Journal des Economistes et des Etudes Humaines

Volume 13, *Number* 4 — 2003 — *Article* 5

NUMÉRO 4

Fiscal Decentralisation: The Swiss Case

Victoria Curzon Price, *University of Geneva*

Recommended Citation:
Price, Victoria Curzon (2003) "Fiscal Decentralisation: The Swiss Case," *Journal des Economistes et des Etudes Humaines*: Vol. 13: No. 4, Article 5.

DOI: 10.2202/1145-6396.1108

Fiscal Decentralisation: The Swiss Case

Victoria Curzon Price

Abstract

Switzerland provides a potential laboratory for testing various hypotheses connected with tax competition because of its extremely decentralized fiscal system. Twenty-six cantons (some of them extremely small) have retained the ultimate power of deciding tax questions, and hence not only to limit the Federal level of the State to about 1/3 of total public expenditure, but also to retain absolute power to set their own levels of taxation. Furthermore, citizens can launch referenda on tax issues at any level of government.

Fiscal competition between cantons should therefore be easy to spot, resulting in lower tax cantons enjoying higher economic growth (the "classical" hypothesis), or in a "race to the bottom" with lower tax cantons offering a lower level of public services (the "harmful competition" hypothesis). In fact, neither of these hypotheses is confirmed. This leads the author to suggest a third hypothesis based on public choice theory (politicians in high-income cantons are led to raise high taxes). The author suggests that the classical and the public choice hypotheses cancel each other out, leaving a mixed picture. The article ends with some reflexions on the implications of the Swiss experience for fiscal harmonization at a European level.

La Suisse offre un véritable laboratoire pour tester plusieurs hypothèses de concurrence fiscale en raison de son système fiscal extrêmement décentralisé. Vingt six cantons (dont quelques uns très petits) ont conservé le pouvoir suprême de décider les questions fiscales et, donc, non seulement de limiter le niveau fédéral de l'Etat à 1/3 des dépenses publiques totales, mais aussi de conserver le pouvoir absolu pour fixer leurs propres niveaux de taxation. De plus, les habitants peuvent lancer des référendums en matière fiscale à tout niveau du gouvernement.

La concurrence fiscale entre les cantons devrait être par conséquent plus facile à repérer, les cantons les moins imposés ayant une croissance économique supérieure (hypothèse classique), ou en un « nivellement par le bas » face aux cantons les moins imposés offrant un niveau inférieur de services publics (hypothèse de "concurrence néfaste"). En fait, aucune de ces hypothèses n'est confirmée. Cela conduit l'auteur à suggérer une troisième hypothèse basée sur la théorie des décisions publiques (les politiciens des cantons à revenus élevés sont conduits à lever des impôts élevés). L'auteur suggère que les hypothèses classiques et celles des décisions publiques se neutralisent l'une l'autre, laissant place à un modèle mixte. L'article se termine par quelques réflexions quant aux implications de l'expérience Suisse pour une harmonisation fiscale au niveau européen.

KEYWORDS: Swiss, decentralised fiscal system, "classical" hypothesis, Public Choice

Author Notes: The author wishes to acknowledge the support of IREF in preparing this paper and the comments provided by Andrea CUOMO

FISCAL DECENTRALISATION: THE SWISS CASE*

Victoria Curzon Price°

1. Introduction

This paper discusses three hypotheses linked to the question of fiscal decentralization.

Hypothesis 1 (H1) holds that fiscal decentralization promotes competition between fiscal authorities and providers of public goods, leading to a lower level of taxation, a higher quality of public goods (also because of decentralized decision-taking) and a higher level of economic efficiency. We call this the "classical view" of the benefits of competition as applied to the question of taxation and the supply of public goods.

It can be contrasted with Hypothesis 2 (H2), which sees competition as harmful, leading in tax questions to a "race to the bottom", a dearth of public goods, inefficient factor movements as mobile factors attempt to exploit tax differences and free riding from spill-over effects.

Hypothesis 3 (H3) is based on public choice theory and holds that high levels of taxation are associated with high incomes, since neither politicians nor voters can resist the temptation to tax and spend if the economy is prosperous and flourishing.

In what follows, we shall try to see which hypothesis holds best for Switzerland.

* The author wishes to acknowledge the support of IREF in preparing this paper and the comments provided by Andrea CUOMO

° University of Geneva

Volume 13, numéro 4, Décembre 2003, pp. 527-544.

It is well known that Switzerland is probably the most fiscally decentralized of all federal states, and (since federalism is in itself the most decentralized method of government) is therefore the most fiscally decentralized country in the world. It is composed of 26 sovereign states, or cantons, which have retained their fiscal sovereignty for the 150 years that modern Switzerland has been in existence. In principle, therefore, it should be possible to observe fiscal competition at work in this real-life laboratory. However, the effect of fiscal decentralization on the over-all level of taxation has to be shared with another quite exceptional feature of the Swiss Constitution – the right of citizens to initiate referenda on any matter of public interest, including (and perhaps most importantly) taxation.

The 26 sovereign cantons collectively decide by a complicated triple majority system (both houses of parliament and direct referenda) what resources the federal government should enjoy and how they should be levied. They have also agreed, since 1848, that certain tasks are best assigned to the federal level of government – otherwise why bother with a federal structure in the first place? But the legal competence to decide this arises at the cantonal level, today transposed to the Federal Constitution[1].

Switzerland thus practises bottom-up subsidiarity[2]. The lower levels of government (the cantons) devolve power to a higher level of government (the federation) in cases where the higher level of government is (exceptionally) deemed to be the more appropriate. This is very different from top-down subsidiarity, where the higher level of government devolves to lower levels matters in which it (exceptionally) deems itself to be less effective. The locus of power is essential when it comes to applying the principle of subsidiarity in practice and will give rise to a very different division of labour between levels of government depending on which level of government takes the decision. Thus, bottom-up subsidiarity would tend to result in more decentralisation than top-down subsidiarity.

The cantons also practise top-down subsidiarity and devolve part of their tasks to *lower* levels of government – some 3,000 « communes ». The communes enjoy no more fiscal sovereignty than does the federal government – they act as agents for the cantons in areas (such as nursery schools or street-cleaning) where it is felt they are more efficient providers of public goods.

The cantons are in competition with each other. They are constantly torn between avoiding fiscal « inefficiency » (a euphemism for fiscal competition and free-riding on other cantons' public services) and maintaining their fiscal sovereignty. They aim at – and achieve – a delicate balance, described below.

[1] Schoenenberger/Zarin-Nejadan-1994, pp. 67-78, Weber-1991.

[2] As is well known, "subsidiarity" consists in the principle that tasks are best accomplished by small units. Applied to government, the rule of subsidiarity implies that tasks should be accomplished by the lowest level of government compatible with efficiency: as a matter of principle one should therefore minimize centralization and maximize devolution. In practice, however, the exact division of labour between levels of government cannot be determined scientifically, and is always a matter of judgment – by those who are in a position to decide.

DOI: 10.2202/1145-6396.1108

2. Basic structure of Swiss taxation

The most original aspect of the Swiss system of government is the right of the adult population to vote on any public issue giving rise to new legislation, including taxes, at all three levels of government. The referendum is an integral part of the law-making process. Furthermore, the public can also initiate referenda to repeal or amend existing laws, or initiate new ones. They do not have to wait for the political class to set the agenda.

The combination of political decentralization and referenda has resulted in a generally low level of taxation. Total tax revenue represents only a little over 30% of Swiss GNP (not including social security charges), a much lower proportion than in the rest of Europe, but already high enough for it to be an issue in Swiss politics. Other receipts from various fee-paying public entities (the post office, the alcohol monopoly etc.) increase this proportion slightly, but while this adds to the capacity for public spending, these receipts will not be taken into account in the context of this paper.

One should add to total tax revenue, however, the cost of social insurance which, though it is provided on a semi-private basis (as far as health and pensions are concerned) is nevertheless compulsory. The public share of social insurance adds another 5.7% points to the public sector, raising it to 35.7% of GDP. This figure does not include health insurance, which is still in the private sector (though heavily regulated). In 1970's these ratios were a good 10 percentage points lower than in 2000, which suggests that Switzerland has not escaped the general trend to bigger government (mainly due to increased cost of social welfare), despite fiscal decentralization. Neither H1 nor H2 are confirmed by this trend.

The following redistributive mechanisms are built into the Swiss tax system :

- From rich cantons to poor cantons (13% of federal tax – see below);–
- From rich communes to poor communes within cantons (at their discretion);
- From richer to poorer individuals, through progressive income tax structures and widespread cantonal wealth taxes;
- From single, childless taxpayers to families, through a system of deductions against income;
- From active to retired members of the population, through a minimum state pension (24,000 CHF per annum, largely responsible for the growth of federal expenditures since 1980);
- From the employed to the unemployed, through compulsory unemployment insurance;
- From the fit to the unlucky, through compulsory accident insurance (deductions for the last three forms of insurance are split 50 :50 between employer and employee and currently amount to 10.5% of income);
- From the healthy to the sick, through compulsory (but privately provided) health insurance;

- From the general public to farmers (i.e. from lowland to mountain areas);
- From salaried employees to the self-employed (it is generally assumed that the latter make the most of all possible deductions and avoid paying most income taxes perfectly legally).

The social welfare system is shared out between all three levels of government, as well as the private sector. The only item which is entirely federal is the minimum state pension.

The cantons still collect most of the taxes and act for the federal government in the execution of many of its tasks. However, since the introduction of VAT at the federal level at a rate of 6% in 1996, this balance is moving in Bern's favour and it is possible that the trend will accelerate in the future as the rate of VAT increases to meet growing social expenditures at all levels. At present VAT (today at a rate of 7.6%) represents 35% of Federal tax receipts. Cantons rely mainly on income and capital taxes, while the federal government relies mainly on indirect taxation (VAT, excise taxes, stamp duties etc.). Personal income tax accounts for only 22% of Federal tax receipts.

Switzerland enjoys all the usual forms of taxation that one finds elsewhere, though at somewhat lower rates. Some forms of tax are exclusive to the federal level (customs duties, VAT etc.) ; others are exclusive to the cantonal/communal levels (personal wealth tax) ; while still others are common to all three levels of government (personal income tax).

It will be noted that there is no personal wealth or capital gains tax at federal level, although a « participation » tax is levied when large shareholdings (over 25%) are realized with capital gains. The argument used by the federal authorities is that a capital gains tax on small amounts is too costly to administer, although equity would normally argue in favour of such a tax (*Conseil fédéral 1983, para. 144.31).*

It will also be noted that the withholding tax on interest and dividends levied at federal level at the rate of 35% can be reclaimed by tax payers, who will do so if their marginal rate of taxation is below this level. It is worth noting that this tax (dating back to 1943) is one of the oldest at federal level and used to account for almost half federal revenues. However, today tax reclaims are now almost equal to the entire revenues from the withholding tax, suggesting that most investors now declare this income and that the marginal rate of taxation is generally below 35%.

DOI: 10.2202/1145-6396.1108

TABLE 1
STRUCTURE OF TAXATION BY LEVEL OF GOVERNMENT AND TYPE OF TAX

	Confederation	Cantons	Communes
Personal income tax	X	X	X
Personal wealth tax		X	X
Corporate profit tax	X	X	X
Corporate wealth tax	X	X	X
Capital gains tax		X	X
Inheritance & gift tax		X	X
Real estate taxes		X	X
Real estate transactions tax		X	X
Withholding tax on interest & dividends	X		
Stamp tax on financial transactions	X		
Customs duties	X		
VAT	X		
Excise taxes, environmental taxes	X		
Military service exemption tax	X		
« other » consumption taxes	X	X	X
Other receipts (PTT, alcohol monopoly, factor income, « forfait » (lifestyle tax for non-Swiss)	X	X	X
Social security payroll levies	X		

Sources : CORNEVIN-PFEIFFER Katrin et MANZINI Antonio « Le financement de l'Etat » *in* WEBER Luc (ed.) *Les finances publiques d'un Etat fédératif : la Suisse*, Economica, Paris et Genève, 1991, pp.87-188, p.118 ; *Administration fédérale des Finances, Charge fiscale en Suisse 2001, Recettes fiscales de la confédération, Recettes fiscales des cantons et communes, dernières années disponibles.* Administration Fédérale des Finances, *Finances publiques en Suisse, diverses années. Also :* Conseil fédéral, *Message concernant les lois fédérales sur l'harmonisation des impôts directs des cantons et des communes ainsi que sur l'impôt fédéral (Message sur l'harmonisation fiscale) du 25 mai 1983.*

3. A move to reduce fiscal « inefficiencies »: harmonization of the tax base

In 1990, Switzerland adopted a federal law on the harmonization of cantonal tax bases (*Loi fédérale sur l'harmonisation des impôts directs des cantons et des communes : LFHID).* This concluded a long process, started in 1968, to reduce the complexity and diversity that many years of cantonal fiscal sovereignty had produced and to limit so-called « inefficiencies » (in other words, inter-cantonal fiscal competition).

The legal and formal definitions of the types of tax, by whom they are due, what type of allowances to permit, their definition, administrative procedures and measures to ensure enforcement are now harmonised. Actual tax rates, however, remain firmly within the province of the cantons, with the exception of the federal taxes, the rates of which are naturally determined at federal level, with the consent of the two houses of parliament and the people.

Harmonization therefore remains partial. No canton is obliged to levy the same taxes as its neighbours. However, if a canton decides to levy, for example, a capital gains tax, then it must follow the agreed, harmonized definition of what capital gains consist of. Formal harmonization is supposed to have put a stop to fiscal competition which took the form of all sorts of *ad hoc* allowances and deductions, which varied from canton to canton and which were often arbitrarily decided upon[3].

It took over 30 years to achieve this level of coordination, showing how sensitive the issue is. The cantonal authorities are indeed acutely aware of the trade-offs. If they want to limit inter-cantonal tax-hopping and free-riding on the part of mobile tax-payers/tax-beneficiaries, they must either agree to a minimum amount of harmonization of tax systems and levels among themselves (especially between neighbouring cantons), or agree to raise the problem to the federal level. They are loath to do either. In fact, all three avenues are used, to some degree. Inter-cantonal tax disparities exist, but are kept within bounds, such that systemic tax-hopping is not much in evidence; but some is tolerated as a lesser evil, while some issues are pushed up to the federal level.

4. Growing centralization

In the 1960s Switzerland developed its own version of the welfare state, which mirrors many of the features found elsewhere in Europe, but which relies to a greater degree than most on market-based providers. It is clear that social transfers are potentially troublesome for a federation like Switzerland, where geographic distances are small and people can very easily live in one canton and

[3] Cornevin-Pfeiffer/Manzini-1991, p. 131

DOI: 10.2202/1145-6396.1108

work in another, or simply "vote with their feet" by moving from one canton to another. The consensus was that the minimum state pension scheme should therefore not be left to the cantons to decide upon, but should be raised to the federal level in order to ensure that the pool of beneficiaries coincided with the pool of contributors, and to prevent any competition between cantons on this account. This was probably the single most important centralizing move in the past 50 years. It gave rise, over time, to a crisis in federal finances. This was finally resolved by the adoption of VAT, another major centralizing move. Along with endowing the federal government with a new, modern, and broad tax base, and thus resolving the federal deficit crisis, the adoption of VAT was also motivated by a desire to render Switzerland as "Euro-compatible" as possible.

The effect of these two inter-connected developments on Switzerland's centralization ratio (share of central government in total tax revenues) is now becoming apparent (see Table 2). Thus according to the OECD the federal level of government accounted for 32 % of total government receipts in 2000 (as opposed to 28% in 1975).

TABLE 2: Share of central government, 1975 & 2000
as a % of total government revenue, (including social security charges)

	1975 %	2000 %	Change 1975=100
Belgium	65	39	59
Japan	47	38	80
Sweden	51	42	83
Canada	48	42	88
Germany	34	31	91
Denmark	68	62	91
Finland	59	54	91
Austria	51	46	92
France	52	48	93
Netherlands	60	57	96
Spain	48	48	99
USA	46	46	102
Portugal	65	67	103
Luxembourg	64	68	106
Ireland	77	85	110
UK	71	79	111
Italy	53	60	113
Switzerland	**28**	**32**	**118**
Norway	52	62	119

Source: OECD (2002) derived from Tables 3 (pp.73-74), 4 (p.75), 133 (p. 219, 135 (p. 221)

However, if we *exclude* social charges and *include* vertical transfers from federal to cantonal level, and from cantonal to local level, the trend towards centralization is even more marked: federal tax receipts rose from 32% in 1975 to 39% of the total in 2000, cantonal shares remained stable, and communal shares fell from 30% to 24% (see Table 3). This begs the question of what might be responsible for this trend, since social transfers have been removed from the data.

One reason for the centralizing trend might be that there are economies of scale in raising revenue and/or providing public goods. This is certainly one reason VAT is levied at a single rate throughout Switzerland, and why the trend towards centralization on the revenue side is set to rise in the future. This argument is frequently used in Switzerland by parties on both sides of the political spectrum to support further centralization.

TABLE 3
Tax receipts after vertical transfers (social charges not included)
% shares, 1975-2000

	Federal level	Cantonal level	Communal level
1975	32	38	30
1980	30	40	29
1985	33	38	29
1990	36	36	27
1995	38	36	26
2000	39	37	24

Source: Administration fédérale des Finances, Charge fiscale en Suisse, various issues, Recettes fiscales de la Confédération, various issues, *Recettes fiscles des Cantons et Communes*, various issues.

Another reason might lie in the political dynamics of federal systems. Thus, in any federal system, state and local politicians have an incentive to try to finance local projects out of centralized general taxes. In this they will find willing allies in other state and local politicians pursuing the same objective. Log-rolling and inter-cantonal dealing will surface at the federal level, where federal politicians will generally be only too happy to go along. State and local politicians in Switzerland, furthermore, represent sovereign entities which ultimately decide on the tasks to be accomplished at federal level. The result may be a cross-party political collusion against the public. The introduction of VAT in Switzerland in 1996 fits this hypothesis rather well – all political parties of any importance, at all levels, were in favour of the measure. Only the public was against it. In the end, after four referenda, the politicians finally won.

DOI: 10.2202/1145-6396.1108

5. Growth of government

During this period, the general level of taxation in Switzerland also grew (see Table 4), mainly because of the development of social insurance and social services, broadly defined.

Thus taxes (including social security charges) rose from 28% of GDP in 1975 to 35.7% in 2000, an increase in 28 per cent (outdone only by Italy, Spain and Portugal). While the over-all level of taxation remains below the OECD average (40%), the trend is on the high side. More time is needed to see where the trend is leading.

Given the link between social services and centralization described above, it would seem that there has been, historically, a link between centralization and the growth of government in general. But it would be unwise to infer a more general link between these two trends.

TABLE 4
Taxes as % GDP (including social security)

	1970	1975	1980	2000	change 1975-2000 %
Austria	34.6	37.4	39.8	43.7	17
Belgium	34.5	40.1	42.4	45.6	14
Canada	30.8	31.9	30.7	35.8	12
Denmark	39.2	40	43.9	48.8	22
Finland	31.9	36.8	36.2	46.9	27
France	34.1	35.9	40.6	45.3	26
Germany	32.3	35.3	37.5	37.9	7
Ireland	28.8	29.1	31.4	31.1	7
Italy	26.1	26.1	30.4	42	61
Japan	20	21.2	25.1	27.1	28
Luxembourg	24.9	37.3	40.2	41.7	12
Netherlands	35.8	41.6	43.6	41.4	0
Norway	34.5	39.3	42.7	40.3	3
Portugal	19.4	20.8	24.1	34.5	66
Spain	16.3	18.8	23.1	35.2	87
Sweden	38.7	42.3	47.5	54.2	28
Switzerland	22.5	27.9	28.9	35.7	28
UK	37	35.3	35.2	37.4	6
USA	27.7	26.9	27	29.6	10
Average	29.95	32.84	35.28	39.69	21

Source: OECD (2002) Comparative Tables 1965-2000, Table 3 pp. 73-74.

6. Transfers from federal to cantonal level: another element in achieving the balance

In 1959 Switzerland adopted a system of inter-cantonal tax redistribution in order to promote national unity and to even out some of the differences between the rich cantons and the poor ones. 13% of most federal tax is redistributed from richer to poorer cantons every year, according to a complex formula which takes into account per capita incomes, geography (mountainous regions are intended to be subsidized) and "fiscal capacity"[4]. On the other hand, along with this federal grant comes control over how most of the money is to be spent. Thus only 30% of the 13% is "free" money to be spent as the recipient canton wishes.

The idea is basically that « poor » (*i.e.* mountain) cantons might not be able to raise enough revenue from their own tax base to provide public goods up to the standard fixed by common agreement at the federal level (in areas such as housing, the military, civil defence, education, environmental programmes, roads, farming, water and avalanche management, etc.).

Not only is it deemed that « poor » cantons' capacity for raising their own taxes is comparatively low, but it is also assumed that some of their costs of providing public goods are greater than for richer and more urban cantons (maintenance of public transport and roads in mountainous areas, coping with land-slides and avalanches, for instance, costs more than in lowland urban districts). Furthermore, many town-dwellers spend their holidays or own holiday homes in mountainous cantons and want a similar level of public services.

In the absence of such transfers, « poor » cantons might have to *raise* their tax rates in order to raise revenues[5], and in so doing might provoke an exodus of the mobile tax base. Or, inversely, poor cantons might *lower* their tax rates in order to attract mobile tax payers. In short, the transfer system aims to limit the inter-cantonal movement of mobile tax resources and, incidentally, to limit the need for harmonization of taxes. It amounts, at a maximum, to 13% of 39% of 35.7% of Swiss GNP, namely 1.8% of GDP.

However, during the past 40 years, all kinds of differences between cantons have grown rather than shrunk, and people commute over much longer distances (over ever better roads and public transport facilities). Inter-cantonal fiscal competition is therefore lively, some rural cantons are accused of being free-riders on neighbouring urban cantons' public goods, and the Federal government has become progressively more and more indebted. A new system of redistribution is therefore under discussion.

In particular, it is suggested that more objective criteria for redistribution should be adopted, that recipient cantons should enjoy more freedom to decide on how the money should be spent (at present it is largely tied to federally

[4] See Cornavin-Pfeiffer-1991, p. 242.

[5] Cornavin-Pfeiffer-1991, pp .233-240.

DOI: 10.2202/1145-6396.1108

determined projects), and that inter-cantonal cooperation should be encouraged in order to capture economies of scale in the provision of public goods. If adopted, this reform would actually redefine Swiss federalism. The idea of bolstering Swiss national unity via inter-cantonal income redistribution under close federal supervision would be replaced by the notion of greater decentralization in deciding on how redistributed funds should be spent, along with a possible re-drawing of cantonal frontiers on a functional basis.

As part of the collective cantonal effort to fight the centralizing trend mentioned above, the cantons have kept the *execution* of many federal policies for themselves, and indeed continue to participate financially in most federal programmes (for roads, higher education, agriculture, civil defence, even the military). Furthermore, the cantons often act as agents for the Federal government in the execution of its (federal) duties. Thus it is very difficult indeed to disentangle the lines of fiscal responsibility. Indeed, the citizen hardly ever comes into direct contact with the federal government at all – subsidies, roads, agricultural support, welfare payments etc. are all handled by the cantons or by semi-market agencies. This may account for a certain amount of “federal fiscal illusion”. Thus the Swiss may remain convinced that their cantons retain fiscal sovereignty, and that there is no worrisome trend toward centralization, because they are rarely in direct contact with the Federal level of government.

7. Inter-cantonal tax and income dispersion

Table 5 shows both the extent of fiscal diversity in Switzerland and the fact that there is no correlation at all between the level of taxation and per capita incomes on a cantonal basis. Average cantonal tax revenue as a share of GDP ranges from a low of only 4.5% in Nidwalden, to a high of 18.8% in Geneva. Per capita incomes range from a low of 30,280 CHF in Obwalden, to 79,722 CHF in Basel-City. Indeed, Table 6 shows that all four extreme situations coexist. High-tax, high-income cantons (Basel City, Geneva) coexist with low-tax, low-income cantons (central, mountainous regions). More intriguingly, we find a few low-tax, high-income cantons (Zug, Zurich); and one high-tax, low-income canton (Ticino).

How can such diversity persist in such a small geographic area? Does it give rise to massive population movements?

In a small polity like Switzerland (the average size of cantons is only 270,000 inhabitants and the average size of communes is just 2,500 inhabitants) one might indeed expect people and firms to be voting with their feet all the time[6]. However, there is in fact very little evidence that this is so, despite the wide dispersion of tax rates and incomes just described. According to Kirchgässner and Pommerehne[7] this is because of the federally organized inter-cantonal tax

[6] Tiebout-1956

[7] Kirchgässner/Pommerehne-1996, p. 366.

redistribution system. This seems slightly implausible, given the small scale of these transfers. An alternative explanation might be that the referendum offers the Swiss voter a good "voice" alternative to "exit".

In addition, Swiss federalism having fostered and maintained local cultural and linguistic specificities, people have a strong preference to stay put. Tiebout's seminal paper referred to the United States, where people are far more foot-loose and move easily at the margin, thus creating the homogenous local communities he describes. In Switzerland, one could argue that homogenous local communities have existed for centuries and are so strongly based in tradition that they can afford large fiscal disparities without provoking extensive inter-cantonal migration. In any event, each canton remains free to determine its own tax-and-spend mix and seems to exercise this right without causing a disastrous "race to the bottom".

TABLE 5
Cantonal tax revenues as % GDP and per capita cantonal GDP (1999, CH Fr)

	%	Pc GDP CH Fr
Nidwalden	4.5	55,881
Obwalden	5.0	30,280
Schwyz	5.1	49,478
Zug	5.2	72,698
Appenzel Int	6.2	40,068
Schaffhausen	6.2	49,014
Uri	6.2	39768
Zurich	6.3	59,692
Aargau	6.6	44,332
Soleure	6.6	40,029
Thurgau	6.8	38,656
Appenzel Ext	6.9	39,418
Graubünden	7.1	41,476
Lucerne	7.3	37,956
Fribourg	7.8	36,410
Valais	7.8	33,514
Glarus	8.0	53551
St. Gallen	8.0	39,197
Bern	8.2	38,322
Jura	9.2	32,262
Vaud	9.2	46,046
Basel-Land	9.3	49,872
Neuchâtel	9.7	39,759
Ticino	11.5	38,526
Basel-Stadt	13.7	79,722
Genève	18.8	54,298
Switzerland	8.5	46,341

Source: Administration Fédérale des Finances,Finances publiques en Suisse 2000, Tableau E4.3 and Département fédéral de l'économie, La Vie Economique (2003) Tableau B17

TABLE 6
Dispersion of tax rates and incomes across cantons

	HIGH TAX (12-19%)	LOW TAX (5-7%)
HIGH INCOME (50-80,000 CHF)	BASEL CITY GENEVA	ZUG, ZURICH NIDWALDEN, SCHWYZ, SCHAFFHOUSEN
LOW INCOME (30-45,000 CHF)	TICINO	AARGAU APPENZEL (INT & EXT) GRAUBUNDEN OBWALDEN LUCERNE SOLEURE, URI

Source : derived from Table 4

Feld and Kirchgässner[8] try to discover whether cantons with low taxes attract high income self-employed individuals and whether cantons with high supplementary pensions attract low-income retirees. The results are less than startling and they find some evidence for the former but not for the latter. This finding has implications for high tax cantons, like Geneva and Basle-City, which are outliers in tax matters and regularly complain about competition from their lower tax neighbours (respectively Vaud and Basel-Land), but anyone looking for strong evidence either that low taxes are linked to high per capita incomes, or that tax disparities result in harmful tax competition, will be disappointed. There is no correlation either way.

This may be because two plausible effects cancel each other out. According to H1 (*the classical assumption*), low taxes favour entrepreneurship and economic growth in general, and should therefore be associated with wealth creation. However, according to what we call *the public-choice assumption*, (H3) what politician in a rich and productive state can resist raising taxes from a wealthy community? Promising attractive public goods to be paid for out of economic growth is something few politicians (and voters) can resist. Thus one could argue that an attractive location generating high incomes, strong agglomeration effects and economic growth will tend to have correspondingly high taxes, reflecting the higher fiscal potential of the location. In the meantime, low taxes in some areas may well fail to stimulate much economic activity, and may simply reflect the economic reality of a poor location enjoying few agglomeration effects.

8 Feld/Kirchgässner-2001

The fact that, as Tables 5 and 6 show, no correlation exists either way, suggests that both hypotheses may be at work simultaneously, along with others. In short, Switzerland's 26 cantons present many different tax and income profiles. Only one pattern emerges: lower-tax cantons tend to be grouped together in the east of the country, while higher-tax cantons tend to be grouped together in the west[9]. This indeed suggests the existence of some inter-cantonal fiscal competition, a theme to which we now turn.

8. Inter-cantonal fiscal competition

Inter-cantonal fiscal competition is a regular item of public debate. The 1990 federal law on the harmonisation of tax bases referred to above was intended to remove one major source of friction – the fact that some cantons regularly "negotiate" special tax regimes on an *ad hoc* basis with wealthy foreigners, both firms and individuals. Many would claim that these practices are still current despite the federal law. The so-called "forfait individuel" has not disappeared entirely, but has been codified as a "special consumption tax" subject to (fairly) transparent rules. Rules for offering foreign corporate entities special tax breaks have also been harmonised and made more transparent. But the fact that the press regularly reports on such special deals suggests that they are far from having disappeared.

We therefore have a curious situation: while the Swiss themselves seldom "vote with their feet", and may pay fairly heavy taxes as a result, foreigners, almost by definition, are not only foot-loose and respond to fiscal incentives, but inter-cantonal competition in this regard can reach epic proportions.

However, we would argue that this type of inter-cantonal competition is mainly anecdotal, and is in fact regularly monitored by the *Conférence des Directeurs cantonaux des finances*, a committee composed of all the cantonal tax chiefs, who meet regularly to prevent too much blatant inter-cantonal poaching of wealthy investors.

More interesting is the contrast between east and west, mentioned earlier, epitomized by the contrast between Geneva on the one hand (tax-to-GDP rate 18.8%) and Zurich on the other (tax-to-GDP rate 6.3%). Both cantons have comparable levels of per capita income (although Zurich is wealthier), but very different tax rates. Zurich confirms H1, while Geneva seems to follow H3.

Zurich is surrounded by a "crown" of small, low-tax cantons (Schaffhousen, Thurgau, St Gallen, Glarus, Zug, Schwyz, Nidwalden, Uri, Luzern, Obwalden, Argau). Although they are frequently criticized by Zurich for being free riders on Zurich's public facilities, it is conceivable that the reason why Zurich corresponds more to the neo-classical hypothesis than to the public-choice hypothesis, is precisely because of these numerous small competitors. Geneva, on the other hand, has only to cope with Vaud (middling tax ratios) – and France

9 Thierstein/al.-2003 p. 110, quoting a study by UBS Warburg.

(much higher). This gives Genevese voters and politicians the opportunity to favour the public choice alternative.

However, the general picture which emerges from the data is one of considerable inter-cantonal fiscal diversity over a tiny geographic area (43,000 km2), with no evidence at all of a “race to the bottom”, the development of poor public services or large migratory movements. It cannot be argued that inter-cantonal redistribution at a rate of 1.8% of GDP is enough to offset these disparities.

9. Conclusions

Despite a recent increase in the degree of centralization, Switzerland remains decentralized compared to most other developed countries : the central government still only accounts for 39% of total public revenue/expenditure, which in turn accounts for only 35.7% of GNP. Thus, central government accounts for no more than 14% of GNP.

This low level of central taxation combined with a low level of general taxation, a high absolute level of income and normal-to-better quality public goods, provides at least one example of the hypothesis that fiscal decentralization and competition is both feasible and efficient. H1 is thus in conformity with the Swiss experience.

To those who claim that this is only possible because Switzerland is a small country, with no major defence or foreign policy responsibilities, one could answer that Switzerland spends the same proportion of GNP on defence as France or the UK. Nor is there evidence that there are major economies of scale in the provision of other public goods. Boring a tunnel under the Alps costs the same in Switzerland as in France.

Anyone looking for strong evidence of inter-cantonal fiscal competition resulting in a race to the bottom will be disappointed. Quite the contrary, there is every sign that considerable cantonal disparities coexist without causing immense migratory movements or other inefficiencies. H2 is not born out by the Swiss experience.

Looking to the future, the pressure in favour of harmonization and/or centralization is growing. It comes from the tax authorities and the political parties, but is usually resisted by the public.

The Socialist Party, for instance, has proposed that cantons should agree to harmonization of taxes within a band of + or – 20% of the Swiss average tax rate, while right-wing parties are pushing for an increase in VAT rates in the name of tax efficiency, the idea being that cantons would then recover their “share” to spend as they see fit. This seemingly sensible measure would introduce a degree of fiscal incoherence which could lead to higher over-all levels of taxation in the long run[10]. There is therefore considerable political pressure building up in favour of centralization and harmonization.

10 See Curzon Price/Garello-2003.

Whatever the outcome of these debates, the matter will have to pass the public referendum test, and here the public is likely to vote in favour of local autonomy and independence. In fact, we would argue that while inter-cantonal tax competition may have had some effect in keeping the over-all level of taxation low in Switzerland (as suggested by the example of Zurich and its "crown" of small competitors), we would also agree with REY[11] that the main reason for the low absolute level of Swiss taxation lies in the public referendum, operating at all three levels of government.

What do these findings imply for Europe as a whole ?

If Switzerland can live with wide tax disparities within its borders, then Europe as a whole, geographically 106 times larger than Switzerland, can presumably live with even greater fiscal differences without "harmful" effects appearing. Rather, there would appear to be a very wide spectrum of feasible tax rates depending on the specific political democratic choices of each country, which are compatible with full economic and monetary union.

The case of Switzerland shows that a relatively low rate of transfers between richer and poorer nations/cantons is sufficient to substitute politically for tax harmonization. The case of the enlarged EU involves much larger income disparities, but also a much greater resistance to tax harmonization and, curiously enough, a fairly wide tolerance for transfers between member states. At this stage no generalizations can be made.

However, as the "harmful tax competition" debate shows, the forces in favour of tax harmonization and centralization are very strong, and will grow with enlargement. Some new members have adopted low, flat levels of taxation as a means of attracting investment and stimulating growth. Older industrialized western European countries, with high and progressive tax systems will suffer an exodus of mobile resources unless they either adopt more competitive tax profiles, or persuade their new partners to abandon theirs.

The main pressure in favour of tax harmonization comes from the tax authorities themselves, followed at some distance by most political parties anxious not to see their tax base competed away, however unfounded this fear may be.

The pressure on the part of *tax authorities* in the EU to *coordinate* taxes, possibly just tax structures as in Switzerland, will be intense and will grow with time. This would make inter-country tax comparisons more transparent, and might be a first step in a more formal harmonization process.

However, it is not necessarily in the interest of governments *as a whole* to accede to these pressures on the part of their tax authorities. To the extent that tax differences represent deliberate choices on the part of the governments concerned, are part of the political balance of power, or are consciously designed to promote economic growth, these governments should be as keen as the Swiss cantons to preserve their sovereignty in tax matters.

The public in EU countries could do worse than to put pressure on their own political parties to grant them referendum rights in setting taxes.

[11] Rey-1990, p. 41.

DOI: 10.2202/1145-6396.1108

References

Administration Fédérale Des Finances, *Finances publiques en Suisse, diverses années*

Administration Fédérale Des Finances *Recettes fiscales de la confédération,diverses années*

Administration Fédérale Des Finances *Recettes fiscales des cantons et communes, diverses années*

Administration Fédérale Des Finances *Charge fiscale en Suisse,diverses années.*

Conseil fédéral, *Message concernant les lois fédérales sur l'harmonisation des impôts directs des cantons et des communes ainsi que sur l'impôt fédéral (Message sur l'harmonisation fiscale)* du 25 mai 1983.

Cornevin-Pfeiffer K. & Manzini A. (1991) « Le financement de l'Etat » *in* Weber Luc (ed.) *Les finances publiques d'un Etat fédératif : la Suisse*, Economica, Paris et Genève, pp. 87-188

Cornevin-Pfeiffer K. (1991) « La dynamique du fédéralisme suisse » in Weber Luc (ed.) *Les finances publiques d'un Etat fédératif : la Suisse*, Economica, Paris et Genève, pp.189-265.

Curzon Price, V. & Garello, J. (2003) "Index of Fiscal Decetralisation: Methodology and Findings", *Journal des Economistes et des Etudes Humaines*, Vol. XIII, n°4, Decembre, pp. 441-478

Département fédéral de l'économie (2003) *La Vie Economique*, Décembre, TBF.

Feld L.P. & Kirchgassner G. (2001) "Income tax competition at the State and Local Level in Switzerland", *Regional Science and Urban Economics,* Vol. 31, pp. 181-213.

Kirchgassner G. & Pommerehne W.W. (1996) "Tax harmonization and tax competition in the European Union: Lessons from Switzerland", *Journal of Public Economics*, No. 60, pp. 351-371.

OECD (2002) *Revenue Statistics 1965-2001*, Paris.

REY J.-N. (1990) *Barrières constitutionnelles au pouvoir fiscal de l'Etat. Contribution à la théorie du Public Choice à partir du cas suisse*, Etudes et Recherches du Département de science politique, No. 24, Faculté des Sciences économiques et sociales, Université de Genève.

Schoenenberger A., & Zarin-Nejadan M. (2001) *L'économie suisse*, Série Que sais-je ?, PUF, Paris, 1994.

Thierstein A. & Al. (2003) *Les différences spatiales des charges fiscales et compétitivité régionale*, Société suisse d'études pour l'organisation de l'espace et la politique régionale OEPR, Zürich, 2003.

Tiebout Ch.M. (1956) "A Pure Theory of Local Expenditure", *Journal of Political Economy,* Vol. 64, No. 5, 1956, pp. 416-424.

Weber L. (1991) *Les finances publiques d'un Etat fédératif : la Suisse,* Economica, Paris et Genève.