UR), Schwyz (SZ), Obwald (OW), Nidwald (NW), Glarus (GL), Zug (ZG), Freiburg (FR), Solothurn (SO), Basel-City (BS), Basel-Country (BL), Schaffhausen (SH), Appenzell-Outer Rhodes (AR), Appenzell-Inner Rhodes (AI), St.Gall (SG), Grisons (GR), Argovia (AG), Thurgovia (TG), Ticino (TI), Vaud (VD), Valais (VS), Neuchâtel (NE), Geneva (GE), Jura (JU).

power to tax individual income and profits. (An indirect tax is one that is not paid directly by a manufacturer or a vendor, but which is passed on in the form of a higher price paid by the end user, as in the case of a Value Added Tax (VAT) passed on to the buyer.)

More than 95 per cent of Swiss cantons' tax revenue and more than 50 per cent of their total revenue originate from these sources. As well, local jurisdictions add a surcharge on cantonal taxes. The federal level also taxes income and profits, but derives this power from the cantonal responsibility. This is why federal income and profit taxes, including their tax rates, have to be renewed regularly in a federal constitutional referendum. Although the federal level finances a larger part of its budget by VAT revenue, the federal income tax is significant as the upper five per cent of the taxpayers pay more than 50 per cent of federal revenue.

Cantons and local jurisdictions use their taxation powers to a considerable degree. For instance, cantons like Zug, Schwyz and Ticino have 50 per cent or less of the average income tax burden, while Obwalden and Uri have a tax burden higher than 50 per cent of the average. In another example, in Zurich, unmarried taxpayers with taxable income of one million Swiss francs (about $818,000 U.S.), paid cantonal and local income taxes of 25.1 per cent in 2005. Less than an hour travel time away, in the community of Wollerau in the canton of Schwyz, unmarried taxpayers with the same income only paid cantonal and local income taxes of 7.9 per cent. Although taxpayers additionally pay the federal income tax without any compensating credits between the tax systems, these differences give taxpayers a strong incentive to move to cantons with relatively lower tax burdens – if other attractions are the same.

Similar differences are found in the area of profit taxation, and as before they are larger at the local level than at the cantonal level. In this case, however, taxation is becoming more differentiated, with specific tax provisions. For example, tax holidays are offered for newly founded firms or holding privileges, special agreements for division of a company's taxes among the cantons and so on. In many Swiss cantons, "holding privileges" give companies exemption from income taxes if either two thirds of the company's income is derived from dividends or two-thirds of its assets consist of participations in other companies and the company does not engage in active business in Switzerland. Moreover, fiscal equalization payments cover between 12 per cent (Geneva) and 51 per cent (Jura) of total cantonal revenue. Three-quarters of these transfers are in the form of matching grants. The relatively small horizontal component of the fiscal equalization system (between entities of the same order) involves direct compensation of spillovers - that is, the effects on other cantons of an action by a neighbouring canton.

Is tax competition really taking place today?

The supposed impact of tax differences in residence or location choices can only be expected if other factors influencing these choices are the same in different regions. This is, however, not necessarily the case in the real world. It is thus fair to ask whether tax differences really matter that much in Switzerland, given other factors related to the attractiveness of each location. Empirical studies lend support for the varying impact of taxes on residence or location choices. The higher the income tax rates, the lower the number of taxpayers with high income in a canton. This phenomenon is especially pronounced at the highest end of the income distribution spectrum. As well, young, highly educated people react relatively strongly to tax-rate differentials. The effect of taxes also is more pronounced for self-employed taxpayers than for employees or retirees. As well, it is stronger at the local level than at that of the canton. Public services partly compensate for the impact of taxes, but there remains a noteworthy net impact. Income and profit taxes also affect the location of firms.

There are several factors that weaken the effects of interregional tax competition. On the one hand, tax levels are reflected in housing prices. The lower taxes are, the higher housing prices are. Thus, people moving from Zurich to Wollerau for tax purposes pay relatively high prices for their apartments. However, the reflection of tax differences in housing prices is incomplete, leaving room for tax competition to have an effect. On the other hand, vertical fiscal externalities exist that counteract horizontal fiscal externalities. Horizontal fiscal externalities might occur when cantonal governments reduce tax rates to attract taxpayers inducing taxes to be inefficiently low overall. However, taxes tend to be inefficiently high if different orders of government tax the same base, and this vertical fiscal externality offsets the tax reduction by some cantonal governments. The picture is completed by evidence of strategic tax setting by cantons and local jurisdictions. They, indeed, set their tax rates to attract desirable taxpayers, although other factors also affect their choices. Thus, the bottom line is that tax competition exists in Switzerland, but it is not as fierce as the tax rate differentials suggest.

Where does tax competition lead?

Given that tax competition exists in Switzerland, does it have the effects that most proponents of tax harmonization fear? Empirical studies of the efficiency of tax competition in Switzerland largely indicate that tax competition enhances efficiency rather than reducing it. First, regional spillovers are less important than is often thought, or they balance each other out. In addition, the horizontal components of fiscal equalization internalize regional spillovers – that is, negative effects of one canton's policies on a neighbouring canton. Second, tax competition leads to lower spending and revenue in the cantons because there is lower tax revenue. Third, tax competition likewise shifts the revenue structure toward a greater use of fees and user charges. (However, larger user fees contribute to an increased inequality of after-tax income.) Fourth, it leads to higher overall labour productivity in the cantons, indicating higher efficiency as the cantons are forced to use their scarce resources at the lowest cost and according to citizens' preferences. However, tax competition also restricts the ability of cantons to redistribute income through broad-based tax-transfer programs, although cantons and local jurisdictions do conduct income redistribution nevertheless. Thus the federal level, with its system of social security and the highly progressive federal income tax, is more important for income redistribution.

A balanced approach

Tax competition between the Swiss cantons and local jurisdictions is thus a very important phenomenon. Given the empirical evidence, however, there are not strong grounds to justify a major tax harmonization at the moment. The Swiss fiscal constitution appears to be well-adapted to the advantages and disadvantages of its competitive federalism. In particular, the federal income tax system plays an important role as regulator of cantonal tax competition and is, thus, able to serve demands for individual equality. The new fiscal equalization system is supposed to lead to a fairer regional distribution of income. Further measures restricting cantonal fiscal competition will only increase inefficiency in the public sector.

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Moscow and regions share Russia's oil and gas revenues

quality and availability of public health and educational services, increasing housing for the population, improving the transportation infrastructure, the reconstruction and construction of projects in the communal infrastructure (gas- and water-supply systems, heating systems, etc.) and improving the environment. Thus, the resources of the Stabilization Fund, endowed by the taxes from oil and gas extraction, will ultimately be directed to decreasing regional disparities in living standards.

In conclusion, it is interesting to note that, despite the almost complete centralization of revenue from taxes on mining operations in the federal budget, high prices for oil and gas still allow oil- and gas-producing regions to raise significantly greater per-capita budgetary revenues than in other regions. This is achieved through the tax on the large profits of the oil- and gas-producing companies, and income taxes collected from the high wages of workers involved in oil and gas production. All income taxes paid by workers of these companies within a given region flow into the budget of that region, as does a portion of the taxes on profits of these companies, at a rate ranging from 13.5 per cent to 17.5 per cent. As a result, the Autonomous Areas of Nenetskiy, Yamalo-Nenetskiy and Khanty-Mansiyskiy rank first, second and third among Russian regions in terms of revenue per-capita.

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Rethinking fiscal federalism

world. "Beggar-thy-neighbour" or "race-to-the-bottom" fiscal policies and barriers to the mobility of goods and factors of production have the potential to undermine gains from decentralized decision-making, as recent experiences in Brazil, India, Mexico and Spain indicate. The Canadian and U.S. federal systems have, on the other hand, successfully met this challenge by securing a common economic union.

Incentives for responsive governance

In most federal countries, especially in the developing world, intergovernmental transfers are focused on dividing the pie without regard to creating incentives for responsive and accountable service delivery. Revenue-sharing arrangements often discourage local taxation efforts and introduce perverse fiscal incentives through gap-filling approaches. Conditional transfers in most federal countries are focused on input controls and micromanagement, thereby undermining local autonomy. In a few countries such as the United States, they serve as a tool for pork-barrel politics. The practice of output-based transfers with conditions on standards and access to public services but having flexible choices in designing programs and in spending allocations to create incentives for results-based accountability is virtually non-existent. A notable exception is the Canadian Health Transfers (CHT) program by the federal government. The principal conditions of the CHT program are on the universality of access to health care and portability of health insurance across provinces.

The ability to adapt

Federal countries have shown a remarkable ability to adapt and to meet emerging challenges in fiscal federalism. While the challenges they face might be very similar, the solutions they discover and adopt are always unique and local. This represents a remarkable attestation to the triumph of the spirit of federalism in its never-ending quest for balance and excellence in responsive, responsible and accountable governance. The long march to attain new heights in inclusive governance continues.