
Annex 9B

Tax coordination and competition in Switzerland

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I — Historical background

'Switzerland is the oldest and probably the best functioning example of a highly federalistic State, as it developed from the need to combine in a small community four different native languages, two major religious affiliations, and substantial differences in economic power and cultural background.'¹

Fiscal federalism in Switzerland has its roots in history. It results not from planned development but from political compromises among the cantons. They were jealous of their autonomy and yet needed to coordinate. The Constitution of 1848 transformed the relatively loose confederation of cantons into the present federal State. It took the power to raise custom duties from the cantons and gave it to the national government. The forgone revenues were progressively replaced by taxes on income and wealth.

There lies the origin of a form of fiscal specialization that still exists today: the national government raises mostly indirect taxes while the 26 cantons and about 3 000 communes earn the largest part of their revenues from direct taxation (see Table 9B.1). Each entity has its own budget, which is related to that of the other entities through several politically determined transfers. Specialization is not absolute: the two war efforts in this century forced the national government to levy its own tax on income and wealth. Introduced in 1941 on the basis of emergency legislation, the tax for national defence (called federal direct tax since 1982) was extended on a provisional basis, without fundamental changes, on average every six years and now until 1994.²

The history of this country is reflected in its political structure. The cantons enjoy sovereignty in so far as it is not limited by the federal constitution; they retain all powers that are not explicitly delegated to the national government. The cantons' major instruments of control over the national government are (i) the requirement for constitutional votes to gather approval in a majority of cantons, and (ii) the upper council of the Legislative Assembly, where each canton is represented by two delegates. In addition, cantons and municipalities are consulted on new federal legislation before it is brought before the Legislative Assembly, both in broadly-based commissions and

¹ Nowotny (1983), p. 266.

² For the history of federal taxes, see Oechslin (1967), Bieri (1979) and Administration fédérale des contributions (1991a).

in a procedure of consultation. Those instruments give equal weight to small and large cantons and protect language minorities.¹ In effect, the complex system of Swiss federalism makes it very difficult and time-consuming for true reforms to be enacted. That is particularly true for reforms that aim at increasing political and fiscal centralization. A relatively small number of cantons can suffice to block a project.

The cantons are free to levy all kinds of taxes, in so far as they are not explicitly reserved to the national government. Among the latter there are customs duties, a turnover tax, a withholding tax on capital income, and stamp duties. The national government shares with the cantons the right to levy a tax on the income and wealth of households and firms. However, the federal direct tax (FDT) is limited in time and will expire in 1994 if a new extension is not approved by the electorate. The Constitution requires the national government to take account of cantonal and communal taxes when setting its own rate. It imposes forms of taxation and ceilings on the rates of the FDT. Table 9B.1 shows the major sources of revenue for the national government, the cantons as a whole and the communes as a whole.

Each canton also delegates some competence to the lower tier, its communes or municipalities.² The communes enjoy an autonomy granted by cantonal law that is protected by the Federal Court of Justice. The degree of communal autonomy is different in every canton. They may only levy taxes that are delegated to them by the canton.

To understand the diversity of the fiscal landscape of Switzerland, we must visualize the economic differences that exist among the cantons. Table 9B.2 shows that per capita income changes widely from one canton to another. Some of the differences can be explained by geographical factors: the richest cantons are densely populated and located on the central plateau while the poorest cantons are sparsely populated and located in the mountains.

II — Main features of federal and local corporation taxes³

The Swiss tax system distinguishes 'natural' and 'legal' persons. Natural persons are households. Unincorporated enterprises are not distinct taxpayers; instead, their profits and equity are added to the incomes and wealth of their owners. Incorporated enterprises take mostly the form of limited liability, shareholder companies. They are treated as distinct entities for tax purposes, so-called 'legal' or 'moral' persons.

The addition of the profits of personal firms to the incomes of their owners constitutes the main difference in tax treatment compared with that of incorporated enterprises. The tax base itself is determined basically in the same way, at least for unincorporated firms that are large enough to be required to keep books.⁴

¹ For more detail, see Dafflon (1977), pp. 72-78. There is also a form of horizontal cooperation among the cantons: ministerial conferences on education or accounting practices, for instance.

² For lists of the tasks allocated to the cantons and to the communes, see Bieri (1979), pp. 43-44.

³ For taxes other than those that are levied on corporate profits and equity, the reader may refer to the brief description in OECD (1989/90), Appendix III.

⁴ Zuppinger et al. (1984), pp. 163-164.

The next sections describe the law as of 1991. Modifications are due to be implemented over the next years, particularly as regards cantonal taxes. Indeed, a law was just approved, which aims at harmonizing cantonal taxation. Its innovating features will be mentioned in Section IV(c).

The 'federal law on the harmonization of the direct taxes of the cantons and communes' of 14 December 1990, pursues formal harmonization only. The constitutional basis for tax harmonization gave the national government a mandate for working towards uniform definitions of tax objects, the circle of taxpayers, the bases of calculation, and rules over tax dispute. It does not allow for uniform tax rates, schedules, deductions or allowances.

Some formal harmonization has already taken place. Indeed, numerous cantons which altered their direct taxation since 1941 used the FDT as a model. They often did so under the pressure of their tax administrations, which are also responsible for collecting the FDT for the national government.¹ Still, important differences remain, not only as regards the tax rates and schedules but also as regards the definition and delimitation of taxable items.

(a) Tax base

The base for the corporate income tax is net worldwide corporate income. It is measured as the balance of the profit-and-loss account. The accounts must satisfy the accounting rules of business law and a few rules that are specific to tax law (mainly for depreciation and provisions). Thus, the firm may have to add to the balance of the profit-and-loss account all deductions that do not correspond to business expenses and all incomes that were left out, in particular extraordinary incomes and realized capital gains.

Depreciation. For the FDT and in most cantons, the tax authority sets allowed rates for tax depreciation. In some cantons, in particular in Zurich, the firm may choose the speed at which it writes off its assets. The tax authority sets only a lower bound on the residual value in the books (e.g. 20% in Zurich) until the asset leaves the firm.² There are no investment credits.

Taxes paid. For the FDT and in all but eight cantons, all direct taxes paid to the national government, the cantons and the communes on income and equity are deductible in the year in which they are paid. In one canton (Berne), only half of the taxes paid may be deducted.³

Unrealized gains and losses. It is a legal accounting rule that unrealized gains not be added to profits but that book losses be included as soon as their realization becomes likely.

Historical costs. Another fundamental accounting rule requires corporations to carry assets in their accounts at historical costs.

¹ Dafflon (1986), p. 38.

² The tax harmonization law of 1990 does not provide for uniform cantonal depreciation rules (Zuppingier et al. (1984), pp. 179-181).

³ The tax harmonization law of 1990 provides for uniform deduction of all income and equity taxes paid.

Two systems are used in Switzerland to determine the tax base over time:

- (i) The 'praenumerando' system: the taxes a firm owes for 1991 and 1992 are based on its average profit in 1989 and 1990. The taxes for 1991 are due in 1992 (usually on 1 March) and those of 1992 are due in 1993. Alternatively, in the one-year system, the firm owes taxes every year based on its profit in the preceding year.
- (ii) The 'postnumerando' system: the taxes a firm owes for a given year are based on its profit in the same year but assessed and collected in the following year.

Currently, the national government and 12 cantons use the 'praenumerando' system with two-year periods, six cantons use the 'praenumerando' system yearly and the remaining eight cantons use the 'postnumerando' system.¹

Losses are automatically reported to some extent in the 'praenumerando' system. In addition, the FDT allows for the reporting over three taxation periods, i.e. over six years.²

(b) Statutory corporation tax rates

The tax rate on profits depends usually on the rate of return on equity. That coefficient is viewed as an indicator of the fiscal capacity of firms. For the FDT, there is a proportional ground tax of 3.63%, plus 3.63% on the portion of profit which raises the rate of return over 4%, plus again 4.84% on that part of profit which raises the rate of return above 8%. However, the tax may not exceed 9.8% of total net profit, a limit which is attained at a rate of return of 23%.³

Seven cantons use schedules similar to that of the FDT, with two or three steps. Nine cantons set the tax rate as a fraction of the rate of return on equity, with lower and upper bounds. The other cantons use standard progressive schedules, some applying different rates to distributed and retained earnings; two cantons apply a lower rate to that part of profits that does not exceed some limiting rate of return. Only in one canton is the rate of tax on profits constant (Jura).⁴

The communes in most cantons enjoy tax flexibility, as opposed to tax autonomy. That is, they may decide the tax rate but not define their own tax forms and schedules. In practice, communal taxation of income takes the form of a surcharge on cantonal taxes. It is driven essentially by the legal requirement of a balanced budget. The surcharge is of the same magnitude as the cantonal tax. In six cantons the surcharge is the same for all the communes. Some cantons rather share the proceeds of the corporate tax with their communes.

The sum of federal, cantonal and communal statutory tax rates ranges from a minimum of 11 to 30% of total net profit over the country.⁵ More will be said on those geographic tax differentials in Section IV.

¹ Administration fédérale des contributions (1988), p. 36.

² The laws of 1990 on the FDT and on tax harmonization allow for the reporting of losses over a maximum of seven years.

³ These rates are valid since the tax period 1975/76. Before that date they were lower by 10% and more. They have now reached the upper limit allowed by the Constitution.

⁴ The systems are described by Amman (1989) and Margairaz and Merkli (1989).

⁵ Rivier (1990), p. 98, OECD (1989/90), Appendix III.

The system of progressive profit taxation based on the rate of return on equity is believed to hurt labour-intensive firms compared with capital-intensive firms, and young firms that have not yet accumulated large reserves. The system is favourable to equity finance since greater net worth, obtained either from new shares or from retained profits, lowers the rate of return. Retaining earnings also avoids dividend taxation; it is particularly interesting because personal capital gains are untaxed in all but one canton (Graubünden).

On the other hand, those firms which are supposed to be at a competitive disadvantage due to tax progressivity do earn higher returns. Furthermore, they pay less of the tax on equity. Debt finance is favoured by the deductibility of interest payments while new share issues pay a federal stamp duty.¹

The progressive schedules used by the national government and many cantons result, by their designs, in marginal tax rates that jump considerably at boundary values of the rate of return. An extreme case is that of Zürich, where the combined cantonal and communal marginal tax rate jumps from 45.2 down to 22.6% at a rate of return of 20%.²

There is a tendency to move towards proportional taxation. The national government intended to replace the stepwise tax rate with a single constant rate of 8%, but its project was rejected by popular vote on 2 June 1991.

(c) Integration of corporate and personal income taxes

Corporate income distribution is subject to double taxation in the same manner as in the United States, the Netherlands and Luxembourg. Only three cantons apply a lower rate of tax to distributed earnings than to retained earnings. Nowhere are shareholders allowed to deduct any part of corporate taxes paid. If profits were fully paid out, the total (personal and corporate) rate of tax could exceed 67%. There are no plans to alleviate the taxation of dividends. Several reasons are advanced against such a reform: (i) the revenue losses would have to be compensated, probably by higher taxes on reinvested profits; (ii) any compensation of corporate taxes by lower personal taxes for shareholders would be complicated by the fact that corporate and personal income taxes rates are very different among the cantons and among the communes; (iii) any solution must make sure that corporate profits are not taxed more lightly than the profits of unincorporated firms.

In fact, it is very frequent for profits to be retained for very long periods. Distribution rates are low. Furthermore, the tax rates on corporate income are much lower than those that apply to personal income. On the other hand, the distributed and undistributed profits of unincorporated firms are added to the income of their owners who face steep progressivity. Thus, the latter may pay more taxes than shareholders in similar conditions. Finally, it is to be noted that if shareholders are subject to heavy taxation, this is not due to double taxation of dividends. Rather, the culprit is the wealth tax, which weighs heavy in comparison with the small returns on shares.

In conclusion, the issue of double taxation is not of great concern; it is not a centrepiece of tax harmonization efforts.³

¹ Zuppinger et al. (1984), pp. 231-233, OECD (1989/1990).

² Amman (1989).

³ Zuppinger et al. (1984), pp. 228-231.

(d) Taxation of intercantonal income flows

In theory, local taxes may hit taxpayers who exercise economic activities or hold assets in several cantons or countries according to the worldwide principle — all incomes and assets of a resident taxpayer are subject to local taxation — or according to the territoriality principle — all incomes that are sourced in the territory and assets located in the territory are taxable. If each canton may decide which system it chooses, double taxation may result. It would be actual — the same tax base is subject to taxation in two cantons — or it would be virtual — two cantons give themselves the competence to tax the same base but one renounces. Double cantonal taxation, actual or virtual, is contrary to the Constitution. On the other hand, taxpayers whose activities were taxed separately in different jurisdictions might escape the progressivity of the tax schedule. Some of their incomes might even go fully untaxed.

These problems are avoided in Switzerland through binding decisions of the Federal Court of Justice. Its case-law determines which canton is allowed to levy a tax on which base. The fundamental principles followed by the Federal Court of Justice are:¹

- (i) The firm must file a tax form in each canton of activity. It must report its total worldwide income. Since the cantonal tax rules differ, the firm's total taxable income will not be the same amount in all the cantons concerned.
- (ii) The tax rate in each canton depends on worldwide income of the firm subject to taxation. This principle is designed to guarantee that two firms earning the same total profit pay the same tax, whether or not they are active in the canton alone or also in other cantons and countries. It matters for all those cantons which apply progressive tax rates to corporate income.
- (iii) Each canton taxes a share of the firm's total taxable income, that total being defined according to the canton's law. The shares sum to one but, of course, the taxed incomes do not sum to any cantonal measure of total taxable income.
- (iv) The fundamental principle for calculating the shares is that the firm is taxed basically in the canton of the seat of its executive offices. Its 'permanent establishments', however, are taxed in the canton where they are located.

'Permanent establishments' are buildings and other installations (offices, factories, branches, etc.) which are dedicated permanently to contributing substantially to the activities of the firm. A firm's branches may keep their own separate accounts and produce distinct incomes. In that case, it is possible to separate the firm's taxable incomes among the cantons on the basis of those accounts.² This method is used only for banks as they are required by federal bank law to keep separate accounts in their branches. For other firms it would be easy to shift their profits to the canton with the lowest taxation. The apportionment of a firm's profit is usually based on other criteria, depending on the nature of the firm: turnover for a commercial enterprise, premiums earned for an insurance company, capitalized assets and payroll for an industrial enterprise. When the criterium selected gives too little weight to the activity of the headquarters, an initial share of profits of 10 to 20% may be attributed to them.³

For the tax on equity, the allotment of the tax base reflects the localization of the firm's assets. Buildings which are pure investment objects rather than being used directly

¹ See Dafflon (1986), pp. 32-36.

² The canton in which a branch makes losses is not entitled to any part of the tax base.

³ Gunter (1988), Rivier (1990), Chapter 40.

by the firm are not 'permanent establishments'. Their value and incomes are taxed separately in the canton of their location.

(e) Taxation of groups of companies

To avoid treble (or more) taxation of the dividends received by a parent company from its affiliates, those dividends can be deducted by the former from its taxable income. However, for the FDT and in most cantons, the progressive tax rate applied to profits minus dividends is based on total profits. Taxes due are reduced in the proportion of the dividends received to total gross income of the parent company. Some cantons are moving towards a system where taxes due are reduced in the (greater) proportion of the dividends received to net profits. The FDT and 15 cantons allow for the deduction of dividends when they are received from holdings of at least 20% or SFR 2 million, that is, from so-called 'substantial interests'. Nine cantons set similar lower bounds and only two cantons do not allow for any reduction.¹

Firms whose principal activity consists in holding participation in other companies receive special treatment in numerous cantons, the so-called 'holding's privilege'. They are fully exempted from income taxes. This privilege is granted for variable proportions of income from participation in total income. Therefore, holding companies benefit from undue tax breaks on non-dividend income (mainly interest and licence income) paid to them by their affiliates. Those payments are deducted by the latter from their taxable income.²

(f) Taxation of foreign-source income

For international taxation, Switzerland follows the same system of exemption with progressivity as for the taxation of intercantonal income flows: tax rates are determined on the basis of worldwide income, but the earnings of immovable property and 'permanent establishments' located abroad are exempted from Swiss taxes. To apply that principle, the same apportionment rules are applied as for intercantonal taxation.

International double-taxation treaties broaden the definition of 'permanent establishments'. They introduce the principle that they should be treated like independent entities dealing 'at arm's-length' with fictitious firms. That principle matters both for the calculation of tax bases and for their apportionment. It is abandoned for some transactions between the main firm and its establishment, notably for interest payments and some management services. In general, the OECD model for tax treaties is observed.

When a firm exercises its international activities through an independent legal entity, how should dividends received by the parent firm be taxed? In general, bilateral treaties share the power to tax by setting maximal rates on dividends paid. Dividends from 'substantial interests' are free of tax, by application of the rules governing the taxation of groups of companies.

Both bilateral treaties signed by the national government and unilateral measures it takes to prevent double taxation are binding for the cantons.³

¹ Gunter (1988), Rivier (1990), pp. 335-355.

² Margairaz and Merkli (1989), p. 35.

³ Rivier (1990), pp. 335-355.

(g) Related taxes

On top of taxes on their profits, firms pay federal and cantonal taxes on their equity. They also pay federal stamp duties on the transfer of securities and other commercial documents and the issuance of shares. In addition, they are required to withhold a tax on their dividend and interest payments.

The tax base for the corporate equity tax is total worldwide net worth. It is the sum of share equity raised and of open and hidden reserves. The 12 cantons with two-year periods of profit taxation and the national government base the equity tax on the situation on the first day of the period for which taxes are calculated. The other 14 cantons use five different reference dates. The tax on corporate equity is levied at a flat rate for the FDT (0.0825% since the 1973/74 tax period) and in all but six cantons. Cantonal tax rates range from 0.202 to 0.85% (for SFR 1 million of equity).

Federal stamp duties are levied on the following bases:

- (i) on new shares issued or on similar participation rights; the rate is 3%;
- (ii) on the sale of securities to or by a Swiss title trader. The securities concerned are Swiss or foreign shares, bonds, and all other assets similar to those two categories. The rate is 0.15% for Swiss securities and 0.3% for foreign securities.

The withholding tax is levied only by the national government on the returns of mobile assets, at a rate of 35%. Thus, every payment from the firm to its shareholders is subject to the tax that does not modify the face value of shares.¹ The rate of 35% can be compared to the top statutory rate on personal income (central and local taxes) of 44%.

The taxes withheld can be recovered by residents (firms or persons) when they report the corresponding capital incomes. Foreign residents cannot recover the withholding tax, unless a treaty of double taxation exists between their country of residence and Switzerland. Most of those treaties allow only for partial reimbursement of the taxes withheld; effective tax rates range from 5 to 15%. In effect, one-fifth of the proceeds from the withholding tax was never reclaimed (on average over the last 10 years).

III — Revenue-sharing and equalization

(a) Historical evolution and development

Originally, the national government made payments to the cantons as compensation for the loss of revenue sources. Thus, in 1848, when the monopoly of customs was transferred to the national government, the excess of the duties over the limited needs of the national government was returned to the cantons. Later, the cantons were granted shares in federal revenues as indemnities for collection costs (the FDT is collected by the cantons) or as incentives for cooperation.

Before an equalization law was passed in 1959, the national government attempted several times to reduce or suppress revenue-sharing programmes. It claimed that it

¹ Rivier (1990), p. 107ff.

needed the funds itself. The cantons opposed such changes because they feared they would not be able to raise the same revenue themselves; the local electorate would oppose the higher taxes.

The equalization law of 1959 completely changed the perspective on revenue-sharing. It was to be used more and more for revenue equalization among the cantons.¹ That change in perspective is not unrelated to the increasing differences in cantonal per capita incomes and to the above-average voting power of the poorer cantons.²

(b) Apportionment formulas

The cantons were granted the following percentages of major federal taxes in 1990:

30% of the federal direct tax, and

10% of the net proceeds of the withholding tax.

For each tax, specific parts of the funds available for revenue-sharing are reserved for revenue equalization (e.g. 13% out of the 30% for the FDT revenue). The remainder is allotted on the basis of the method of tax collection. When tax collection is administered by the cantons, a constant proportion of the total cantonal yield of the tax is returned to each canton (e.g. 17% of the FDT). When tax collection is administered by the national government (e.g. the withholding tax), there is no statistic of cantonal yields. A fixed proportion of net tax yield (total yield minus administration costs) is returned to the cantons in proportion to their population. Thus, of the 85% of available funds that were not redistributed on the basis of capacity in 1972, 54% were allotted according to their origin and 31% were shared in proportion to populations.³

The formulas for revenue equalization are very complex. For instance, of the 13% of the proceeds of the FDT which are reserved to that purpose, each canton will receive the following share, starting in 1992:

$$2.71828(-0.0192104 \times \text{IFC}) \times \text{POP} \times K$$

where IFC is the index of the canton's financial capacity, POP is its population, and K is a constant that guarantees that the shares received by the cantons add up to one.⁴

The 10% of the net proceeds of the withholding tax are shared as follows among the cantons: half of the available funds are allotted in proportion to population and half are shared equally among all the cantons whose index of financial capacity is below a certain ceiling.

How important is revenue-sharing for the cantons? In 1989, revenue-sharing contributed to the total revenues of the cantons in proportions ranging from 4 to 16% (6% on average). In comparison, conditional grants from the national government (subsidies) contributed up to 4% to cantonal revenues (14% on average). Those numbers reveal that the proportion of unconditional grants to conditional grants is very low compared with other federal countries.⁵ Table 9B.2 shows the dependency of each canton on total transfers from the national government. Comparing those numbers with income per

¹ Dafflon (1977), pp. 139-141 and 158-173.

² Frey (1977).

³ Dafflon (1977), p. 145.

⁴ Administration fédérale des contributions (1991a).

⁵ Bangerter (1990). Compare with King (1984), p. 185.

capita or the index of fiscal capacity, the expected relationship appears: poorer cantons receive more help from the national government. The richest canton (Zug) still receives relatively generous transfers because of the return-to-origin component in FDT revenue-sharing.

(c) Cantonal revenue-sharing

Grants from the cantons to their communes follow similar principles as the grants from the national government to the cantons. The unconditional grants received by a commune depend on its population and its fiscal capacity. They are not related to expenditure needs or performance. The initiative for seeking cantonal contributions comes from the lower tier. So does the opposition to extensive revisions.¹

IV — Current concerns

(a) Economic efficiency and tax competition

Table 9B.3 shows the great disparity in cantonal tax rates on corporate profits (first column).² That disparity is dampened when account is taken of the FDT and the relatively uniform taxes on equity (columns 2 and 3). Such taxes have been compared with other differences among the cantons. The main result is that no relationship can be found, either with the economic capacity of the cantons, or with the taxation of individuals, or with public services. It does not appear that poorer cantons systematically attract firms with lower taxes. The converse is not true either: they are not poorer because of excessive business taxation, nor do they try to extract the maximum of tax revenue. No compensation seems to exist between the taxation of individual income and corporate profit, nor is it possible to distinguish different cantonal preferences for business taxation. Finally, cantons with higher corporate taxes do not seem to offer more public services or infrastructure.³ It is difficult, after those observations, to find an economic rationale for the tax differentials. An explanation could probably be found in the changing power of interest groups over time and space.

The substantial differences in corporate taxation among cantons suggest potential for tax arbitrage. Yet, the geographic differentials in effective tax rates on corporate income and equity are believed to be relatively innocuous for location choices. They do not weigh heavy compared to other business cost differentials.⁴ Non-cost factors, like communication possibilities and labour pools, are believed to be more important. The cantons view location efficiency as too weak an argument for relinquishing control over taxation and for modifying vested interests for it. If anything, they would rather grant specific tax breaks to attract business to less developed regions and to pursue their own redistributive policy. The canton of Zug with its low taxes is often stigmatized

¹ Bieri (1979), pp. 65-66.

² Calculations are reported for a representative firm that produces profits amounting to 20% of equity. Administration fédérale des contributions (1991b), (Tables 18 and 20) shows that in terms of net profits, the median net worth is SFR 50 million and the median rate of return on equity is 20%.

³ Dafflon (1977, 1991a), Nowotny (1983).

⁴ It is very difficult to estimate the impact of differentials in effective tax rates on capital location since Switzerland carries no statistic of capital stocks.

by the other cantons as a 'tax haven'. That debate, however, hinges more often on the issues of equity and inadequate law enforcement than on tax competition.

The differentials in cantonal tax rates shown in Table 9B.3 depend much on the multiples applied in that particular year (1989) to its basic rate by each canton and its capital. The communal coefficients vary considerably within each canton. For instance, in the canton of Fribourg, where cantonal law sets an upper limit of 1.0 on the communal multiples, 66% of the communes applied a coefficient of 1.0 in 1988 while 14% applied a coefficient of 0.8 or less. The lowest coefficient was 0.3.¹ Obviously, those differences in communal statutory rates are of similar magnitudes as intercantonal differentials.

It is not clear that intercommunal differentials in tax rates reflect tax competition among the communes. Indeed, the multiples are often the instrument used to satisfy the legal constraint of a balanced budget. On the other hand, a small commune which manages to attract some major firms can reduce its coefficient. Still, corporate taxation remains a major source of revenue for central urban communes. Those communes suffer more from the competition of their neighbouring communes for higher-income households than from competition for business seats.²

(b) Tax holidays

Even if intercantonal and intercommunal competition for business settlement is not a dominant concern, some cantons still have the reputation of being tax havens. They manage to attract a disproportionate number of seats of national or international companies. Incentives take the form of material or administrative help with acquiring land, low-interest loans, tax exemptions, and accelerated depreciation.

In addition, some cantons are particularly attractive for holding and other companies which do not exercise any important productive activity. Table 9B.3 shows that in the canton with the highest tax on holding companies (Vaud), the statutory rate is almost three times higher than in the most favourable canton (Schaffhausen).

The practice of granting incentives to attract enterprises had reached such magnitude after the Second World War that several cantons signed an agreement limiting such concessions. They were allowed only to encourage industrial development, for a maximum of 10 years. Those measures became somewhat effective after being introduced into the federal constitution, in 1958. The national government was granted the power to issue regulations, but it never made much use of that power.³ However, the federal law on tax harmonization (see below) limits tax concessions to 10 years for newly established firms.

The legislation intended to limit tax holidays requires the local tax law to be enforced equally for all taxpayers. It does not prevent cantons from taxing certain items very lightly or not at all. Intracantonal discrimination is banned, intercantonal discrimination

¹ Dafflon (1991a).

² Still, the maximum spread in total statutory tax rates is not much greater than shown in Table 9B.3 because the capital with the highest tax rate happens to have close to the highest coefficient of its canton (Zurich) and the capital with the lowest tax rate imposes the lowest coefficient of its canton (Zug).

³ Buschor, König, Rey, and Rondi (1984), p. 63.

is not. The legislation does not coordinate regional development either: every canton may grant the tax concessions to new industries as it wishes.¹

In fact, 'there is growing evidence that the use of tax relief is not appropriate in the Swiss case. Two problems have emerged. Firstly, tax relief is obtainable by immigrant industries only and this has been denounced as inequitable to developing local industries. Secondly, the tax relief method relates the value of the incentive to high initial profitability, which may run counter to the need for longer and more stable types of investment. Many companies decentralize only the more footloose part of their business, with the decision centre remaining outside the region. These "subcompanies" are quickly removed or closed down when the tax relief provision ends, when the profitability diminishes or in the case of economic downswing'.²

(c) Tax harmonization

Some harmonization of the tax base has already taken place. Indeed, numerous cantons which altered their direct taxation since 1941 used the FDT as a model. They often did so under the pressure of their tax administrations, responsible for collecting both cantonal and federal taxes.³ Still, important differences remain, as we saw, not only as regards the tax rates and schedules but also as regards the definition and delimitation of taxable items.

More harmonization is to be enforced over the course of the next decade, based on two recent laws: the 'federal law on the harmonization of the direct taxes of the cantons and the communes' and the 'federal law on the federal direct tax', both dated of 14 December 1990. They will come into effect on 1 January 1993. The first law is a model tax law which designates the income and wealth taxes (both personal and corporate) the cantons and communes may raise, as well as the principal terms thereof. The cantons must adapt their laws to the federal law. That law does not rule over all the terms of direct taxation. Indeed, the national government had been given the mandate to work towards uniform definitions of tax objects, the circle of taxpayers, the bases of calculation, and rules over tax disputes (formal harmonization). The cantons did not give up their sovereignty over tax schedules, rates, deductions and allowances (no material harmonization). For the latter items, cantonal law continues to apply. The second federal law will adapt the terms of the FDT to match the clauses of the harmonization law.

The main items of corporate taxation to be harmonized are:

- (i) all income and equity taxes paid shall be deductible;
- (ii) corporate taxation shall be based on the 'postnumerando' system: the firms may choose their own 12-month period;
- (iii) losses may be reported over a maximum of seven years;

¹ The equalization law of 1959 (see Section IIIa) set further limits on tax holidays because the national government was not prepared to pay higher transfers to cantons that were granting tax rebates. In fact, those measures never applied (Dafflon (1977), p. 90).

² Dafflon (1977), pp. 89-91.

³ Dafflon (1977), pp. 218-219.

- (iv) taxes due shall be reduced by the ratio of dividends received from 'substantial interests' to net profit: 'substantial interests' are holdings of at least 20% or SFR 2 million;
- (v) the 'holding's privilege' shall apply in all the cantons but not for the FDT: firms shall be dispensed from cantonal and communal income taxation when their participation or returns from participation make at least $\frac{2}{3}$ of their total assets or revenues;¹
- (vi) equity shall be taxed on its value at the end of the tax period.

The history of those recent harmonization laws is very revealing about the process of tax reform in Switzerland.² The debate truly started in 1968, when the conference of directors of cantonal finance departments designated a commission to elaborate a complete model tax law to be used as a guide for future harmonization efforts. The project was terminated by the end of 1972. It made it already clear that harmonization would only apply to formal aspects of taxation and leave the right to set rates and schedules with the cantons. The experts first believed that harmonization could be obtained by intercantonal agreement. Soon it became clear that the cost of compliance with a unanimity rule would be too high. Indeed, the project would have to be accepted (without modifications) by each cantonal parliament and each cantonal electorate. A solution imposed at the national level was unavoidable.

By the end of 1973, a second commission had prepared a project law for the FDT parallel to the model law for cantonal and communal direct taxes. Between 1974 and 1977 a broad-based consultation gathered comments and suggestions on the two legal projects and on a new clause of Constitution. That clause would mandate the national government to work towards material harmonization of direct taxation. In 1974, two parliamentary initiatives and two popular initiatives (more than 50 000 signatures) launched by centre-left parties strived at pushing the harmonization efforts at the national level. They wanted to reserve more power to the national government than the two projects aforementioned. One of the popular initiatives asked for centralized direct taxation which would only allow the cantons to levy a multiple on the national taxes. The other one intended to reserve corporate taxation to the national government. Both were opposed by majorities in the Legislative Assembly. They were rejected in popular votes in 1976 and 1977 respectively.

In 1976, the national government was given, by popular vote, the mandate to work towards the material harmonization of direct taxation. That article specified explicitly that 'the cantons participate in the elaboration of the federal laws'. A new consultation was undertaken in 1978 among the cantons, the political parties and the other interested organizations. Their comments were integrated into a new project of federal law on tax harmonization in 1980. In 1983, the national government delivered a message to the Legislative Assembly advocating that law and the law on the FDT. Deliberations took place in the two councils of the Legislative Assembly and in their commissions. It was only by the end of 1990 that both councils agreed on the two laws which are dated 14 December 1990.

¹ Masshardt (1975).

² Maintaining the 'holding's privilege' was promoted to the rank of a *sine qua non* condition for the harmonization project by several cantons.

During the debate on tax harmonization, the following considerations were determinant for inducing the cantons to agree to give up some, but not much, of their tax sovereignty:¹

- (i) Taxpayers do not understand the geographical diversity of tax burdens. They feel it to be unjust.
- (ii) The diversity complicates the task of tax administrations (who raise local and national taxes) as well as that of taxpayers active in several cantons.
- (iii) Revenue equalization is problematic when not all cantons drain their tax base equally.

The cantons were not willing to give up their right to set tax rates and schedules for the following reasons:

- (i) Tax burden differentials are believed to be compatible with the efficient allocation of resources. However, the differentials should be congruous with coordinated regional development. That target can be reached through national grants that offset differences in cantonal revenue-raising capacity. Once they are relieved of the concern of covering their expenses, the cantons can adapt their tax rates to the objective of balanced growth.
- (ii) As long as no national consensus exists on the appropriate degree of redistribution, each canton should be allowed to implement its progressive tax tariff.
- (iii) Each canton should have the possibility to determine its own mix of taxes and public services.
- (iv) 'Equalization of the cantons' tax tariffs ... would modify so many vested interests that it would be politically unacceptable.'²

(d) Fiscal stabilization

The historical development of federal taxation, described in Section I, has led to the introduction into the Constitution of tight limits on the national government's fiscal flexibility. Thus, Article 41 defines the taxes it may levy and the tax bases. It sets very narrow limits on the statutory tax rates. Any meaningful change in federal taxes must be approved by the electorate. Many local governments face similar constitutional restrictions. Changes in taxation are very time-consuming and backdating is not an accepted practice.³

In fact, since 1978, the Constitution allows the national government to raise tax supplements or to grant rebates on a temporary basis, to stabilize the economy. That clause is of little practical application, in particular because such changes would affect the cantons through revenue-sharing.⁴

The lack of flexibility is not the only impediment to fiscal policy. When tax changes are finally implemented, they often develop their effects only after lags of several years. The FDT, for instance, taxes income according to the two-year 'praenumerando'

¹ Commission intercantonale d'information fiscale (1983).

² Dafflon (1977), pp. 102-113, Ritschard (1970), pp. 26-27, and Höhn (1970), pp. 48-49 predicted the gains from rationalization to be too weak to justify the administrative costs of the process.

³ Dafflon (1977), p. 110.

⁴ Dafflon (1977), p. 220.

system. As a consequence, tax changes implemented in year T affect the taxable incomes of the years T + 1 and T + 2, which serve as base for taxes paid in the years T + 3 and T + 4.

A further limit on fiscal stabilization resides in the required vertical coordination. Indeed, national tax revenues account for only 43.6% of total tax revenues (in 1989).¹ In terms of expenditures, the share of the national government is even lower at 35.2%. The ratio of expenditures by the national government to GNP is 9.0%, while total public expenditure amounts to 25.6% of GNP.

As a result, the responsibility for avoiding business cycles is left to the central bank.

V — Conclusion

The Swiss cantons managed lately to agree on some measures of formal harmonization. They should suppress, in due time, the most blatant administrative headaches. The cantons had to entrust the national government with elaborating a project and with pushing it through the Legislative Assembly. They participated in all the steps of drafting the law. They all recognized the importance of administrative simplicity and greater understandability for taxpayers. The law was forbidden to infringe on cantonal sovereignty over tax rates and schedules.² Still, the cantons opposed strong resistance to any fundamental change. At least, firms active in several cantons may soon be able to file a single tax form for all cantons and the national government. Cantonal auditors may also be happier with understanding a single tax code.

The debate around tax harmonization (and the duration of the process from the first cantonal initiatives at the end of the 1960s to the laws of 1990) showed that fundamental changes in the federal tax system of Switzerland are not to be expected. There have been many calls for uniform tax rates on corporate income or, at least, for tax differentials that result from a policy of coordinated regional development.³ There have also been calls for a single corporation tax at the national level, for the integration of corporate and personal taxes, etc. Right now, several political initiatives are under way that want to force the national government to give up direct taxation and to concentrate, instead, on consumption taxes. Table 9B.1 shows that income and wealth taxes contribute only 17% of total tax revenues of the national government, against more than 80% for the lower levels. Unfortunately for that approach, there have already been three attempts to replace the obsolete turnover tax by a more easily expandable VAT. All failed in popular vote.

All of those proposals of real fiscal reforms, which originated in political as well as academic circles, were rejected in the political arena. Some observers have come to favour Switzerland adhering to the EC to help push tax reforms.

¹ Nowotny (1983).

² This ratio is based on revenues inclusive of cantonal shares.

³ See Schwartz (1978), pp. 57-58 and the references therein.

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TABLE 9B.1
Public revenues in 1989

(million SFR)

	National government ¹	Cantons	Communes
Taxes on			
Income and wealth	8 838	18 824	13 930
Income of individuals	2 834	11 954	9 631
Wealth of individuals	0	1 151	918
Corporate profits	1 076	2 310	1 373
Corporate capital	151	700	394
Withholding tax	2 398	0	0
Stamp duties	2 379	0	0
Other	169	2 709	1 614
Consumption and expenditure taxes	15 111	1 179	67
Revenue-sharing	3	2 169	619
Federal direct tax	0	1 870	0
Withholding tax	0	269	0
Cantonal taxes	3	0	619
Other	0	30	0
Grants-in-aid and reimbursements	20	7 980	4 111
From the national government	0	5 186	60
From the cantons	20	0	4 051
From the communes	0	2 794	0
Other	2 024	7 284	8 888
Total	25 996	37 436	27 615

¹ Revenues net of actual cantonal shares.

Source: Administration fédérale des finances, 1991.

TABLE 9B.2

Cantonal disparities in 1989

		Population (1 000)	GNP per capita (SFR 1 000)	Index of fiscal capacity	Share of CIT in total tax revenue (C + C)(%)	Dependency ratio (%)
ZH	Zurich	1 153	48.7	151	15.1	12.4
BE	Berne	943	34.4	71	5.2	23.1
LU	Lucerne	613	31.6	67	7.1	24.6
UR	Uri	34	30.2	30	4.8	52.7
SZ	Schwyz	109	32.6	79	6.4	33.0
OW	Obwalden	29	29.0	49	8.3	41.8
NW	Nidwalden	32	37.7	90	12.8	30.7
GL	Glarus	38	43.0	90	6.6	22.9
ZG	Zug	85	65.0	202	19.1	23.1
FR	Fribourg	204	33.7	62	5.9	26.1
SO	Solothurn	223	34.5	84	8.0	18.3
BS	Basle-City	192	56.0	171	16.1	9.4
BL	Basle-Land	230	38.0	102	7.4	10.6
SH	Schaffhausen	71	34.1	100	10.0	20.7
AR	Appenzell A-Rh	51	31.9	69	8.7	27.8
AI	Appenzell I-Rh	14	28.7	51	9.3	34.9
SG	St Gallen	416	33.0	87	11.4	22.9
GR	Graubünden	177	34.3	67	11.6	40.9
AG	Aargau	490	36.1	96	12.4	17.7
TG	Thurgau	202	31.1	93	8.4	17.2
TI	Ticino	287	30.6	76	14.4	24.4
VD	Vaud	576	36.8	90	8.1	15.8
VS	Valais	249	29.0	44	8.1	37.9
NE	Neuchâtel	160	33.1	54	9.7	37.1
GE	Geneva	378	49.6	152	13.2	10.5
JU	Jura	65	29.6	37	6.0	42.8
	Total	6 723	38.3	100	10.8	19.6

NB: Population: OFS, Annuaire statistique de la Suisse, (1991).

GNP per capita: OFS, *Vie économique*, Vol. 9 (1991), Table B18.

Index of fiscal capacity: 1990-91, Dafflon (1991).

Share of corporate income tax (CIT) in total tax revenues of cantons and communes (C + C): Administration fédérale des finances (1991), Table 68.

Dependency ratio: share of total revenues granted by national government, Bangerter (1990).

TABLE 9B.3

Corporate tax rates in capital cities (1989)

		(%)					
		CIT rate (C+C)	CIT rate (N+C+C)	CIT and capital tax (N+C+C)	Effective marginal structures (N+C+C)	Tax rate equipment (N+C+C)	Total tax, holding company
ZH	Zurich	23.8	29.4	31.6	41.8	40.6	1.9
BE	Berne	13.9	20.5	23.8	45.5	42.1	1.7
LU	Lucerne	20.0	26.0	28.4	42.0	39.7	1.7
UR	Uri	16.4	22.6	26.5	42.1	41.3	1.5
SZ	Schwyz	15.1	21.6	24.2	39.2	38.2	1.8
OW	Obwalden	15.5	22.0	24.2	38.1	37.0	1.7
NW	Nidwalden	14.9	21.6	23.2	37.1	35.9	1.5
GL	Glarus	18.1	24.2	28.9	49.2	48.0	2.0
ZG	Zug	9.6	16.8	18.5	31.9	31.0	1.7
FR	Fribourg	18.0	24.2	27.0	42.5	41.5	2.5
SO	Solothurn	18.0	24.2	27.2	40.2	39.3	1.6
BS	Basle-City	17.1	23.2	26.6	43.3	42.3	2.0
BL	Basle-Land	14.9	21.2	25.9	47.4	46.5	2.0
SH	Schaffhausen	16.9	23.3	25.4	41.0	39.8	1.3
AR	Appenzell A-Rh	15.6	22.1	24.9	46.7	37.3	1.5
AI	Appenzell I-Rh	15.8	22.3	24.8	50.5	40.5	1.5
SG	St Gallen	15.1	21.5	24.7	53.1	41.6	2.2
GR	Graubünden	22.7	28.4	32.4	48.9	47.1	1.3
AG	Aargau	17.5	23.7	26.9	43.2	42.2	1.8
TG	Thurgau	15.7	22.1	24.8	46.9	43.6	1.6
TI	Ticino	22.2	27.9	31.1	51.0	44.4	1.7
VD	Vaud	18.6	24.7	27.4	50.2	45.0	3.6
VS	Valais	19.0	25.0	28.4	51.7	46.2	1.8
NE	Neuchâtel	23.3	28.8	32.4	53.5	46.6	1.9
GE	Geneva	18.5	24.7	27.3	48.1	42.5	1.9
JU	Jura	15.2	21.7	24.6	46.4	43.6	1.6

NB: Assumptions: Representative firm with equity capital of SFR 50 million and profits of SFR 10 million.

The statutory rates (basic rates times 1989 multiples) are calculated from Administration fédérale des contributions (1990).

CIT rate (C+C): Cantonal and communal statutory tax rates on corporate profits (before tax).

CIT rate (N+C+C): National, cantonal and communal statutory tax rates on corporate profits.

CIT and capital tax rate (N+C+C): National, cantonal and communal statutory taxes on corporate profits and equity, calculated as a proportion of net profit.

Effective marginal tax rate for corporations: King-Fullerton formula, Zarin-Nejadan (1991).

Total tax holding company: Statutory CIT and capital tax rate (N+C+C) for a company benefiting from the 'holding's privilege', with net profit of SFR 0.16 million.