

1. Introduction

Switzerland's geography and historical development have led to a unique political system among the world's federal countries. A small country at the centre of Europe, Switzerland is surrounded by member states of the European Union, without being a member itself; the country shares borders with Germany, Italy, France, Austria and Lichtenstein. The result is a high level of ethnic, linguistic, and religious diversity within a small territory. With a population of 7.3 million, there are four national languages: German (64%), French (20%), Italian (6.5%), and Romansch (0.5%). Roman Catholics make up 42% of the population, and Protestants 35%. Growing levels of immigration have meant an increased diversity of languages and religious affiliations within the population, including 9% Muslims.

Looking at the geographical location and diversity of the population described above, there is in the traditional understanding of the nation state no obvious reason why the country should exist in its current borders. Switzerland began as a collection of small, independent communities, physically separated by mountainous terrain. Despite their diversity, these communities shared a common objective to defend themselves against much larger neighbours. The Swiss federation, therefore, emerged not from the devolution of sovereignty from a centralized state, but from the gradual merger of three loosely coupled states in 1291 till 26 cantons to date. Switzerland can therefore be described as a "bottom-up," rather than "top-down" federation. Even as federated entities, the cantons retain their sovereignty, undiminished by the federal constitution. This historical context is central to understanding the country's current political structure as one of the most highly decentralized, multi-ethnic federation's world wide.

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2. Federal Structure

There are three levels of government in Switzerland: the federal government, 26 cantons, and over 2,500 municipalities (see Figure 1). At the federal level, the legislative branch consists of two chambers, the House of Representatives (Nationalrat), with 200 members, and the Senate (Ständerat), with 46 members. Each chamber has equal standing, and laws must pass through both houses. Parliament, in turn, elects a seven-member executive; the presidency rotates among them annually. As a creation of the 26 federated cantons, the federal government operates on the principles of power-sharing and consensus.

The vertical division of powers among the governments clearly demonstrates the level of decentralization in the Swiss federal system. The powers of the federal government are specified in the Constitution, with all residual powers remaining at the cantonal level. The creation of new powers for the federal government, therefore, requires an amendment to the constitution. By contrast, the cantons are free to define their own tasks within their field of competence. The autonomy of the cantons is further strengthened by the composition of the senate, which consists of 46 cantonal delegates. Lastly, the municipalities represent the third tier of government, which is formally recognized in the 1999 Constitution. Municipal governance is regulated by the individual cantons, and therefore varies significantly. In terms of the divisions of powers, the municipalities interact directly and exclusively with the cantonal government.



Figure 1: Switzerland and its cantons

3. Fiscal Federalism in Switzerland

Switzerland's high degree of decentralization is readily apparent in the country's fiscal structures. While governments interact, both vertically and horizontally, in a number of complex ways, the delivery and financing of public services remains heavily devolved to the lower levels of government. Switzerland's system of fiscal federalism is based on three guiding principles: that of subsidiarity, fiscal equivalence, and direct democracy. Each of these will be examined in turn.

Subsidiarity

While the term has resurfaced recently in discussions on the future constitution of the European Union, the idea has always guided the allocation of tasks and responsibilities within Switzerland. In essence, subsidiarity refers to the principle that public services should be provided at the lowest practical level of government. In assigning responsibilities, this means that local problems should be dealt with locally, and national problems at the national level. The federal government, for instance, is exclusively responsible for defence and foreign relations. Health care, justice, and police, on the other hand, are largely the responsibility of the cantons and municipalities. Areas

where all three levels of government coordinate their efforts include social welfare and transportation.

One effect of the scrupulous application of the subsidiarity principle is the relative prominence of the lower levels of government both in expenditure and revenue (see Figure 2). Subsidiarity also has an important impact on the ratio between public expenditure and the Gross Domestic Product (GDP) which is the third lowest in the world, behind Japan and the United States.



Figure 2: Public level expenditure (left) and revenue (right) by level of government (approximations)

The respective roles of the three levels of government are also reflected on the revenue side. Each tier has the power to raise taxes, and again, the cantonal and municipal governments together raise two thirds of overall government revenues (see Figure 2).

The federal government relies primarily on indirect taxes, such as the value added tax, tobacco, transport levies and import duties. Cantonal and municipal governments, on the other hand, raise revenue mainly from direct taxes, particularly personal income and corporate taxation. Finally, the cantons also receive significant transfers from the federal government, which provide nearly 30% of their revenue.

Fiscal Equivalence

The principle of fiscal equivalence links cost with benefit. In essence, it stipulates that those who benefit from a public good should be the ones to pay for it. Those who finance a public good through their taxes, in turn, should also have a voice in how the money is spent. Altogether, fiscal equivalence ensures that those benefiting from, financing and deciding on the provision of public goods are the same. With respect to the division of responsibilities, fiscal equivalence adds an efficiency component to the subsidiarity principle. The coincidence of those paying and benefiting from a policy ensures the optimal or most efficient provision of public services by reducing spill-over effects to neighbouring jurisdictions. In the absence of fiscal equivalence, governments would not have an incentive to counteract the resulting cost or benefit externalities.

In Switzerland, fiscal equivalence has important implications for both vertical cooperation between the levels of government, and horizontally among cantonal and municipal governments. With respect to federal laws implemented at the cantonal level, the legislation should allow sufficient organizational flexibility to the cantons. Horizontally, there is significant cooperation at the cantonal and municipal level, allowing governments to manage economies of scale and regional spill-over in public services. As will be discussed later on, the way in which these burdens are shared between the governments, both vertically and horizontally, is the subject of far-reaching reforms at the moment.

Direct Democracy

The concept of direct democracy represents the most important instrument for maintaining government accountability. Swiss voters are given a number of opportunities to approve decisions at all levels of government, through elections, popular initiatives, and referendums. As will be seen, the deeply entrenched system of direct democracy has a significant moderating effect on public spending throughout the confederation.

As in most established democracies, representative chambers are directly elected at every level of government. Members of government at the communal and cantonal level are also elected directly, while the federal executive is elected indirectly by the federal parliament. Government decisions and legislation are also susceptible to popular referendum, usually held several times a year. An optional referendum must be held if either 50,000 voters or eight cantons request one. Referendums are compulsory for any change to the constitution, in this case requiring a double majority of both individual voters and the cantons. Direct democracy is further strengthened by the possibility of voter-initiated amendments to the constitution, known as popular initiatives. Upon the collection of 100,000 signatures, a referendum may be held on a proposed amendment. In general, these mechanisms provide an ongoing check on government decision-making throughout the policy-making process, rather than the intermittent input provided by general elections. In other words, voters do not need to wait until the next election to register their discontent.

Democratic mechanisms affect public spending in Switzerland in a number of ways. First, sources of taxation and minimum levels are set out in the constitution, and are therefore protected by the amendment procedures. While there is no budget referendum at the federal level, the Constitution sets out that the federal government's spending should be in accordance with the economic cycle, and restricts public spending accordingly. Such a "debt brake" has been incorporated into the law of a number of cantons. In most cantons, expenditures beyond a certain threshold are also subject to either an optional or compulsory referendum. Unlike at the federal level, a number of cantons also submit budgets and tax rate adjustments to a public vote. Meanwhile, at the municipal level, issues concerning user fees, capital investments, as well as the annual budget, are frequently subjected to referendum for approval. In general, these features of Swiss democracy have meant relatively smaller government, a lower tax burden, and demand-based public spending.

4. An Assessment of the Fiscal System and Accountability in Switzerland

A brief assessment reveals both strengths and weaknesses within the Swiss system. As noted above, Switzerland does enjoy a lower overall tax burden, much of which can be credited to fiscal competition among cantons. However, this has come at a cost in inter-cantonal cleavages, both in terms of tax burden and overall level of economic development. The highest taxed canton, for instance, has a burden of over two and half times that of the lowest.² In principle, the differences in overall level of development among cantons are meant to be addressed through the system of fiscal equalization. Unfortunately, the system has until now been based on expenditure rather than performance. This has led to false incentives, and a system in which efficiencies in public administration are frequently penalized through the allocation of subsidies. As a result, the system has not adequately addressed the significant inter-cantonal cleavages.

The demand for public goods and services has also continued to grow. In the past, most services were funded and provided by local and cantonal governments, with a marginal role for the federal government in financing certain national projects. Over time, however, the response to this increased demand has had two consequences. The first has been a gradual but significant growth in the role of the federal government, leading to a more centralized system of government. Second, the increase in publicly provided goods and services has created a highly complex division of responsibilities. This, in turn, has led to redundancies in service provision and complicated fiscal relationships.

Switzerland's system of direct democracy has often led to the complaint that the pace of reform is too slow to respond to fast-changing political and economic forces. This criticism, however, must be balanced against the gains in stability over time, as well as the benefits of gradual reform. The following section will briefly outline the most recent reforms designed to counteract the perceived weaknesses discussed above.

5. Reform of Financial Equalization and Task Allocation

² Schwyz has a tax burden index of 50.6, while that of the canton of Jura is 131.6.

In the early 1990s, the three levels of government agreed on the need for a thorough reform of the Swiss fiscal system. Over the next decade, a proposed reform of both the system of equalization and the division of tasks was developed. The proposal encompassed four pillars: On the financial side, (1) a new basis for calculating equalization transfers, and (2) inter-cantonal cooperation on cost compensation and burden sharing; with respect to the division of responsibilities, (3) a disentanglement of tasks, and (4) new forms of cooperation in areas of shared responsibility. The reform package was approved in November 2004, and its implementation will be completed by 2008. Throughout the approval of the reforms, it is significant to note the high level of agreement achieved, even from cantons that will lose out in the reforms.

1. Equalization. The reform of the equalization system involved a change in the method for calculating equalization. The original system was based on the financial capacity of the cantons. The index used included factors such as cantonal income, fiscal capacity, and tax burden. A number of the factors used, in particular tax burden and fiscal capacity, were directly linked to total expenditure. The result was a favouring of high spending cantons, and the consequent incentive difficulties discussed above. The new system replaces the financial capacity index with a resource-based indicator, based on taxable corporate and personal income. The resource-based indicator is meant to better represent the relative economic strength of the cantons, and improve the incentive structure for public spending. The objective of the new equalization mechanism is to bring the financial capacity of all 26 cantons to within 85% of the national average

2. Cost Compensation. The second pillar is related to the first, filling in the gaps not accounted for in the equalization formula. Each canton is unique, and many face particular challenges resulting from geography or demographics. Highly mountainous regions, or cantons with a high proportion of urban residents, for instance, may face higher costs in areas such as transportation and social welfare. The new system of cost compensation replaces the previous, highly complex, system of overlapping service delivery and inter-cantonal spill-over effects.

3. *Disentanglement of Tasks.* The third pillar is, in essence, a reinvigoration of the subsidiarity principle. The bulk of responsibilities currently shared between the federal and cantonal governments will be either fully decentralized or centralized. Until now, for instance, the building and maintaining of national highways has been undertaken by the cantons, but up to 95% financially subsidized by the federal government. In such scenarios, the cantonal government has reduced policy-making autonomy. The federal government, on the other hand, is financing initiatives without being able to oversee their execution. Under the new reforms, national highways will fall to the federal government, while regional roads will be entirely the responsibility of cantonal governments. Generally, this aspect of the reforms will involve the federal government removing itself from a number of cantonal areas of jurisdiction. The federal government, meanwhile, will maintain primary responsibility for the enhanced system of equalization.

4. *Cooperation in Areas of Joint Responsibility.* Despite the efforts to clarify the allocation of responsibilities, a number of tasks will remain joint ones. The last reform pillar sets out guidelines for inter-governmental cooperation in these shared domains. In general, the Confederation will always set out overall policy objectives, and define strategies accordingly; the cantons will implement them. The goal is to promote a system of cooperative federalism. Overall, this will allow the federal government to ensure a level of national consistency, while the cantons will have the freedom to tailor public services to local needs. The reform package also addresses the need for greater inter-cantonal cooperation. Increased mobility has meant that individuals are no longer as tied to cantonal territories, and often make use of infrastructure and services of neighbouring cantons. In a number of particularly affected areas, including cultural institutions and public transportation, cantons will be required to deliver services on a cooperative basis.

6. Conclusion

A federal system of government must recognize regional differences, and the corresponding diversity in demand for public services. At the same time, an overall equivalence in services and comparable quality of life must be maintained throughout the territory. The principle of subsidiarity allows diverse demands for public services to be

met in the most responsive way possible. In the Swiss case, the system of direct democracy creates multiple avenues for preferences to be expressed. Lastly, by linking cost with benefit, the principle of fiscal equivalence ensures that those services are delivered efficiently. Taken together, these principles allow for a system of federal governance which meets both democratic and economic objectives.

As we've seen, the powers of taxation and decision-making in Switzerland have always been highly decentralized. The growing demand for public services by an increasingly mobile population, together with the federal equalization efforts over the last 50 years, however, have brought with them a centralizing trend, as well as a confusion of roles and responsibilities. The purpose of the current reforms is to reinvigorate some of the primary principles upon which the Swiss system is built, in particular those of subsidiarity and fiscal equivalence, without abandoning the redistributive objectives of the previous system.