

Frey, René L.; Wettstein, Gérard

## Article

# Reform of the Swiss Fiscal Equalisation System

CESifo DICE Report

## Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

*Suggested Citation:* Frey, René L.; Wettstein, Gérard (2008) : Reform of the Swiss Fiscal Equalisation System, CESifo DICE Report, ISSN 1613-6373, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 06, Iss. 1, pp. 21-26

This Version is available at:

<https://hdl.handle.net/10419/166929>

## Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

## Terms of use:

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## REFORM OF THE SWISS FISCAL EQUALISATION SYSTEM

RENÉ L. FREY\* AND

GÉRARD WETTSTEIN\*\*

While Germany and Austria continue to grapple with general federalism reforms, Switzerland approved a complete overhaul of its fiscal equalisation system by a majority of almost 65 percent in a 2004 referendum. The enormity of this project is evident in the fact that 27 of the 196 articles of the Swiss constitution have since been amended. The reform came into effect at the beginning of 2008.

This article begins with a brief overview of Swiss federalism and its longstanding equalisation system, looking at the various shortcomings that prompted the federal government and the cantons in 1992 to undertake a joint, comprehensive reform of the system. This is followed by a presentation of the reform of fiscal equalisation and task allocation between the Confederation and the cantons, otherwise known as the new fiscal equalisation system. The report ends with an appraisal of the new system.

### Swiss federalism and the past fiscal equalisation system

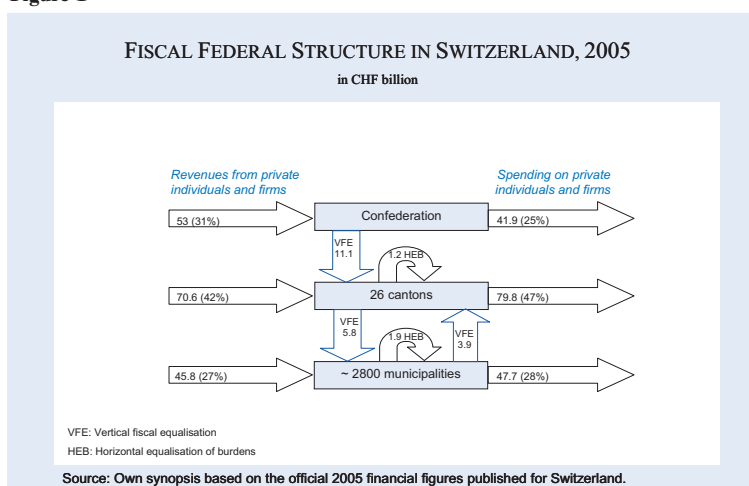
Alongside direct democracy, the federal structure is one of the key founding principles of Switzerland. Each of the 26 cantons

has its own constitution in addition to that of the Confederation. The local authorities or municipalities, of which there are some 2,800, also enjoy a high degree of autonomy under the cantonal legislation. In Swiss-style federalism, any task or jurisdiction not specifically assigned to the Confederation under the federal constitution falls within the competence of the cantons. The same applies for taxation: the cantons are allowed to levy all taxes to which the Confederation is not exclusively entitled. As all constitutional amendments require a referendum passed by a majority of the electorate and a majority of the cantons, the barriers to change are high.

Accounting for almost 75 percent of overall state spending and some 69 percent of state revenues, the subnational units (i.e., the cantons and municipalities) play a very important role in the Swiss federal state (cf. Figure 1). The imbalance between the expenditure and revenue side is corrected by a system of vertical fiscal equalisation. The Confederation's sources of revenue are the personal income tax, the value added tax and various excise duties. Taxes on individual wealth, firm capital and expenditure are levied at the cantonal and local levels only. Earnings-related direct taxes, i.e. personal and corporate income tax, are levied at all three federal levels. The taxation autonomy of cantonal and local authorities was curbed to a certain extent in 2001 through the introduction of formal tax harmonisation, which seeks to simplify the canons of taxation, the assess-



Figure 1



\* CREMA Center for Research in Economics, Management and the Arts, Basel/Zurich. René L. Frey was Head of the Department for Public Policy at the University of Basel up to 2004. He has compiled two reports on the reform of the Swiss fiscal equalisation system. email: Rene.Frey@unibas.ch

\*\* Project Manager for new fiscal equalisation at the Swiss Federal Department of Finance FDF, Berne.

ment basis and procedures. As before, the tax burden (tax rates, allowances and deductions) is determined at the cantonal and local levels.

The former fiscal equalisation system was introduced in Switzerland in 1959. It was further developed in the decades that followed, sprawling out of control to become a disordered and confusing system of vertical fiscal transfers from the Confederation to the cantons. The Swiss system had very little horizontal fiscal equalisation such as that of the German Länder, for instance. But Switzerland's vertical fiscal transfers did have an element of horizontal equalisation, as most of the funds were raised by the "financially strong" cantons. For some of the less privileged cantons, fiscal transfers from the Confederation accounted for up to 50 percent of their overall revenues.

The two main elements of the former fiscal equalisation system were:

- cantonal share in the revenues from direct federal taxes, fuel excise tax and the earnings of the Swiss National Bank, and
- conditional (earmarked) grants and compensation from the Confederation to the cantons (federal contributions).

The amount transferred was determined by the cantons' financial strength, covering four components: 1. the cantonal income per capita, 2. the cantonal and local tax revenues per capita, 3. the average cantonal tax burden, and 4. the percentage of mountainous terrain in the cantons. The financial strength index was used to divide the cantons into three groups: the financially strong, the financially average and the financially weak. The financially strong cantons had a low share in federal taxes and low subsidy rates for the federal contributions. Conversely, the financially weak cantons had a higher share in federal taxes and higher contribution rates.

The allocation effect of fiscal equalisation per se amounted to some CHF 2.8 billion in 2006 (approximately EUR 1.7 billion). The Confederation as well as most of the cantons viewed this as insufficient.

Over time, areas of overlap have developed between the Confederation and the cantons in terms of tasks and expenditures. Although healthcare, education and culture are primarily the responsibility of the cantons (and municipalities), the Confederation – as a financial contributor – also has an important say in these issues. There is also shared responsibility for social services and transportation and for the environment, regional policy and agriculture. In effect, the sharing of expenditures favours executive federalism and restricts the cantons' autonomy. Nonetheless, compared with other states, Swiss federalism can still be said to allow its sub-national units substantial autonomy.

### The new fiscal equalisation reform package

With a view to stepping up the cantons' autonomy, improving the controllability and effectiveness of fiscal equalisation and halting the trend towards executive federalism, the federal government and the cantons embarked upon an extensive overhaul of the federal fiscal relationships in 1992. This reform package comprises the following six elements: the disentanglement of tasks, an overhaul of the co-operation between the Confederation and the cantons, the fostering of intercantonal cooperation with equalisation of burdens, the equalisation of financial strength (resource levelling), the equalisation of financial needs (compensation for special burdens), and hardship relief as a temporary interim instrument.

#### *Disentanglement of tasks*

Of the 31 tasks previously shared, 15 were completely transferred to the cantons' responsibility and six

**Table 1**

#### **Disentanglement of tasks (some of the main tasks that have been reassigned)**

Tasks assigned solely to the Confederation	Common tasks between Confederation/cantons	Shared cantonal tasks	Tasks assigned solely to a canton
Old-age pensions Disability pensions Motorways National defence	Health insurance Scholarships Urban transportation Regional transportation Nature, landscape, noise prevention and water protection	Cantonal universities Technical colleges Advanced medicine and specialist clinics Waste disposal Wastewater treatment	Homes for the disabled, the elderly and the handicapped Special schools Scholarships for general schools

placed under federal responsibility. This disentangled a total of some CHF 5 billion (around EUR 3 billion). As a rule, tasks were allocated on the basis of the subsidiary principle: public tasks were only assigned to the Confederation if the cantons could no longer take them on. This is the case for national public goods, i.e. those benefiting a broad circle of users across all regions. Under the new system, apart from those tasks assigned exclusively to the Confederation or the cantons, there are now very few shared and common tasks (cf. Table 1).

#### *Vertical cooperation between the Confederation and the cantons*

Because so many vertical fiscal transfers are currently conditional grants and are calculated on the basis of the costs incurred and the financial strength, the cantons with high subsidy rates have sought to receive high federal contributions. Such incentives have distorted the priorities for tasks and created inefficiencies in the performance of public tasks.

To overcome this problem, the new system provides for a new form of vertical co-operation between the Confederation and the cantons, designed along the same lines as New Public Management. For those tasks of national interest, where the Confederation calls upon the cantons to perform them, it will in future confine itself to taking strategic decisions. The cantons are responsible for operational matters. The Confederation has to negotiate its interests in partnership with the cantons. The results of such negotiations are drawn up in programme agreements. Here, the cantons are required to consider overlying interests, while the Confederation provides global contributions for programmes instead of, as up to now, conditional contributions to specific projects. This new vertical cooperation should ensure a more efficient use of funds, as the cantons are free to optimise their use of federal funds within the negotiated scope.

However, this element of partnership is not consistent throughout the new fiscal equalisation system. For instance, the Confederation can enact decrees on subsidies, if necessary by means of unilateral legisla-

**Table 2**

#### **Average size of Swiss cantons compared with EU territorial units**

	Switzerland	European Community (1987)		
	Cantons	NUTS1	NUTS2	NUTS3
Subnational units	26	71	183	1044
Inhabitants (in millions)	0.28	4.9	1.8	0.4
Surface area (1000 km <sup>2</sup> )	1.6	35.6	13.3	2.8
Note: NUTS = <i>Nomenclature des Unités Territoriales Statistiques</i> (nomenclature of territorial units for statistics) Example for Germany NUTS1 = Federal <i>Länder</i> NUTS2 = <i>Regierungsbezirke</i> (primary administrative division of a <i>Land</i> ) NUTS3 = <i>Kreise</i> (district)				

Source: Statistisches Jahrbuch (2004), p. 64; Bundesamt für Statistik (1999), p. 23; Eurostat 1998.

tion. There are also provisions in place should negotiations break down between the Confederation and a canton. This has given the Confederation, a priori, a stronger negotiating position than the cantons. Furthermore, it is authorised to sanction any “inappropriate action” on the part of the cantons.

#### *Intercantonal co-operation with equalisation of burdens*

Until the mid-twentieth century, most of the Swiss population lived, worked and used public services in one and the same canton. Nowadays, hundreds of thousands of people commute across cantonal borders every day. This is so often the case in Switzerland because, compared with the subnational units of other countries, Swiss cantons are very small (cf. Table 2) with an average surface area of around 1600 km<sup>2</sup>. The smallest canton (Basel Town) is only 37 km<sup>2</sup>. The public services of one canton are increasingly being used by those living in other cantons, resulting in spillovers (geographical external effects). The absence of co-determination rights and inadequate contributions to the costs of central services mean that the population receives insufficient support. The principle of fiscal equivalence is thus violated. Particularly in urban regions, there is now a geographical mismatch between those paying the costs, those reaping the benefits and those making the decisions.

The spillover compensation is primarily a matter for the regional authorities affected. Under the new system, the Confederation merely provides the instruments required. To ensure that solutions can be found in partnership between cantons on an equal standing, the provider must offer certain services in

Table 3

## The former financial strength index and the new resource index

Criteria for determining the cantons' financial strength	
Former financial strength index	Resource index under the new system
<ul style="list-style-type: none"> <li>• Per capita income</li> <li>• Tax revenues per inhabitant</li> <li>• Average tax burden (reciprocal)</li> <li>• Percentage of mountainous terrain (reciprocal)</li> </ul>	<ul style="list-style-type: none"> <li>• Taxable income of individual taxpayers</li> <li>• Earnings from taxable assets of individual taxpayers</li> <li>• Taxable profit of firms</li> </ul> Per cantonal inhabitant in each case

return, particularly by creating cost transparency, guaranteeing the same rights and obligations for all cantons involved, and by institutionalising co-determination rights for the paying cantons. The proposed solution can be seen as a step towards fiscal equivalence. Instead of actually merging cantons as a means of adapting institutions to urban growth – something that is not really a political reality in Switzerland for the foreseeable future – this serves as a functional solution. However, there is still the danger that the beneficiary cantons may prefer to continue their free riding. For this reason, the new system allows the Confederation, under certain circumstances, to exercise a contractual obligation at the request of the cantons.

*Equalisation of financial strength*

The equalisation of financial strength, known as “resource levelling”, is used solely for redistribution purposes and is now clearly separated from allocation objectives on the basis that each objective has an instrument, in each case the one that best suits.

Replacing the former financial strength index, the resource index is based on the cantonal tax potential. Unlike before, the cantons will no longer be in a position to directly influence their financial strength, specifically via their tax policy.

*Equalisation of financial needs*

There are two elements to the equalisation of financial needs. First, geographic cost compensation takes account of the higher

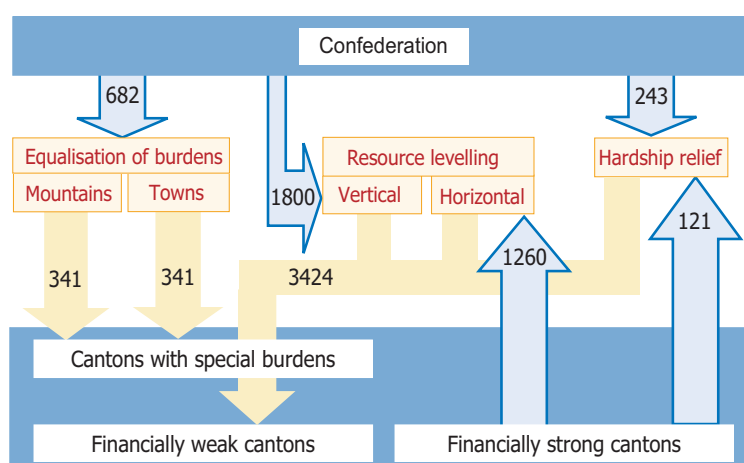
expenses incurred by mountainous cantons as a result of their sparse population and the difficult topographical conditions. Secondly, socio-demographic cost compensation takes account of the additional expenses incurred by conurbations as a result of their unfavourable population structure. Due to the phenomena connected with urban sprawl, the percentage of population groups costing the community

more than they contribute in cantons with large towns is far above average in comparison with the surrounding areas and the national average.

*Hardship relief*

If the new fiscal equalisation system consisted only of the previous five elements, the transition from the old system to the new one would have resulted in some of the poorer cantons losing out on revenues from federal sources. Given that it would have been difficult to explain, leading up to the referendum, why the financially weak cantons appear to come off the worst in switching to the new system (even if this is supposed to be so under the new criteria for resource capacity and special burdens), it was decided to set up a transitional hardship relief fund of CHF 365 million (approximately EUR 220 million). The Confederation finances two thirds of this, with the rest coming from the cantons. The hardship relief fund can be interpreted as an attempt to distribute the reform profits fairly, i.e. compensating those who

Figure 2

FISCAL FLOWS UNDER THE NEW SYSTEM  
in CHF million

Source: Information brochure for the Swiss referendum of 28 November 2004.



lose out and moving the system closer to a win-win situation.

Just how strong the redistributive effect of the new fiscal equalisation system should be is a matter of political debate. In 2007, Parliament decided to increase the redistribution fund by some 50 percent, from around CHF 2 billion to over CHF 3 billion a year (EUR 1.2 billion to EUR 1.8 billion; cf. Figure 2).

### Appraisal of the new fiscal equalisation system

The constitutional principles were only agreed upon in 2004. It then took almost three years to pass the implementing legislation. This came into effect at the beginning of 2008. Thus we have not yet had much experience with the new fiscal equalisation system, and it will take another few years before certain elements can even be implemented.

To a certain extent, the impact of the new system will depend on how the cantons respond to the various transfers. A financially weak canton receiving additional funding with the fiscal equalisation system can respond in three ways: it can cut taxes, increase spending or reduce debt. The financially strong cantons that find themselves with a greater burden under the new system can opt to raise taxes, cut spending through more efficient provision of state benefits, or increase debt. In anticipation of the new system, some of the winning cantons already decided in 2005 to lower taxes, thereby intensifying intercantonal tax competition.

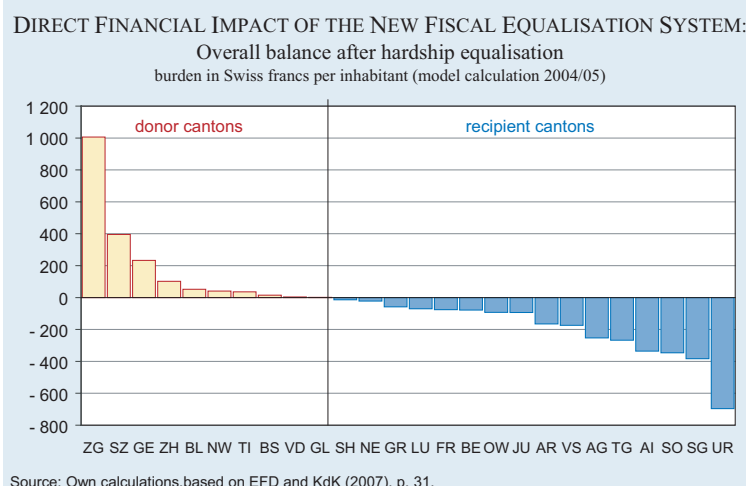
Figure 3 shows how the 26 cantons are likely to be affected by the new fiscal equalisation system. Overall, as the chart shows, the cantons with the greatest burden are, for the most part, those previously classified as financially strong. However, this chart only shows the transfer payments. If the impact of the overhaul of vertical and horizontal cooperation were to be taken into account, probably all cantons would come out winners. The fact that the cantons will increasingly receive payments not earmarked for a specific purpose means that they can make better use of each

franc transferred for their own residents than under the previous system.

A wide range of criticism of the new fiscal equalisation system was voiced in the parliamentary debate and prior to the referendum:

- The left-wing parties and the trade unions objected to the fact that tax competition continues to exist among the cantons and is merely made “more tolerable” by the new system. They threatened with an initiative to amend the federal constitution so as to limit the differences in the cantons’ tax burdens to  $\pm 20$  percent of the national average.
- Western Switzerland, which more closely resembles France in its approach, tends to make more demands on the level of public spending than German-speaking cantons. The French-speaking cantons claimed that the new system did not take sufficient account of this.
- Some legal experts in constitutional law were concerned that the Confederation may under certain (albeit very restrictive) conditions force dissident cantons to provide horizontal co-operation and financial compensation for spillovers in regional tasks.
- Advocates of the social state feared its demise as the disentanglement of tasks gives the cantons a broader sphere of competence. These were supported in their opposition to a certain extent by the social welfare offices of the Confederation and the cantons, which feared losing some of their authority (“pillarisation”).
- Some financially weak cantons in mountainous regions would have preferred to see an even greater distribution of revenues among the can-

Figure 3



tons. They have now shifted their attention to trying to retain the previously hidden inter-regional redistribution as part of regional and sector-specific policies (e.g. for transport, environment, agriculture). The new fiscal equalisation system wants – if not quite explicitly – to replace this somewhat inefficient and ineffective redistribution scheme with the new transfer system, in other words, to gear the regional and sector-specific policies to allocation and growth objectives.

- Some financially strong cantons opposed the new fiscal equalisation system as they felt they were being too heavily burdened and would lose their international competitiveness. These cantons, which are most heavily burdened under the new system, were in fact the ones that rejected the reforms in the referendum.

Such criticism has had little effect, however. The referendum was passed by a majority of the electorate (64 percent) and by 23 of the 26 cantons.

It is also interesting to see that the OECD believes these reforms reduce regional disparities to an internationally comparable level and afford the cantons greater financial autonomy. It notes that, with the possibility of forcing cantons to cooperate, Switzerland is entering new territory within the OECD. Therefore, and based on Switzerland's experience to date, it could well play a key role in promoting horizontal cooperation.

### Concluding remarks

- The new fiscal equalisation system is an important and necessary step towards strengthening Swiss federalism.
- The new fiscal equalisation system takes intercantonal tax competition to a tolerable level.
- Further federalism reforms will be required in the medium to long term. Most of the present cantonal boundaries were set by the Congress of Vienna back in 1815, and these no longer correspond to today's population centres and economic poles. Such a long-term reform can only succeed if, as evidenced in the preparations for the new fiscal equalisation system, it is conducted in close co-operation with the cantons. However, the initiative in this respect must come from the cantons themselves.

### References

- Bundesamt für Statistik/Bundesamt für Raumplanung (1999), *Die Großregionen der Schweiz: Die Schweiz im NUTS-Regionalsystem*, Neuchâtel.
- EFD and KdK (2007), *Neugestaltung des Finanzausgleichs und der Aufgabenteilung zwischen Bund und Kantonen*, NFA, Bern.
- Frey, R. L. et al. (2005), *Föderalismus – zukunftstauglich?!* Verlag Neue Zürcher Zeitung, Zurich.
- Schaltegger, C. A. and R. L. Frey (2003), "Finanzausgleich und Föderalismus: Zur Neugestaltung der föderalen Finanzbeziehungen am Beispiel der Schweiz", *Perspektiven der Wirtschaftspolitik* 4, 239–58.
- Statistisches Jahrbuch der Schweiz 2004.
- Swiss Federal Council (2006), *Third Dispatch on the New Fiscal Equalisation System from 8 December 2006 (endowing the equalisation funds)*.
- Swiss Federal Council (2005), *Second Dispatch on the New Fiscal Equalisation System from 7 September 2005 (implementing legislation)*.
- Swiss Federal Council (2001), *First Dispatch on the Overhaul of Fiscal Equalisation and the Tasks between the Confederation and the Cantons from 14 November 2001 (constitutional amendments and new law on fiscal and burden equalisation)*.