

Sustainable Public Finances with Sub-Federal Fiscal Autonomy: The Case of Switzerland

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The Swiss system demonstrates that, in federal countries with the appropriate environment and institutions, it is possible to have sustainable public finances while maintaining a very large degree of fiscal autonomy for the sub-federal units. A reform of the fiscal equalization system which will come into effect in 2008, along with instruments available to encourage fiscal responsibility among the cantons, are a few of the reasons why this is the case.

Switzerland's cantons have a greater power to tax than constituent units of any other federal country in the world except for some states in the U.S. Swiss income tax is largely a cantonal tax, and each canton has its own set of tax categories, some more progressive than others. This holds not only for large cantons like Zurich, with more than 1.2 million people, but also for the smallest one, Appenzell Innerrhoden, which has less than 15,000 inhabitants. Moreover, Switzerland has direct democracy at every level of government. This means that a Swiss citizen, with enough signatures on a petition, can either put a proposal before the electorate, or call for referendum to approve or reject a new law passed by the government. Such direct democratic powers vary among the cantons, but are nevertheless rather more extensive than almost anywhere else.

The small size of the country leads to intense tax competition among cantons, which results in huge differences in the tax load. In 2003 in Delémont, the capital of the canton Jura, a family with two children and a taxable income of 150,000 Swiss francs had to pay 23,847 Swiss francs in cantonal and local taxes in addition to the federal income tax of 3,466. That same family would have paid only 10,094 Swiss francs in Zug. Not surprisingly, this leads to a tendency for the wealthy to live in low-tax cantons. This is possible because the small distances in Switzerland allow at least some people to have their home in a low-tax canton and to earn their income in another canton.

A large part of income redistribution is done with progressive income taxes in the cantons. This is contrary to textbook wisdom that states that redistribution can scarcely be done at sub-federal orders, as the competition between sub-federal units might lead to a race to the bottom. Four institutional factors make this possible: federal income tax is low, but highly progressive; the first column of the old age pension system that is highly redistributive is at the federal order; there is a withholding tax rate of 35 percent on dividend and interest income; and a fiscal equalization system exists. Thus, high income people living in a low-tax canton cannot totally avoid contributing to the fiscal burden of the country.

The Swiss fiscal equalization system is necessary to keep the country together and at the same time to maintain tax competition. Such a system can, however, provide perverse incentives, stimulating some cantons to seek additional grants from the central government and other cantons rather than to attract taxpayers. The longstanding equalization system - still in operation today - had such effects. That was why last year the people voted for a reform of this system which will come into effect in 2008. It will avoid such incentives to a large extent. Under the new system, grants will be provided not only to cover the burdens of the urban areas and of the mountain regions, but also to subsidize the poorer cantons; it is estimated that after the reform comes into effect, the latter's revenues per capita will be no less than 85 percent of the national average. This will still leave a large leeway for tax competition between the cantons. The money

for these grants will come partially from both the central government and the richer cantons. Under the present fiscal system, the large differences in the fiscal burdens result, as is typical, from asymmetries; well-located small cantons can exploit larger cantons.

Switzerland has a further problem common to federal systems: how can individual cantons, especially poorer ones, be prevented from introducing irresponsible fiscal policies with increasing deficits, while counting on a bail-out by the federal government? In practice, the cantons perform quite differently. In 2003, the average cantonal debt per capita was 10,522 Swiss francs. Six of the 26 cantons had less than 4,000 Swiss francs per capita as debt, while the canton of Geneva had a per capita debt of 46,512 Swiss francs.

Given the fiscal autonomy of the cantons and, if necessary, the grants from the equalization system, every canton should theoretically be able to take care of its finances in a responsible manner. In addition, two instruments are available which help the cantons to maintain a sustainable fiscal policy. First, the fiscal referendum allows citizens to scrutinize, debate, and stop the government and/or the parliament from any proposed expenditure.

A second instrument is the “debt brake,” used by some cantons. It forces the canton not only to balance the current budget - including depreciations of investment projects - but also to save some amount of money if there is a surplus, as in boom times. The surplus can be spent if there is a deficit – as in a recession - before taxes have to be increased. This allows the canton to undertake some anti-cyclical fiscal policy while at the same time ensuring that the budget is balanced in the long run.

In St. Gallen, which has had such a rule for more than 70 years, this has proved very effective and consequently the cantonal debt is relatively low. Fribourg has had a similar rule since the 1960s, and it also has sound finances. In the last ten years, Solothurn, Appenzell Ausserrhoden, Graubünden, Luzern, Bern, and the Valais also introduced similar rules. As long as these rules are observed, there is no danger of a debt crisis in a canton and, correspondingly, there is no necessity for a bail-out or for an intervention by the federal government. In brief, the Swiss fiscal system works particularly well in those cantons which have adopted these fiscally responsible institutions.