FISCAL FEDERALISM IN SWITZERLAND:  
a survey of constitutional issues, 
budget responsibility and equalisation

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CONTENTS

1. Introduction

2. Fiscal democracy
   2.1. Vertical division of power
   2.2. Direct democracy -
   2.3. Initiative and referendum
   2.4. Co-operative federalism

3. The public sector: facts and figures
   3.1. General indicators
   3.2. Size and growth of the public sector
   3.3. Public expenditures
       3.3.1. Exclusive functions and shared responsibilities
       3.3.2. Subsidiarity
       3.3.3. Centralisation
   3.4. Public revenues
       3.4.1. General characteristics
       3.4.2. Tax sovereignty
       3.4.3. Direct access to many revenue sources
       3.4.4. Tax administration

4. Budget responsibility
   4.1. Budget orthodoxy
   4.2. Macroeconomic policy

5. Tax co-ordination and harmonisation
   5.1. Tax co-ordination
       5.1.1. Vertical co-ordination
       5.1.2. Horizontal co-ordination
   5.2. Tax harmonisation
   5.3. Tax competition
       5.3.1. Some stylised facts
       5.3.2. A prisoner's dilemma framework
       5.3.3. Out of the dilemma
   5.4. Fiscal burden in the Cantons

6. Equalisation
   6.1. Financial capacity of the Cantons
   6.2. Federal equalisation programmes
       6.2.1. Conditional federal grants-in-aid
       6.2.2. Revenue sharing
       6.2.3. Cantonal contributions to social security
   6.3. Importance of the transfer payments

7. Conclusion

References
Tables
1 INTRODUCTION

This paper deals with the institutions and actual problems of fiscal federalism in the case of Switzerland. It is divided in five sections. Starting in section 2 with a short summary of some issues in fiscal democracy, which have relevance to Swiss decentralised public finance, the paper describes in section 3 the main components of the fiscal structure and the assignment of functions and revenue sources at decentralised levels. Then it develops in three directions: budget policy (section 4), taxation (section 5) and fiscal equalisation (section 6).

Switzerland is a small country located in the heart of Europe, without being a member of the European Union. Its population of 7.2 millions (see Table 1 for some general indicators about the Swiss Cantons - column 4 for population) is composed of Swiss-German speaking people (64 %), French speaking (20 %), Italian speaking (10 %) and Rätoromanche speaking (0.5 %). All four language are national official languages entrenched in the Swiss Constitution (art. 4 Constitution of April 18, 1999 - thereafter N.Cst.). Forty-seven percent of the population is Roman-Catholic, 41 % is Protestant. Fourteen cantons have a catholic majority, 11 of them with more than 70 % of Catholics; 6 cantons have a Protestant majority, but only one (Berne) with more than 70 % of Protestants. Yet languages and religions are crosscutting over the cantons' territories.

Since the Constitution of 12th September 1848, Switzerland has been, in institutional terms, a relatively complex system of three layers of government: (1) the communes, at the local level, (2) the Cantons, at the intermediate level and the Confederation, at the national level - which are interconnected by many vertical and horizontal relationships. At the end of 2000, there were 26 Cantons and 2880 communes (Table 1, column 2).

Fiscal federalism in Switzerland can be characterised in terms of overall fiscal restraint and minimising the centralisation of fiscal power. Formally, it is a “bottom-up” federalism. Constitutional arrangements, both at the federal and the cantonal levels, certainly explain this performance.

- A first reason is that the federal executive government is not as strong a government as it appears in other European countries. The Swiss political system is based on consensus. The federal executive is a cabinet of seven ministers chosen and elected by Parliament (the National Council and the Council of States together - see section 2.1) according to a ritualised but unwritten composition that ensures the major political forces as well as the main regions and languages to be represented. Since 1959, the so-called “magic formula” applies: each federal executive government is composed of two members of each the radical free democratic party, the christian-democratic people's party and the social democratic party + one representative of the federal democratic union (Klöti, 1999: 165-166). The collegial principle serves the function today of enabling compromise solutions. As a general rule, the Federal Council avoids taking votes as such; a majority position often already emerges from the opinions expressed during the discussions. There are many other smaller political parties, who are in cantonal governments, but not included in the federal government (Ladner, 1999).

- The subsidiarity principle, which recommends that competencies in the provision of public services should be vested to the lowest possible level in the fiscal hierarchy, is a second reason. It has been probably more scrupulously respected in this country than in many other federations because of both constitutional guarantees and a traditional mistrust of global nation-wide policies. In addition, the Cantons and the communes are seen as laboratories of innovation in public policies and management, without widespread risks of failure. As a consequence, the power to decide and finance the provision of public services has remained largely in decentralised hands, in the Cantons or in the communes. Many forms of co-operative federalism have flourished in the last decades, whether in formal institutions like the inter-cantonal treaties (“concordats intercantonaux”) or informal, like the inter-cantonal conferences of Ministers or of high civil servants for various
functions. At the local level, various forms of inter-communal cooperation have flourished, with the aim of gaining economies of scale in the provision of public services without undue centralisation.

However, the fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. Competition between jurisdictions is a first limit. Second, many cantons have introduced their own constitutional rules with regard to (balanced) budget and debt limitation (section 4). Fiscal competition is partly softened by rules of tax co-ordination and harmonisation (section 5). However, autonomy in public expenditures, direct access to many revenue sources and, above all, differences in the Cantons’ economic potential (see Table 1, columns 6 to 8) have led to relatively important regional disparities, expressed in the fiscal burden of the Cantons (Table 9 thereafter) and in their financial capacity (Table 10). These disparities are at the core of the Swiss equalisation policy, although there is no claim for perfect equality between the Cantons or the communes (section 6).
2 FISCAL DEMOCRACY

In fiscal federalism, institutions play an important role in shaping the relations between the layers of government. It is therefore of interest to shed some light on the working of the institutions in Switzerland, particularly on the rules and principles, which govern the assignment of functions and revenue sources to decentralised jurisdictions. Four institutional characteristics are essential in the working of Swiss federalism: (1) the vertical division of power in the Constitutions, (2) direct democracy, (3) initiatives and referenda and (4) horizontal co-operation between governments at the cantonal and communal levels.

2.1 The vertical division of power

The Swiss federal system emphasises the sovereignty of subcentral jurisdictions, i.e. the Cantons, at the intermediate level, and the communes, at the local and lower level. This sovereignty is derived from the federal and cantonal constitutions, which lists not only the tasks of each government level, but also fix their right to levy some sorts of taxes. Thus, the assignment of competencies and revenue sources is guaranteed at each level of government. The vertical division of power, intended to prevent stable majorities from being able to exploit minorities, is strongly safeguarded in the Constitution (Knapp, 1986; Zimmerman, 1987).

Article 3 N.Cst. guarantees the Cantons' sovereignty in all the spheres in which the Constitution does not explicitly provide for the federal government's competence. Article 42 N.Cst. defines in a restrictive manner the assignment of functions to the Confederation: "it shall accomplish the tasks which are attributed to it by the Constitution." Therefore each new competence of the centre requires a constitutional amendment, which necessitates the consent of both a majority of the voters and a majority of the Cantons. In contrast, article 43 N.Cst. stipulates that "the Cantons shall define the tasks which they shall accomplish within the framework of their powers". At cantonal level, there is no need for a constitutional explicit clarification.

The autonomy of the Cantons is also guaranteed by the legislative power with two Chambers, which have equal power (art. 148 N.Cst.). The National Council (House of Representatives) is elected on the basis of population in the Cantons according to the system of proportional representation. The Council of States (the Senate) consists of 46 delegates of the Cantons, two for each canton and one for each half-canton (Appenzel Rh. Int. and Appenzel Rh. Ext., Basel-City and Basel-Land, Nidwald and Obwald) whatever its population, size or economic and financial power. The Cantons regulate themselves the election of their Senators.

Before the New 1999 Constitution, fiscal/financial arrangements were discussed either at the federal-cantonal levels or at the cantonal-local levels. The federal government addressed itself always and exclusively to the Cantons. It could not by-pass cantonal governments to address local governments either to impose or to negotiate fiscal or financial matters or the provision of public services. The inverse was also true: local governments could not by-pass cantonal authorities; they had no direct access to federal bureaux or institutions. In this way, federal decisions concerned the Cantons only; and each canton organised - and still organises - communal competencies on its own. This vertical division of power left a high degree of autonomy to the Cantons but also has created problems for the larger municipalities. On one side, the Cantons have their own fiscal systems, which are independent of the federal system. The Cantons are therefore able to set their own tax rates, and they decide on the provision of public goods and services on their own. Although the modification procedures are long and complex, each voter/taxpayer in a canton or in a commune is able in the end to compare the costs and benefits of the public activity under

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1 Title 3, chapter 2 N.Cst. provides the enumeration of federal competencies. The constitutional articles also fix the role of the Cantons for those functions. It follows that for a large number of public expenditures, the Cantons have only residual autonomy and act rather as "agencies" for the centre.
consideration and to decide on the amount of public expenditure in a vote or in a referendum. On the other side, large municipalities or agglomerations (like that of Zürich, which alone has more residents than the five neighbouring Cantons) create spillovers over cantonal boundaries, but have not the ability to negotiate directly over those limits. Although agglomerations have a statistical definition and have been an expanding economic reality for the last three decades (with now over 75 per cent of the population living in those urban areas), only the new 1999 Federal Constitution gives them an institutional recognition. What will be the effective consequences of this article is not yet clear. But, as a first step, in matters concerning large urban areas, a Tripartite Conference on Agglomerations has been institutionalised as the privileged forum for discussing policy issues.

2.2 Direct democracy, initiative and referendum

Direct democracy participation is provided in most cantonal constitutions for the communes so that citizens themselves may take part in the decision-making process on all important political and economic issues. In local public finance, this competence concerns: current budget, individual investment items of the capital budget, annual tax coefficients, user charge regulations (taxation according to the benefit-principle in general), local public property sale or purchase, horizontal co-operation in the form of inter-communal association or special purpose district for the joint production of public facilities, and the amalgamation of communes.

In addition to participation, control and audit competencies of some sort exist in all direct democracy. The communal assembly of citizens, or the communal "parliament" where it exists, elects a finance committee for the length of the political term of office. This committee has not only traditional audit competencies, but also the duty to report to the assembly about the financial aspects of capital expenditures, changes in taxation. In addition, it has the powers to investigate financial matters without warning, if necessary. In some cantons, it may lodge a complaint against individual members of the local authorities for misuse of public funds.

When democracy is representative, which is the case in a large majority of the Cantons and in large cities, voters express their preference about political and economic issues not only through ordinary votes, but also via referenda, which may be brought up for vote several times during a year.

- At the local level, the most common items which might be included in the initiative or the referendum procedure are: individual investment items of the capital budget, taxation, user charge regulations, property sales, co-operation in inter-communal associations or special purpose districts and the merging of communes.

- In most Cantons, constitutional or legislative initiatives are possible on taxation, current or capital expenditures, which require a minimum number of citizens' signatures. Referenda against capital, unique or recurrent expenditures are also possible. The institutional and legal conditions about the distinctions between compulsory or facultative referendum, unique and recurrent expenditure, capital or current expenditure, the number of signatures required, the time allowed for collecting the signatures, differ widely from one canton to another (Novaresi, 2001). While the influence of referenda in general on the outcome of

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2 The Federal Constitution of 1999 contains for the first time an explicit reference to the communes and municipalities. Art. 50 says: "(1) The autonomy of the communes is guaranteed within the limits fixed by cantonal law. (2) In its activity, the Confederation shall take into account the possible consequences for the communes. (3) In particular, it shall take into account the special situation of cities, agglomerations, and mountainous regions."

3 The three parties in the Conference are: the Confederation, the Conference of the Cantons and the three associations representing the communes: the Association of Swiss Communes, the Union of Swiss Towns and the Swiss Grouping for Mountainous Regions. See “Mise en ouvre de l'article 50, alinéas 2 et 3, de la Constitution fédérale. Lignes directrices du Conseil fédéral à l’attention de l’administration fédérale concernant la collaboration entre la Confédération, les cantons et les communes du 16 octobre 2002”, Département fédéral de justice et police, Berne.
the public budget are known, the influence of the detailed cantonal referendum conditions, as a measure of budget orthodoxy, on public deficit and the indebtedness of the Cantons have been studies by Kirchgässner, Feld ans Savioz (1999), Pujo (2000) and Novaresi (2001). Together with popular initiatives, these institutions play a role of moderator for cantonal and local governments, as usually all important public decisions are subject to the voters' approval.

At the federal level, each and every federal bill can be submitted to a referendum if 50'000 citizens or 8 cantons request it (optional referendum, art. 111 N.Cst.). Any constitutional change and participation to an international treaty are automatically submitted to a compulsory referendum. Compulsory referendum necessitates the double majority of voters and cantons. Citizens can also propose a constitutional changes by submitting an initiative if supported by at least 100'000 valid voters' signatures (art. 139 N.Cst.).

Obviously these institutions of the federal system do not have a unique purpose of (economic) efficiency in the performance of expenditures and taxation. The more direct and democratic the institutions are, the better is their general capacity to strengthen the system of checks and balances, by both dividing and sharing political decision-making power. They give citizens/voters/taxpayers multiple access to government, increase their capacity to control the budgets and reduce political and bureaucratic leeway in rent-seeking behaviour. In Hirschman's terminology, they not only have the "exit" (Tiebout-style mobility), but also the "voice" solution. The outcomes are that the growth of government activity has been significantly lower than in representative democracy (Pommerehne and Schneider, 1978), the size of government is limited (Pommerehne, 1978) and public expenditures are driven by the demand side (Kirchgässner and Pommerehne, 1990).

2.4Co-operative federalism versus executive federalism

The federal and cantonal Constitutions permit intensive horizontal co-operation at the cantonal and communal levels of government. This horizontal co-operation is important for the principle of fiscal equivalence so that the circles of deciders, beneficiaries and payers coincide (Olson, 1969). The Cantons and communes are free to conclude with one another agreements for co-operation in the most varied responsibilities and so establish for themselves the optimum area and/or population size necessary for the efficient provision of public goods and services, from University funding (inter-cantonal co-operation) to school districts and water provision (inter-communal co-operation). Yet it must be said that whereas inter-cantonal "concordats" are quite a success for many cantonal public policies and functions (financing the Universities is a good example), they have failed with regard to taxation, left widely unrespected or without real content as for the law on (formal) tax harmonisation (see section 5), under the motive of tax competition or the arguments of regional growth policies.

Horizontal "face-to-face" co-operation between the Cantons has taken another form which was not foreseen in the Constitution. When the need for a nation-wide steering policy arises, fiscal federalism in theory suggests that this should be realised at the centre, by the federal government. This is not always the case in Switzerland where the Cantons have organised themselves horizontally in a set of powerful Committees, the so-called Conferences of Cantonal Ministers, one for each department in the administrative division of government executives, of which the Conference of the Cantonal Ministers of Finance (CCMF) is the most influential. From a constitutional point of view, fiscal/financial relations between the federal government and the Cantons cannot be tailored according to individual cantonal particularities or wishes. Equality of treatment applies, except within the equalisation law. Although each canton could challenge or negotiate individually

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4 Beside traditional intercantonal agreements and intercommunal associations or special districts, new forms of co-operation between jurisdictions at the local / cantonal levels, called FOCJ for "Functional, Overlapping and Competing Jurisdictions", are developed in Frey and Eichenberger, 1999.
fiscal/financial arrangements with the federal government, no single canton would have much chance in succeeding in modifying fiscal/financial arrangements for its own objectives, since any change applies (and indeed should be acceptable) to the other cantons. Within the Conferences, the Cantons negotiate common policies without interference from the centre, then present a common package to the federal government. The objective of the CCMF is to discuss fiscal/financial matters which are of common interest to all or a large number of the Cantons. It has been organised not so much to coordinate and harmonise fiscal and financial affairs of the Cantons (horizontal relations), as to intervene more persuasively in federal-cantonal relations and to interfere in federal-only fiscal and financial matters. The Conference is not a constitutional institution. Yet, fiscal matter cannot be decided at the federal level without previous consultation of the CCMF. It is a powerful pressure group, regularly consulted by the federal Finance Administration. It has been successful in negotiating global financial packages in which the point of view of the Cantons differs from that of the federal government. It has played an important role in shaping federal finance, the federal tax system and tax harmonisation, which was to remain "formal", and has a dominant position in federal equalisation policies (DAFFLON, 1995).

- The Conference of the Canton (CdC) also exerts a powerful balance against federal policy proposal. The whole process of a New Fiscal Equalisation package, which is presently under discussion, is a joint venture of the Federal Ministry of Finance and the CdC. Cantonal tasks which have spillover effects (such as professional schools, universities, hospitals, specific medicare, public transportation in transcantonal agglomerations, sport and recreational facilities, cultural institutions, waste disposal plants, sewage purification plants, penitentiaries) must be performed in contractual co-operation (CF, 2001: 48). Free rider behaviour will be banned: a Canton which benefit from services provided by another will have to pay compensation to the providing unit. According to the new equalisation law project, the Confederation could oblige a reluctant Canton to participate to a co-operation if at least half of the co-operating Cantons ask for such an intervention. The attribution of a coercive power to the Confederation in the matter has already generated vigorous reactions. It is quite problematic in a country where the cantons are used to a large autonomy in decision-making and want to maintain their particularities. Intercantonal co-operation, that already exist in several areas (although the Cantons have not proved to be very interested in co-operating yet), raise furthermore the issues of visibility and transparency of the decisions and of democratic control over the provision of public services (Bullinger, 2001: 22).

- At the local level, the main incentives for inter-communal co-operation are, traditionally, economies of scale and regional spillovers and, more recently, limited managerial skills in many small municipalities, especially when local governments function as production agencies for the centre (Cantons or Confederation), as for example in the field of national environmental policies. There is no doubt that the opportunity to create inter-communal institutions has been largely used by the communes and has improved efficiency in producing and delivering local public services. But the multiplicity of inter-communal special purpose districts has also created many institutional problems: a democratic deficit in the regime of communal assembly, higher information and participation costs for individual citizens who henceforward belong not only to one commune but to several other "clubs", strategic blockages of votes by negotiating communes when a qualified majority is required, and the like (Della Santa, 1996). Despite these inconveniences, it may be precisely this executive flexibility of federalism which has long made it resistant to attempts of centralisation on the part of the federal government vis-à-vis the Cantons, or on the part of the Cantons vis-à-vis the communes. It also explains why so many small communes can survive without merging and why the compulsory merging of too small communes is not easily accepted by the citizenry (Dafflon, 1996a).

- Cooperative federalism should not be idealised too much because the pressure for centralisation are also and simultaneously very high (see section 3.3.3 on centralisation). At the local level, the room of manoeuvre in general has been considerably reducing for
the last three decades. The same can be said for the cantons, true however only in very specific fields of public policies. Yet, contrary to other federal countries, there are no de-concentrated "federal agencies" which act as regional producers of services for the provision of public services that have to respect minimum standards set by the central government, as “principal”. The Cantons are the federal agencies and as "agents" decide the form and how they intend to implement those services. Usually, these are in turn assigned to the local tier in several matters. There is no duplication of similar producing organisations at the decentralised levels.5

5 For example, the federal government has no tax administration for collecting direct taxes on personal income and on corporate profit. This is in the hands of the Cantons. And the cantons pay the due amounts every month to the federal treasury without delay. There has never been any problem; and the law does not even foresee any sanction.
3 THE PUBLIC SECTOR: FACTS AND FIGURES

This section summarises the overall present situation of the public sector in Switzerland at the three tiers of government. All figures are based on 2000. Tables 1 to 11 also exist for the period 1990 to 1999, but there have been no significant changes over this last decade. Section 3 is divided into four sub-sections: a) general indicators concerning the Cantons, b) the size and growth of the public sector, c) public expenditures and d) public revenues. Whenever possible, the current state of research on fiscal federalism in Switzerland is mentioned.

3.1 General indicators

The institutional issues presented in section 2 have of course a price to be paid in terms of economic efficiency and equity. The solutions and practical arrangements do not exactly correspond to the canon of fiscal federalism in the textbook. And they do not permit to level out all differences in the economy and the public sector. A few statistical data will illustrate this argument. Table 1 gives five general indicators about the organisation and the economy of each Canton: the number of communes, the surface in km², population, national income in the Cantons (NIC) total and per capita, public expenditures and revenues.

Marked differences exist in the organisation of local government, the number of communes, in size, population and national income, that one probably does not find in another federation (Frenkel, 1986).

- The area of the smallest Canton (Basel-Town, 37 km²) is 0.5 per cent of the area of the largest (Grisons, 7 105 km²).
- The population in the least populous Canton (Appenzell Rh. Int., 15 021 residents) is 1.13 per cent of that in the most populous (Zurich, 1 211 647 residents).
- In 2000, the Canton with the highest NIC was Zurich, with a total 17 millions SFr., that is 21 per cent of the national NIC for 17 per cent of the population. The variation in per capita NIC is rather large: from 68 320 SFr. in Zoug to 31 012 SFr. in Jura, that is a ratio of 2.2 between the two Cantons with the highest and the lowest per capita NIC (or a range from 154 points to 70 points, for an average 100 points = 44 500 SFr. per capita).

There are also:

- Marked differences in the growth of per capita NIC between 1980 and 2000 (in real values): in 13 of the 26 Cantons, the rate of growth has been higher than the average 15 per cent (an average 0.9 per cent annual for the 17-years period), with a maximum at 36 per cent and a minimum at 1 per cent (Table 1, column 8).
- Graph 1 also presents the comparative position of the Cantons in comparing their NIC per capita for 2000 in nominal values (national average: 44'500 SFr.) and the growth of per capita NIC between 1980 and 1997 in real value (Table 1, columns 7 and 8). The graph shows that, despite some thirty years of national fiscal equalisation policy and as many years of regional development policies, the eight richest Cantons (top right hand box) are also ahead in term of growth. The canton of Geneva is the only exception, being a canton with higher-than-average NIC per capita, but a lower-than-average rate of growth (down right hand box).
- On the opposite side, eleven Cantons have remained in a bad position (down left hand box) with at the same time a NIC per capita and a rate of growth below national average.

6 Available by the author.
7 Tables are given at the end of the text.
Only five Cantons (Appenzell Rh. Int., Uri, Lucerne, Fribourg, Tessin and Vaud) registered a slight improvement, with still lower-than-average NIC per capita but higher-than-average rates of growth.

From this performance, one cannot say that both equalisation and regional development policies have been very successful. Though it must also be remembered that the federal equalisation policy has not a total "gap-filling" objective in setting revenue sharing formulas or equalising grants (see section 6 below).

- The indices of fiscal burden in the cantons and communes (Table 9) extend:
  - for the income tax: from 54.6 points in Zoug to 128.5 in Jura, for an average 100 points, that is 2.35 time more in the latter.
  - for the wealth tax: from 39,5 points in Nidwald to 232.4 in Valais, that is 5.90 fold;
  - for the global indices, from 58.2 points in Zoug to 126.3 in Jura, a 2.18 fold.

- The financial capacities of the Cantons, represented in the official indicators (Table 10) vary from 30 point in Jura to 218 point in Zoug, for an average of 100.

### 3.2 Size and growth of the public sector

Differences in the public expenditures of the Cantons and the size of the cantonal public sector expressed in proportion of NIC are important: it runs from 11 per cent in Schwyz and Zoug to 28 per cent in Bâle-Ville and 29 in Geneva and to a record 35 per cent in the canton of Jura (Table 1 column 12). Yet, this comparison must be interpreted with caution.

But with the same size of the cantonal public sector, as expressed in proportion to NIC, different interpretations are given if one considers per capita public expenditures (Table 1 column 13). For example, in Bâle-Town, a "town-Canton" with only 3 communes in the same urban area, the cantonal layer plays a central role: per capita public expenditures are much higher (2.30 ×) than the national average; this is also the case with Geneva, another "town-Canton". A more centralised delivery of public services internalises urban benefit spillovers and reduces co-ordination and information costs. On the other hand, the Canton of Valais, with 160 small communes, has a low financial capacity. Yet despite the fact that its public sector size compared to NIC is also 24 per cent, the per capita cantonal public expenditures only amount to 8'081 Sfr., that is much less than that of Basle-Town (Table 1, column 12 compared to column 13).

Table 2 shows the size and growth of the public sector over the period 1970 to 1998. In 1998, total public expenditures amounted to 143 459 millions SFr. or 32 per cent of Gross National Product (GNP) (without social security; 39 per cent with social security insurances). In proportion to GNP, the size of the public sector is still quite low compared to other countries in Europe. The growth of public expenditures has been relatively important between 1970 and 1980 both in relative and absolute values. It has continued to grow over the past decade (1980-1990) in absolute amounts, but the relative share of the total public sector in GNP has remained stable around 26-27 per cent. It has regained in proportion since the beginning of the nineties, partly because the economic situation has deteriorated and partly because social aid expenditures and unemployment benefits have increased above average.

- The rates of growth of public expenditures for each layer of government followed a different trend over the period. One can read it in diagonal from column 6 line "Communes" to column 9 line "Cantons" and column 12 line "Confederation". Between 1970 and 1980, only the average rate of growth for the Communes, at 141 %, was higher than the total average; between 1980 and 1990, this was the case only for the Cantons; and between 1990 and 1998, for the Confederation. For the total period, the figures give a creeping centralisation towards both the Cantons and the Confederation (both around 500 per cent, column 13) to the detriment of the Communes, with a total rate of growth of 475 % below average.
The actual shares of the Confederation, the Cantons and the communes in total public expenditures correspond in aggregate values to 33, 40 and 27 per cent. The repartition has remained stable for the centre, for almost thirty years around 31 per cent; yet, increasing to a 33 % in the last 8 years. At the cantonal level, the share of total expenditures has remained around 40 per cent for the last two decades. At the local level, it decreased from 29 to 27 per cent. In difficult time (1990-1998) a soft trend towards centralisation at the federal level with the Communes loosing weight is perceptible.

3.3. Public expenditures

The assignment of functions between the three tiers of government has continually changed over the 150 years of the Confederation's existence. The "optimum" division of competencies is of course never definitive and the question of which tasks should be assigned to which level of government has never been finally answered (DAFFLON, 1992). The division of public expenditures may be explained in terms of subsidiarity and centralisation. However, it must be said that the whole process has been laborious and rather conservative, political strategies and bureaucratic locking often jeopardising the results.

Articles 54 to 125 of the 1999 federal Constitution contain an exhaustive and detailed enumeration of the federal competencies. The Constitution always states whether a function is an exclusive federal or cantonal matter and, with shared responsibilities, the limits of central interference in the cantonal functions.

3.3.1. Exclusive functions and shared responsibilities

Total expenditures for each function performed by the three levels of government are summarised in table 3. Responsibility is shared, to some degree, by the three layers of government in almost all fields of public intervention. Obviously, the Confederation is solely responsible for foreign affairs and to a less-than-full extent for national defence (90 %). But other items, like education, culture, sports and recreation, health, environment, roads, generally remain the main responsibility of the Cantons and the communes.

Table 4 indicates the respective shares of public expenditures in proportion of the total budget of each of the three layers (column “within” – vertical) and the proportion between the three tiers (column “between” – horizontal). If we look at which governmental tier is the biggest spender in single items:

- the communes have the highest share in the budget items: environment (63 %), culture, sports and recreation (56 %), administration (44 %);
- the Cantons in: public order (67 %), health (56 %) and education (53 %);
- the Confederation has an exclusive position in foreign affairs (100 %), a dominant position in defence (90 %) and assumes more than half the public expenditure in economy (52 %), transportation and finance (both at 51 %).
- Although the Cantons and the communes together spend more, the centre has the largest single share in social affairs (44 %).

The exclusive competence of one layer of government in a function (as indicated a contrario by a value 0 in the table 3) occurs only in a few cases. Otherwise, the division of powers and the principle of subsidiarity apply. Thus, general functions must be subdivided. For example, under the heading of “Social Affairs” in general (see table 3), the federal government plays an importantrole (44 % of total social expenditures), though not dominant. The division of functions shows that it has the first role in social security only (old-age pensions: 82 %, and invalidity: 71 %). Illness insurance and individual social aid are both more important in the Cantons and the communes (with total of 64 % and 82 % respectively). The item “other social insurance” (mainly family allowances) is cantonal (51 %). This type of vertical assignment...
exists for almost all sub-functions, but it differs within each individual Cantons between the cantonal and the local layers.

The general trend in the division of responsibilities between the three layers of government has almost not changed for the last thirty years. When one particular function require more resources relative to others, the growth of expenditures for that function runs almost parallel in the three levels. This is a very conservative situation. The various attempts to modify the existing constitutional division of tasks between the federal government and the Cantons have either invariably and lamentably failed or produced insignificant results. Changes in the relative position of the three tiers may however happen, due essentially to external circumstances. For example, with the economic crisis of the nineties, the federal government was first faced with higher unemployment. Thereafter, the Cantons were concerned with individual social aid because individual unemployment often persisted longer than the period of unemployment benefits. Whereas the individual social assistance of the Cantons represented only 66 % of the communal expenditures for this function in 1988, it has doubled in ten years and raised to almost the same amount (97 %) in 1998. In fact, in this period the burden of the financial solution has shifted from the local to the cantonal level. This experience will certainly shape the future of this particular task and its assignment at the federal (unemployment insurance) and the cantonal levels (individual social allowances), with the main responsibility being taken away from the communes.

3.3.2. Subsidiarity

The fundamental principle in the distribution of tasks between the various levels of government is subsidiarity. Competencies are vested at the local level and can be transferred to the cantonal level only insofar that the lower level is no longer in a position to provide a service "efficiently". In most cantons, a constitutional amendment decided by popular vote or, at least, a law decided by the cantonal parliament, sometimes subject to referendum, is necessary. The same principle is valid between the cantonal and federal levels. A transfer of competence from the Cantons to the federal government must be passed by constitutional law, with a double majority vote of the people and the Cantons.

Sure, it has not been too difficult to reach agreement on the concept of "subsidiarity". The key questions are not semantic, but start with (a) the definition and measurement of "efficiency", (b) who decides when the provision of a local (decentralised) public service is no longer "efficient" and (c) at which level the responsibility should be “centralised”?

Opinions also diverge about which "efficiency" criteria are appropriate for the organisation (and the reorganisation) of functions within the three layers of government. Economies of scale, homogeneity of preferences, spillovers and congestion costs, are generally accepted as efficiency criteria (DAFFLON, 1992). Poorer governments which argue that they ought to receive more equalisation payments dispute the criteria of financial capacity and budgetary resources. WISEMAN (1989) argued that efficiency criteria must be related to the capability of strengthening political checks and balance through appropriate procedures and not to the tax-and-expenditures outcomes as such. This is probably the closest theoretical argument for Switzerland. The resulting allocation of expenditure functions and of policy-making within the communes, the Cantons and the Confederation does not obey simple rules that ensure neatness, tidiness and smoothness. Instead, an elaborate system of compromises (call it...
"checks and balance") limits horizontal and vertical coercion, which has led to the budgets of the different levels of government becoming increasingly entangled.

Education (table 5) is a good example of the subsidiarity principle. Total expenditures in table 4 show that the main responsibility lays at the cantonal level, with around 53 per cent of total public outlays, followed by the local level (35 %) and the Confederation (12 %). However, when various functions are distinguished “bottom-up” within education, the image stands out in contrast. Kindergartens and public schools are principally in local hands (with respectively 63 % and 56 %). For the public (primary and secondary) public schools, however, the communes have command mainly of the school buildings and the equipment. The teachers’ salaries are predominantly paid at the local level, but according to cantonal standards. The Cantons also decide almost exclusively the teachers’ qualification, and the schools’ programmes (for the latter, sometimes in co-ordination with other cantons within the Conference of the Cantonal Ministers of Education – see section 2.4 on co-operative federalism). Special schools are in some cantons local, cantonal in other. Professional, teachers’ school, colleges and technical schools are predominantly if not exclusively placed at the cantonal level. The federal government does not intervene very much. Except for the Federal Polytechnics, the Universities are cantonal, but they are partly financed by all the cantons through horizontal transfers per student, according to their residence, and through federal grants-in-aids.

The subsidiarity principle implicitly carries with it the acceptance of asymmetry in the provision of public services. But it is difficult to assert whether this couple “subsidiarity - asymmetry” is a formidable tool to recognise diversity, whether differentiation is needed to attain a somewhat uniform service delivery or will foster national integration or disintegration at the same time. Again, education and primary schools can serve as an illustration. Subsidiarity and asymmetry are certainly needed and useful if the objective is to preserve or promote cantonal historical and cultural diversity: Geneva and Zürich have neither the same approach nor the same tradition in teaching History, which in turn differs in a bilingual Canton like Valais or Fribourg. There is no objective necessity for uniformity. But the Cantons have to harmonise and partly succeeded in harmonising their public school programs because of the increasing mobility (private and professional) of parents between the Cantons. This has been achieved and is operative through intercantonal agreement (“concordat intercantonal”). Yet, for example, the Cantons were unable to agree on the beginning of the school year (Spring or Autumn) to the point that it had to be fixed in the federal Constitution (article 62 in the 1999 Constitution) after a popular vote in September 22 1985 with the double majority of the voters and the Cantons. Nowadays, teaching a second national language is at the crux of a difficult dispute. While a majority of the Cantons (and all the French speaking Cantons or with a French speaking majority) advocates learning in first priority the second national language (German for the French speaking, and inversely) for reason of national cohesion, the Canton of Zürich decided in 2000 that, in public schools, the place of English will be as important as French as a second language for reason of economic realism and globalisation. This has been criticised by many Cantons, included German-speaking ones, qualifying the decision an arrogant, disruptive and anti-confederal move. A federal parliamentary proposal is now in the way to oblige all the Cantons to consider the other national language as the first priority. If it succeeds, this will be another step towards creeping legal centralisation.

3.3.3. Centralisation

Table 2 gives the relative shares of each level of government in total public expenditures for the period 1970 to 1998. These figures give over the first period almost stable proportions of the division of the public sector between the three layers. In the 1970-80, the proportions

10 The largest part of 1 803 millions SFr. (1 138 millions = 63 %) goes to the two Federal Polytechnics in Zurich and Lausanne and research Institutes. 500 millions SFr (27 %) served for granting the Universities; and 323 millions SFr (18 %) for the Swiss National Fund of Research.
were 32 per cent for federal expenditures, 39 per cent for the Cantons and 29 per cent for the communes. In 1998, these percentages were respectively 33, 40 and 27, which represents a slight increase of the federal and cantonal shares to the detriment of the communes.

Although statistical data show that the relative shares of each tiers have not much changed over the past 30 years, centralisation creeps in the ways in which cantonal and communal governments perform. A distinction, described in the literature of fiscal federalism as "agency" or "choice" models, may be useful for understanding the issue. In the last three decades, the federal government has increasingly confined itself to the issuing of framework laws and has delegated the implementation of nation-wide functions to the Cantons (which in turn often have transferred the tasks on to their communes) - the "agency" model.

- One of the most impressive example of this is the implementation of the federal environmental legislation. The federal government systematically issues normative legal rules (on the basis of art. 74 Cst.). The Cantons have to give impulses to their implementation, co-ordinate (public) provision and control the results. The communes are the executive agencies. The importance of local public expenditures in environment is clear from Tables 3 and 4: it amounts to 63 % of the public outlays for this function. Incentive conditional grants are distributed along the way.\(^\text{11}\)

- Health is another illustration of the "agency" role of the Cantons and the communes. The federal government is responsible for only a tiny proportion of health expenditures (around 1 per cent), mainly because health insurance is governed by a federal framework law. But implementation of the law remains in the hands of the Cantons in the main (56 per cent) and of the communes (43 per cent), with evident problems along this way (DAFFLON, 2000).

At the lowest level, there is continual dispute in the Swiss Cantons about the effective extent of autonomy in local public expenditures, first and foremost because no single measure of independence is appropriate (WOLMAN, 1990) so that the Cantons and the communes have divergent claims. A second difficulty in measuring a decentralisation concept is that the fiscal-financial relations between local and cantonal governments vary from one canton to another according to the 26 cantonal Constitutions. Yet, the general trend in all the Cantons has been that (1) under the constraint of a current balanced budget, the "choice" role of the communes has made more and more way for the "agency" role and (2) the change in the relative weight of the two roles is inversely related to the population size of the communes: larger municipalities have been better able to maintain a higher proportion of the "choice" role.\(^\text{12}\) In general one can say that probably not more that 1/4 of total local current expenditures are made in response to standards set by higher government levels, less than 1/4 correspond to ad hoc inter-communal institutions co-ordinating particular functions, which leaves more than 1/2 for current expenditures resulting from the own preferences of local residents.

\(^{11}\) From 1960 to 1990, public expenditures for waste water sewage and purification plants amounted to 32 milliards SFr. Local governments paid 63 per cent of the total bill, the Cantons 26 per cent and the federal government 11 per cent. A. BARANZINI, Structures et coûts des stations d’épuration en Suisse et gestion efficace des eaux usées, Swiss Journal of Economics and Statistics, 1996, 4/1, pp. 515-538.

\(^{12}\) Since this was written, a new study has been published in the form of a Working Paper (DAFFLON and PERRITAZ, 2000) focusing on the mandatory functions at local level in the canton of Fribourg and the correlation between the size of the communes and the independent' proportion of their budget /account. The results are that on average 20 % of local current revenue sources are assigned to mandatory functions fixed by the canton, 15 % is due to the inter-communal provision of public services (mainly for the reason that individual communes are too small for such functions) and 9 % corresponds to debt servicing. Thus, 56 % of current revenues remain for the own choice of the local authorities (which does not mean that the total is free for new choices: it must also finance the financial consequences of past decisions and the running management costs). Based on year 1997 only, an inverse correlation between size and independent expenditures exists (the smaller the commune, the lower is the independent part of its current expenditures), but the results are not significant. This is neither an invalidation nor a confirmation of point (2) in the text. There are three questions to be solved. From the conceptual side, there is no agreement about the definition (and thus the measurement) of local public expenditures imposed by the canton or the federal government (mandatory function: "dépenses liées"). From the technical side, the sample is given by the communes in one canton only, for one year 1997 because no such statistical data are available: we had to get all the figures from the communal accounts. For generalisation, the analysis should be extended first to several years in the same canton, and second, if possible, to several cantons.
Now then, what can be said about the tension between subsidiarity and centralisation? There is no simple answer, but a very pragmatic approach and case by case solutions. However, two points deserve attention. First, a higher level of government cannot interfere so easily so as to impose its own idea of "efficiency" upon a lower level of government. The democratic procedure must be respected. The amalgamation of two or several communes is a good example: this has proved almost impossible on a compulsory basis with the argument that communes are often too small to perform correctly the functions assigned to them. And the voluntary amalgamation of communes responds to another logic than strict fiscal consideration (DAFFLON, 1998). Second, if a function needs more centralisation, it will not be enacted by agencies of the higher-level government, but by lower-level acting as agencies. Thus, the communes will first organise in special "inter-communal" jurisdictions rather than giving up a function to the canton. And many federal standards are implemented by the cantons: law and justice are but two examples. In general, one finds no duplication of service precincts, federal agencies acting in the cantons, or cantonal agencies acting in the communes. The Communes act as implementation agencies of the canton or the Confederation, most often with the capacity of performing more than required minimum service level if they want so, with the additional difficulty (from an analytical point of view) to distinguish what is the required standard and what is "choice" component.

3.4. Public revenues

In 1998, public revenues of the Confederation, the Cantons and the communes amounted to 1142'000 millions SFr. Since 1985, 1998 was the tenth year where total revenues were not sufficient to cover total public expenditures at each level of government. The total deficit runs to 1 459 millions SFr, which represents almost 2.5 per cent of GNP. The three levels of government were in the red. Details of public revenue sources are given in table 7. Taxation is the most important single source of revenue for the three levels of government (table 8). The tax system contains a certain degree of flexibility. These variables are largely in the command of the cantons and the communes and consequently determine the volume of financial resources at their disposal, thus the extent of their autonomy.

3.4.1. General characteristics

The main characteristics of the fiscal-financial system are the following.

1. Each level of government and each government within the same level has direct access to many, but at least two major revenue sources: at the federal level, direct taxation and VAT; the cantonal level, direct taxation and grants + revenue sharing; at the local level, direct taxation and user charges. Direct access to taxes and user charges is important in order to maintain financial autonomy.

2. Based on VAT with an actual normal rate of 7.5 %, the main consumption and expenditure taxes are exclusive and belong to the federal level. Taxation on motor vehicle is cantonal; the communes can levy minor taxes on dogs, entertainment and games.

3. Direct taxation is a joint taxation of the Confederation (individual income + corporate profit), the Cantons and the communes (individual income and wealth + corporate profit and capital). For the Cantons and the communes, taxation of individual income and wealth and of corporate business profits and capital ("direct taxation") is the major source of revenue (43 and 47 per cent).

13 Without the deficit of the social security. In 1993, the highest deficit ever was 16 325 Millions SFr, or 4.6 per cent of the GNP. This result did not respect one of the Maastricht criteria, namely that the total deficit of the public sector, including social security, should not exceed 3 per cent of GNP.
4. For the communes, revenues from public property (7 %), user charges from local public services (mainly: water, sewage and purification plants, garbage collection) and indemnities (in total 28 %), are in sum the second most important revenue sources. However, these sources are limited. Revenues from immovable properties, whether public or private, are subject to the federal legislation on rent control. The total amount of user charges for one single function cannot exceed total costs (i.e. user charges must be genuine cost-prices for public services, and not disguised taxes) owing to the jurisprudence of the Federal Court of Justice with regard to the quid-pro-quo rule in benefit taxation.

5. The Cantons and the communes have a rather low dependence on transfer payments: the Cantons receive 17 % of total revenues in the form of specific grants from the Confederation, and the communes 13 % from the Cantons.

3.4.2. Tax sovereignty

There is a long unending debate about the conceptual definition of tax sovereignty. Tax sovereignty concerns both the ability of a government to decide which taxes it should invent and raise, the direct access to taxation and the management of taxes. Let us summarise the general setting in the formula:

\[ T = t \times \left[ B - (D_1, D_2, D_3, \ldots D_i, \ldots D_n) \right] \times (K_{\text{Fed}} + K_{\text{canton}} + K_{\text{commune}}) \]

Where
- \( T \): revenue from a tax
- \( t \): the tax rate schedule
- \( B \): the gross tax base
- \( D \): the possible deductions from the tax base
- \( K \): the annual coefficient aiming at a balanced (current?) budget.

Referring to this formula, the extent of tax sovereignty can be measured in the following sequences of choice:

- a) the use of the ability-to-pay principle (taxes) versus benefit principle (user charges);
- b) the object of taxation, implicit in \([ \ldots ]\) in the formula above;
- c) the circle of taxpayers (including the definition of the taxpaying unit);
- d) the computation of the tax bases (for example, for the taxation of income: the definition of gross income \([B]\), and the adjustments to taxable income, specific deductions and exemptions) \([D_i]\);
- e) the tax rate schedules \([t]\), including the amount of deductions and exemptions in the previous letter \([D_i]\);
- f) the annual coefficient of taxation \([K_{ji}]\);
- g) collecting the taxes;
- h) the procedure in case of tax dispute.

**Full tax sovereignty** comprises letters a) to h) in the list above. **Partial tax sovereignty** exists where a government can decide a) and some but not all items listed between b) and e).

**Tax flexibility** means that a government can at least decide on the coefficient of taxation (f) but has no access to defining the kind of taxes it can raise. **Compulsory taxation** qualifies taxation where a government has no choice over a) to f) and must raise taxes (or user-charges) according to the regulations set by a higher level of government.

- In Switzerland, tax sovereignty lies primarily in the Cantons and secondarily in the Confederation to such an extent that it is stated in article 128 to 134 of the New Federal Constitution. The Cantons are largely free to structure and frame their tax system and to decide the tax burden. This freedom is restricted only by the Federal Court’s jurisprudence that prohibits, in particular, double taxation or unjustified tax rebates. In addition, the Cantons are bound by three articles in the federal Constitution which
allocate indirect taxation (VAT in article 130 Cst., and special consumption taxes in article 131 Cst.) exclusively to the centre and another that forbid taxes in the form of tariff barriers (art. 133 Cst.) which could impede the free movement of goods between the Cantons. In this situation of joint taxation, tax sovereignty means that there are 27 laws, with obvious problems of competition, co-ordination and harmonisation (DAFFLON, 1986 and section 5 below).

- The autonomy of the communes to manage their finance varies from one canton to another. In principle, the Cantons regulate the financial room for manoeuvre of their communes by establishing budget principles, uniform accounting model, taxation rules and debt limits. Local governments have a limited tax sovereignty in that they can choose between ability-to-pay taxes and user charges where appropriate. They are however tied to the tax system of their Canton. For many taxes, local governments have only tax flexibility: they must apply the cantonal laws and limit their decision to an annual coefficient of taxation \( K_{\text{commune}} \) in percentage of the Canton's taxes. Local taxation is also compulsory for a limited number of taxes.

- If a commune chooses to raise user-charges and fees, it can also define the main components (object of taxation, circle of users and thus payers, computation of the user charge base and the tariff), however within the limits set by case law of the Federal Court of Justice (KNAPP, 1982, pp. 358-364).

The objectives of fiscal sovereignty are:

1. To enable each level of government and each government within a level, to finance its own budget independently and according to its own criteria. This includes the capacity of financing public services in response to the preferences of their own electorate (the "choice" model) as well as those expenses which correspond to minimum standard (merit) goods and services set by a higher level of government (the "agency" model), net of conditional grants.

2. To decide redistributive policies: first in selecting ability-to-pay or benefit taxation; second, in choosing the magnitude of redistribution, for example, through the tax rate schedules or the amounts of exemptions and deductions on the income tax (subject to the limits described in section five).

These, however, create two problems. One is tax competition. The other is the necessity of an equalisation policy (between the centre and the cantons; and within a canton, between the canton and the communes) because of disparities in the tax burden which do no correspond to objective differences in local government functions, but to their geographical position off the main economic centres.

### 3.4.3. Direct access to many revenue sources

An important characteristic of fiscal sovereignty is direct access to many (fiscal) sources. In table 7, several finance sources are listed respectively for the federal government, the Cantons and the communes.

Direct access to a number of diversified tax or non-tax sources secures regular annual receipts compared with a situation where a government can rely on one tax only. It enables a better distribution of the fiscal burden and avoids exasperating particular categories of taxpayers in case of higher fiscal needs. This can also be understood in the view of the low dependence of the Cantons on transfer payments from the federal government and of the communes on transfer payments from the Cantons. This is observed in table 8 from the percentage of the various categories of revenue for the three levels of government.

- In 1998, the Cantons received only 24 per cent of their revenues from the Confederation (7 per cent from revenue sharing and 17 per cent in the form of conditional grants). The
net "tax / transfer payments" ratio, as KING observed (1984, p. 185), was 2.0, whereas the "own resources / transfer payments" ratio was 2.8. These ratios give some idea of the independence of cantonal finance on federal transfer payments. They are slightly higher than those computed by KING for Canada and USA. The usual interpretation is that the Swiss Cantons do not depend much on federal payments and benefit from a fairly high degree of fiscal autonomy.

The communes received only 16 per cent of their revenues from the Cantons in the form of revenue sharing (3 per cent) and grants (13 per cent). Although these proportions were about 5 percentage points below for the cantons as well as for the communes in the early eighties, the actual figures do not represent a very high degree of financial dependence compared to other OECD countries. And in any case, these proportions contrast with the degree of centralisation in public expenditures, which is much higher because the agency role of decentralised governments has gained in importance during the last decade compared to the "choice" model.

3.4.4. Tax administration

In principle, each level of government and each government within a same level may have its own tax administration. Thus the Cantons have a legal obligation to collect the federal direct tax (FDT) on individual income, corporate profits and capital and on capital gains. They also participate in managing the federal withholding tax and stamps duties. But since there are 26 cantonal tax laws and as many tax administrations and no tutelage of the federal government over State and local tax administration, there exist 26 ways of managing the cantonal taxes and the FDT. In order to gain economies of scale in the tax administration and coherence in the tax practice, many formulas exist for co-operation between the three tiers of government.

In addition, because the powers of the State tax administrations are limited to the territorial area of the State to which they belong, whereas economic activities may spill over cantonal limits, a decentralised tax administration creates problems and conflicts. These have been solved in the first place by negotiations between the Cantons, eventually (and more often) through the jurisprudence of the Federal Court of Justice. Secondly, a federal law on the harmonisation of cantonal direct taxation has been enforced on 1 January 1993 to introduce some order in the Cantons’ taxation for neutrality and equity reasons. Within the following eight years (on the 1st of January 2001 at the latest), the cantons must adapt their own tax legislation to a common unique framework (see also section 5 below).

At local level, no such difficulties exist. In most cases, the communes can only decide annual tax coefficients for the various accessible tax sources, but have no access to defining the kind of tax they raise: it is a "take-it-or-leave-it" situation. In many cantons, the communes can contract with the cantonal tax administration to collect communal taxes.14

4. BUDGET POLICY

The Swiss Cantons have their own Constitutions, independent power over their budgets and their own financial resources and, above all, they have the power of taxation. Cantonal autonomy in the area of fiscal policy contrasts with the budget principles and the rules of taxation to which member States in other federations are subject. Legislative authorities at the federal level, in the 26 Cantons and in every single municipality must decide the budget (current + capital) before the beginning of the year and, of course, keep books recording revenues and expenditures. Since the mid 80s, budget and bookkeeping techniques have been harmonised. Annual budgets as such do not give a legal base for expenditures and taxation. Each item in the current as well as in the capital budgets must be founded on

14 In the Canton of Fribourg, the cost for a commune is 1.5 /0 of the net tax revenues. The cantonal tax administration collects communal taxes and acts for the commune in all aspects of tax litigation. The tax proceeds are paid to the commune on a monthly base.
particular laws that have been debated separately in parliament and enforced prior to the budget discussion.

The federal Constitution does not impose budget principles on the Cantons. There is no federal constraint on deficit financing, except that all tiers of government have no access to borrowing from the Central Bank. The main external limitation on budgetary sovereignty of the Cantons is intrinsically competition with other cantons: if a canton pursues an inefficient fiscal policy with a poor cost-benefit relationship, it will price itself out of the market. Individuals and firms will move "à la Tiebout" to another canton ("exit", in Hirschman's terminology); or the voters or some groups of them will use initiatives and referenda in order to obtain a modification of the "public goods / tax" mix in comparison to that of other cantons ("voice"). Competition is even more important at the local level, particularly between communes in the same urban agglomeration.

4.1. Budget orthodoxy

The fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. There are also internal limitations in cantonal Constitutions or laws. Two rules are generally respected, at the level of the Cantons in their own financial laws, and in the communes under cantonal supervision (DAFFLON, 1996).

- The first rule is concerned with the requirement of a more or less balanced budget for providing goods and services. Due to financial regulation, for most local and cantonal governments it is quite difficult to run or to accumulate deficits in their (current) budgets. If a large budget deficit occurs, taxation would have to be increased. In many cantons, the amortisation must not only be recorded in the book, but also correspond to an effective instalment of the loans. At the communal level, if a local authority would not follow this rule, the cantonal government might decide to raise the annual coefficient of taxation in place of the commune. In general, the Cantons apply the "golden rule": local current revenues net of current expenditures are sufficient to serve the debt interest and bear the running costs of past and new investments. Whether this rule includes the effective annual reimbursement of the debt on a pay-as-you-use basis (for capital expenditures financed by borrowing) varies from one canton to another. This also necessitate a clear line between current and capital expenditures and, of course, separation of the current from the capital budget. Again, the definition is not identical from canton to canton: in particular with regard to the possibility (i) to transform capital expenditures into current outlays through leasing contracts to shortcut limitation, if any, or (ii) through outsourcing of certain expenditures to external budgets not accounted for by the public sector.

- The second rule concerns borrowing and debt limitation. Public debt is allowed in many cantons only for financing capital expenditures, and if the local and/or cantonal government has the financial capacity to pay the interest and amortisation of the debt out of its current budget. The rates of amortisation are fixed according to the kind of investment and its possible length of use (pay-as-you-use finance). This of course requires a distinction between the current budget, which must be balanced, and the capital budget, which can be financed by borrowing.

These two quite (more or less) strict requirements express the principle of accountability or budgetary responsibility. They must be viewed in the perspective of the cantons' and

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15 For example, in September 1994, the Council of State (executive government) of canton Berne has imposed on the commune of Berne (the capital city of the Canton and also the federal city) an increase of the tax coefficient from a multiple of 2.2 to 2.4 of the cantonal direct taxes levied in the commune. The reason was that the electorate of the commune had rejected for the third time the 1994 budget, which presented a deficit and required for balance an increase of taxation. In Fribourg, the Canton controls on a yearly basis the books and the public debt of the communes. It intervenes if the current account is not balanced or if amortisation of the debt and the effective reimbursement of loans are not sufficient according to legal minimum rates. Cantonal intervention takes several forms, but it can go so far as to impose a higher tax coefficient to the commune at fault in order to restore its financial situation.
communes’ financial autonomy and a large access to own revenue sources as described above. On the one hand, cantonal and local governments have a fairly large (though diminishing) amount of autonomy to decide and offer public services, and direct access to taxation. On the other hand, it is expected that these governments will act in a responsible way and will finance without excess borrowing what they are asked to produce, either by law ("agency") or in response to their electorate’s own demands ("choice"). This is definitely a classical approach to fiscal federalism (TOLLISON and WAGNER, 1986). The interests of the public debt of the cantons in 1998 represented on average 6 per cent of total cantonal own revenues; and 7 per cent for the communes (tables 6 and 7).

- Finally, there is also a large debate about the effectiveness of financial referenda on the size of the public sector, on the one hand, and on the reinforcement of budget discipline, on the other hand (see section 2.3.)

### 4.2. Macroeconomic policy

The decentralisation of government functions raises problems for macroeconomic control at the national level. This is because cantonal and communal accountability involves the access to own revenue sources together with the right of the Cantons and the communes to borrow. Uncontrolled access to capital markets and mismanagement of the budgets by cantonal and local government could jeopardise the efforts, if any, to stabilise the economy. For this reason, so the textbook argument runs, central government ought to have some monitoring or control power. But one must distinguish whether the assignment of responsibilities and revenues to the cantonal and communal tiers is in balance and regular, or volatile and subject to strong cyclical variation. In the first case, control can be restricted to the golden rule, that borrowing is allowed only for infrastructures, and the time-path of capital investment. In the second case, borrowing may be needed not only for investment, but also to compensate for cyclical variation in the budget (higher social assistance expenditures, with less revenue, in downwards cyclical turn).

Yet, effective decentralised public finance may be somewhat distant from the textbook theory. Stabilising tax adjustments is a mere conjecture in the Swiss situation: the electorate has to vote the tax law at the cantonal level, or the tax coefficient at the local level: while it may accept variation in taxation, whether to restore a balanced current budget or for new investments, it is unlikely to do so just for macroeconomic reasons. In addition, the time path required for such a decision is probably foreign to upward or downward changes in the macroeconomic trend.

On the other side, the economic classification of public expenditures, in table 6, gives an interesting first insight for macroeconomic policy. At the federal level, current and capital grants-in-aid account for 59 % of total expenditures, whereas expenditures for personnel and interest payment correspond to 10 % and 7 % respectively. This means that about 76 % of the total budget belong to categories of expenditures that are very difficult, if not impossible, to modify in the short term for macroeconomic purposes. Consumption (11 %) and investments (2 %) amount to as low as 13 % of the total federal budget. This is by no mean sufficient for any kind of functional finance.

With 19 % of total expenditure for consumption (11 %) and investment (8 %), the cantons are in a similar position.

Not surprisingly, one finds that the communes spend much more for consumption (20 %) and investment (13 %), up to about 33 % of their total expenditure.

Because of the difficulty to act on personnel expenditures and transfers in the short term, one must recognise that any macroeconomic policy cannot be driven by and at the Centre only. It requires some form of consensus between the three government tiers and vertical co-operation. This is not an easy matter because regional and local interests are divergent. In
particular, more and more investment projects require important financial resources and long term planning: when such a project is ready to be voted, it is doubtful whether any government will accept to postpone it for macroeconomic reason. And inversely, it is not so easy to accelerate a project for macroeconomic reason without taking the time to present a detailed investment programme. A canton or a commune may be very reluctant to abandon or postpone an investment for the sake of a central co-ordinated macroeconomic policy. This explains also why the fiscal and budget policy plays only a limited role in stabilisation, compared to the position of the monetary authorities through the Swiss National Bank.
5. TAX CO-ORDINATION AND HARMONIZATION

The extensive freedom in shaping the tax system enables each of the Cantons to determine the tax price level for a specific bundle of public goods and services within its own jurisdiction. In the theory of fiscal federalism, Cantons and communes may use their tax systems to compete for firms and individuals to migrate to another Canton or commune. Yet, fiscal sovereignty is not unlimited. Allocative inefficiencies would arise if decentralised jurisdictions were to adopt widely varying forms of taxation. Each individual and business firm would have an incentive to move in that jurisdiction whose particular tax system gave him the best tax break. Under a non-neutral tax system, the location of individuals and productive capital might be guided by particular pecuniary advantages afforded under varying kinds of taxes irrespective of public provision. But tax competition between jurisdictions has no efficiency properties comparable to market pure competition; it is rather in the nature of oligopoly (TULKENS, 1985, p. 45). Furthermore, it is not possible for subcentral jurisdictions to decide a sharp redistributive policy through taxation. Acceptance of this policy will not only vary on ethical grounds, but also depend on the mobility of individuals and business enterprises, that is: their capacity to avoid, through voting-with-their-feet, the incidence of high redistributive taxation. Minimising these distortions calls for a substantial degree of co-ordination and tax harmonisation, that is for a co-operative effort to secure a system of taxation that minimises excess burden and yields a desirable pattern of incidence (WEINER and AULT, 1998).

In the Swiss situation, FREY (1981) and WEBER (1992) show that tax-induced migratory movements are small. Not only the price-service ratio of public policies, but a number of other private determinants influence the choice of residence or location. Legal entities know that they can obtain a tax break in almost any new location, even though this is neither formally nor officially publicised. In addition, with initiative and referendum, the citizens have not only an "exit", but also a "voice" solution. Since tax co-ordination has existed for many years, problems of tax harmonisation have been discussed in terms of neutrality and in the context of reducing administrative and implementation costs, rather than from an equity point of view.16

5.1. Tax co-ordination

5.1.1. Vertical co-ordination

Vertical co-ordination concerns the assignment of tax authority to the various levels of government. It should be clear which jurisdiction is entitled to tax which items from which taxpayer. Attention must be given to the geographical distribution of tax yield. A good tax under subcentral authorities should have a tax base that is widely and evenly distributed throughout the country (KING, 1984, pp. 210-211). In addition, one can say the general objectives of vertical tax co-ordination:

(i) stable and predictable revenue sources at the three levels;
(ii) high proportion of own resources of total cantonal and communal revenue;
(iii) sufficient tax room at the cantonal and communal levels;
(iv) efficient decentralised taxation and accountability.

are fulfilled in the Swiss case:

Referring to table 7, one can see that in Switzerland vertical co-ordination is obtained partly through the attribution of exclusive tax sources to each level of government according to the doctrine of the separation of sources. This is clear for consumption and

16 It is significant that all initiatives for a nation-wide or canton-wide uniform system of taxation on income and wealth of individuals and on corporate profits and capital have been rejected in popular votes because it would restrain the fiscal flexibility of lower levels of government and increase their dependence on transfer payments. Differences in cantonal and communal tax burden are viewed as the price of autonomy (DAFFLON, 1986).
expenditure taxes where there is no overlapping of the tax bases between the Confederation, the Cantons and the communes.

- On the other hand, for "direct" taxation, personal income, corporate profits and capital\(^{17}\) are jointly taxed at the three levels. The vertical apportionment between the three levels of government is rather complex and often left implicit. It is obtained in two ways: a moderate taxation at each level so that no single government exhausts the entire tax capacity; and, the assessment of priority, first to the Cantons, then to the communes and lastly to the Confederation. It has been traditionally admitted for direct taxation that the federal share should not exceed one fourth of the total. Minimum taxable income at the federal level should be higher than in the Cantons and the tax rate schedule more progressive. Yet, the Cantons receive back 30 per cent of the federal direct tax (FDT) in the form of revenue sharing, of which 13 per cent is affected to inter-cantonal fiscal equalisation (see below section 6.2).

- Note also that Switzerland has a particular characteristic: the vertical tax co-ordination is written in it Constitution. Following art. 196 Nr 13 of the transitory provisions of the 1999 Cst., the FDT may be levied until the end of 2006 only. The consequence is that, some years before this limit, the federal government must justify the further necessity of levying a direct tax at the central level in concurrence with the Cantons and the communes, and explain its motives. The decision to continue to levy a FDT necessitates the double majority of voters and cantons, which is a powerful mean for the Cantons to obtain compensatory advantages, notably in the equalisation policy.

With the enforcement of VAT on 1 January 1995, and with it, the extension of expenditure taxation to services, the most orthodox federalists claim that the joint attribution of direct taxation to the Confederation and the Cantons should end. The argument is that the overall burden of indirect (consumption) taxes is still lower in Switzerland than in most other European countries. This gives a freedom of manoeuvre which should be used to reduce the direct tax burden which, combined to social security contributions, is higher that average. For some, there should be a crystal-clear order in taxation under the slogan: "VAT. is federal / direct taxation is cantonal". Opponents argue that the abolition of the FDT will set back income redistribution through ability-to-pay taxation because the tax rate progressiveness of the FDT is higher than in any canton. In addition, the abolition would create difficulty in the federal → intercantonal equalisation policy.

- Vertical co-ordination between the Cantons and their communes is secured because, as explained in section 3.4.2., local governments have no sovereignty on these matters, but only tax flexibility. The most debated question is whether local governments can taper at this source in priority, to the detriment of the cantonal tiers. The usual solution is that communal tax coefficients are subject to an upper limit fixed in the cantonal law in proportion to cantonal taxes (for example: in the Canton of Fribourg, this limit is fixed at a maximum level of 125 % of the cantonal tax).

### 5.1.2. Horizontal co-ordination

Horizontal co-ordination serves to apportion tax competencies and the tax yields among the jurisdictions at the same level where the tax base has its origin in several communes or cantons. In Switzerland, this has been obtained through the jurisprudence of the Federal Court of Justice. Two objectives have been pursued: avoidance of double taxation, and, preventing that taxpayers with taxable activities in more than one jurisdiction avoid the progressiveness of the tax rate schedules through geographical splitting of the tax base. Although the technical rules are rather intricate (DAFFLON, 1986, pp. 32-36), horizontal co-ordination applies itself along the following general guidelines:

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\(^{17}\) The federal direct tax on business capital has been suppressed by the law of October 10, 1997 from 1998 onwards.
- the income tax is entirely paid in the canton and the communes of residence;\(^{18}\)
- any income obtained in other jurisdictions is assessed in the jurisdiction of residence according to the rules of the jurisdiction of residence (and not the rule of the jurisdiction where the income has been gained);
- immovable property is taxed in the jurisdiction where it exists;
- when corporate business takes place in several jurisdictions, the yields of the profit and capital taxes are distributed between those jurisdictions according to financially measurable components of the activity (for example: turnover, the volume of sales, total insurance premiums for insurance companies).

5.2. Tax harmonisation

Different jurisdictions at the same level of government will generally find it desirable to adopt at least roughly similar systems of taxation. There are three reasons; two of them pertain to the criteria of fiscal neutrality. First, where the inter-jurisdictional mobility of certain economic units is of a high degree, taxation of these units, if it is employed, should be of similar form across the jurisdictions. Second, the rates at which these units are taxed locally should not vary greatly among the jurisdictions except to the extent that differences in rates correspond to differences in benefits to these units from the services provided. In this way allocative distortions in both resource use and incidence resulting from the tax system itself can be kept to a minimum consistent with other fiscal objectives of the individual jurisdictions (OATES, 1972, p. 147).\(^{19}\) Third, harmonisation simplifies the tax perceptibility and minimises the administration and implementation costs.

**Formal tax harmonisation** concerns any attempt to bring the various tax systems decided independently by each jurisdiction towards a uniform system and towards a unique definition of the tax bases (letters b to d in the sequence of choice in section 3.4.). As a result, information and transaction costs are reduced for those who pay taxes in several cantons; administrative and implementation costs are reduced for the tax departments, litigious cases decrease.

**Real tax harmonisation** is obtained when allowances, the amounts of deductions and exemptions and the tax rate schedules are identical in all jurisdictions. Such harmonisation is at variance with the federal principle and has never been on the political agenda in Switzerland.

In Switzerland, the problem of tax harmonisation arises exclusively for those taxes that are simultaneously levied by the two higher levels of government - federal and cantonal. Despite the new legislation which has entered into force from January 1 2001 after a transitory period of many years, tax harmonisation at the federal and cantonal levels remains fully and exclusively formal. At the cantonal level, formal tax harmonisation has been realised over the years for two reasons. First, collection of the federal direct tax (FDT) on personal income, and on corporate profits and capital is assigned to the Cantons. Consequently, for obvious reasons of reducing administrative and implementation costs, and thanks to effort-minimising bureaucrats who were reluctant to control several Tax Return Forms (at least, the federal and the cantonal Forms) for one and the same taxpayer, there has been very strong bureaucratic incentives at cantonal level to adopt rules and income concepts (gross income, adjusted gross income, taxable income, itemised deductions and allowances) similar to those of the FDT. Second, more and more taxpayers, corporate or individual, are active outside their Canton of residence, or own immovable assets in another Canton, thus pushing for uniformity of the various rules of taxation (none the less for uniform Tax Return Forms) in

\(^{18}\) This has been confirmed by the Federal Court of Justice early in 1999 in a dispute between the cantons of Geneva and Vaud concerning commuters working in Geneva but resident in Vaud who had received income tax assignment from the canton of Geneva.

\(^{19}\) Since tax breaks are used in all cantonal regional development policies, they do not really give a net advantage to one region over another, which results in a typical prisoner’s dilemma situation.
order to reduce administrative and legal costs.

Nowadays, formal harmonisation is partly achieved by federal legislation, introduced in 1993 and 1995:

- The federal law on the harmonisation of direct taxation at cantonal and communal levels, which has been in force since 1 January 1993, provides a framework within which the Cantons (and the communes if they have more than fiscal flexibility) must define their direct taxation laws, particularly with regard to tax liability of persons and legal entities, assets and tax periods. Standardised tax declaration forms are being introduced, much to the relief of people liable for tax in more than one canton. The income and wealth taxes are annualised (they were based on a 2-years assessment up to this date). The Cantons have been obliged to adjust their tax legislation within eight years, that is by 31 December 2000. Actually the law applies directly wherever cantonal tax law has not been brought into line with it. However, since the Cantons still define their own tax scales, tax rates and the amounts of allowances and deduction, wide variations in taxation levels within Switzerland remain. Thus, formal harmonisation solves problems in terms of administrative costs, but not in terms of tax neutrality.

- The federal law on direct federal tax took effect on January 1st 1995. Matching the provisions of this law with the previous one has ensured vertical harmonisation of direct taxes at the three levels of government.

- At the communal level, formal and real tax harmonisation has been almost achieved except for the annual coefficient of taxation which depends on the balanced budget requirement. Tax competition is on the agenda of most communes, especially because of inter-jurisdictional mobility within urban areas.

What could be concluded from the present situation? (Partial) Fiscal sovereignty is important at the cantonal level, but comes with increasing problems. The difficulties experienced by Switzerland for the last three decades - in fact right from the beginning of the extension of direct taxation as a major source of revenues for the cantons - show a real need for some sort of central tax law. Recently, the Cantons have had to recognise that tax competition has had negative and undesirable consequences on regional development policies and that economic disparities between the regions and the cantons have not been reduced despite a federal regional and equalisation policies (DAFFLON, 2000). The debate is now vivid in this country.

5.3. Tax competition

5.3.1. Some stylised facts

Fiscal competition among regional or local authorities within a decentralised multilevel government has long been an issue for policy makers, especially in a federal system like Switzerland, where the differences in business taxation between (or within) cantons have been rather important over the last twenty years (for a survey see Administration fédérale des contributions, 1990, pp. 63–8). As a matter of fact, empirical evidence shows for instance that in the 1980s the tax burden on the firms' profit varied considerably between the 26 Swiss cantons, with maximum-minimum ratios ranging from 2 to 4 depending on the amount of profits and the formula used to compute them for fiscal policy targets. Similar empirical evidence seems also to exist, though to a lesser extent, for communal business taxation within the same canton (Dafflon, 1991, pp. 58–65). More recently, in fact, the 1999 OECD Economic Survey indicates that in Switzerland the average tax rate on business profits varies from 13 to 31 per cent, when the three-level government taxation is considered altogether (Organisation for Economic Co-operation and Development, 1999, p. 109). Now, such a relatively big discrepancy on business taxation between local governments (see also below section 5.4) provides a framework where fiscal competition and fiscal strategies may
eventually impinge on the implementation of the required fiscal policies at the local level. This is so much so when a balanced budget requirement is taken into account. The remainder of this section focuses therefore on the theoretical as well as empirical issues of fiscal competition from a public choice point of view, illustrated with reference to the Swiss case.

5.3.2. A prisoner’s dilemma framework

Fiscal competition may be considered as a regional (cantonal) or local (communal) strategy implemented in order to attract – or to retain – business activities for a number of macroeconomic reasons (basically, to enhance regional economic development and growth, and to curb unemployment). In Switzerland, several French-speaking cantons have recently lowered (or planned to lower) their taxation on business profit and capital, a phenomenon occurring also in the German-speaking part of the country. In particular, the cantonal fiscal authorities have adopted a discretionary fiscal policy with respect to firms (and/or their managers), to boost economic development at the local level in terms of output growth and labour market. Indeed, this fiscal strategy may also help Switzerland in improving, and consolidating, its competitive ranking within a globalised economic system.

However, failure to co-ordinate such a policy at the general government level leads inevitably to a prisoner’s dilemma situation. In fact, at the fiscal level international co-ordination is non-existent and seems even to be utopian for the time being. Yet, as pointed out by public economic theorists (see Tulkens, 1985), fiscal competition between local governments within the same country does not represent an optimal solution from a political economy standpoint. To be sure, over the long run fiscal competition decreases the tax burden and, therefore, the fiscal revenues of the local governments as a whole. Even if fiscal competition enables to control, and perhaps to limit, the expansion of public sector economics (Pommerehne et al., 1996; Feld, 1999), empirical evidence at the EU level shows that this kind of competition among regions exacerbates structural budgetary deficits and might put the sustainability of government debt at stake (Commission of the European Communities, 1997). Further, according to a recent OECD report, globalisation creates a framework where the number of off-shore places keeps increasing; governments are thus stimulated to implement fiscal strategies in order to attract those business activities which are highly mobile (see Organisation for Economic Co-operation and Development, 1998). At present, fiscal competition between governments aims indeed at limiting the moving of firms – both in terms of plants and capital – towards off-shore places, by decreasing the tax burden on business profits and their managers’ incomes. However, this kind of competition between local governments (but the argument applies to nation-States as well) encompasses a series of drawbacks, namely (i) the risk of diverting profitable trade and investment from the region, (ii) the risk of reducing the revenues of the local government sector considerably, and (iii) the risk of transferring part of the tax burden on less mobile factors or activities (i.e. labour and consumption), a transfer which will impinge on both employment and fiscal equity.

Now, since in Switzerland each canton seems ready to discuss a fiscal agreement with those (newly established) firms producing a relatively high-valued output, over the long run any economic benefit that might result in terms of regional income or employment growth is bound to be nullified by the fiscal competition of other cantons. Whenever a canton’s fiscal strategy is successful in attracting a firm by granting it a fiscal bonus, another canton will soon do the same by reducing its tax burden on business profit and capital, and so on, until all cantonal fiscal burdens are eventually reduced to a minimum owing to a lack of co-ordination between local governments. This self-reinforcing, downward process can be illustrated with respect to the empirical evidence over the period 1985–99 for the seven French-speaking Swiss cantons, with a numerical example assuming a business capital of 2 millions Swiss francs and a profit of 320,000 Swiss francs (Table A).

| Table A | Taxation of business profit in French-speaking Switzerland, 1985–99 |
### Table A

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Berne</td>
<td>72 028</td>
<td>51 710 ↓</td>
<td>51 681 ↓</td>
<td>– 28%</td>
</tr>
<tr>
<td>Fribourg</td>
<td>61 614</td>
<td>59 149 ↓</td>
<td>58 721 ↓</td>
<td>– 5%</td>
</tr>
<tr>
<td>Geneva</td>
<td>59 641</td>
<td>59 607 ↓</td>
<td>63 342 ↑</td>
<td>+6%</td>
</tr>
<tr>
<td>Jura</td>
<td>85 582</td>
<td>56 723 ↓</td>
<td>58 549 ↓</td>
<td>– 32%</td>
</tr>
<tr>
<td>Neuchâtel</td>
<td>90 180</td>
<td>88 897 ↓</td>
<td>88 565 ↓</td>
<td>– 2%</td>
</tr>
<tr>
<td>Valais</td>
<td>74 704</td>
<td>65 325 ↓</td>
<td>65 204 ↓</td>
<td>– 13%</td>
</tr>
<tr>
<td>Vaud</td>
<td>66 914</td>
<td>64 091 ↓</td>
<td>63 976 ↓</td>
<td>– 4%</td>
</tr>
</tbody>
</table>

* current value in SFr.


The example in Table A includes cantonal, communal and church taxation in current value. It shows that all French-speaking cantons, except Geneva, have reduced their tax burden on business profits over the last 15 years. In particular, the canton of Jura has the highest rate of decrease (32 per cent), owing to its awkward geographic position and its relatively low cantonal income (both in absolute and per capita terms). As regional economic theory explains, in fact, the localisation of firms depends on a number of factors other than fiscal advantages (which are actually annihilated by fiscal competition between local governments). Among these other factors one may include the proximity of markets, and easy (i.e. low-cost) access to motorway and railway networks, two factors which are still lacking the Jura canton. Analogously, the canton of Valais probably suffers from its geographic situation and thus tries to attract (or retain) firms via an important decrease in business taxation (13 per cent over the period 1985–99). Conversely, the canton of Berne seems to have considerably reduced its fiscal burden on firms (28 per cent) in order to keep up with, or to catch up, the huge economic development of the Basle–Zürich area during the last 15 years. The cantons of Fribourg (5 per cent), Vaud (4 per cent) and Neuchâtel (2 per cent) have also lowered their business taxation for similar reasons, though to a lesser extent.

Now, as Table B shows, these reductions in cantonal fiscal burdens on firms are such that, despite a considerable decrease in business taxation in the French-speaking part of Switzerland, business activities are still attracted by the German-speaking cantons, which have been able to grant better fiscal advantages to firms. As a matter of fact, if the average index in Table B is set equal to 100 for Switzerland as a whole, the index movements for the French-speaking cantons show a relative increase for all of them (except Geneva) over the last five years (1995–9). Clearly, fiscal competition among the seven French-speaking cantons (including Berne) is not enough to outcompete the rest of Switzerland for attracting business activities and thus enhance regional economic development. On the contrary, as pointed out in Table A, fiscal competition is such that, on the whole, all local governments lose a considerable part of their revenues because of the lowered fiscal burden on firms’ profit and capital.

### Table B

**Index of fiscal burden on business profit and capital in French-speaking Switzerland, 1985–99**

<table>
<thead>
<tr>
<th>Canton</th>
<th>1985</th>
<th>1995</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Berne</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Fribourg</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Geneva</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Jura</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Neuchâtel</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Valais</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Vaud</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>
Now, when one considers the fiscal competition between (French-speaking) cantonal governments from a public choice point of view, one can notice that each canton merely reacts to the contingent situation, instead of taking the lead and obtaining a durable benefit in macroeconomic terms. In the end, firms are therefore not attracted to a specific localisation, since the ongoing process of fiscal competition among local governments removes any comparative advantage these authorities might have one over the other in the short run. This situation is further reinforced by the problem of asymmetric information. In fact, when a firm is looking for fiscal advantages (basically, a reduction of its tax burden), it often starts negotiations with more than one canton or local authority. This allows firms to know and compare the various sorts of fiscal advantages offered by competing governments, whereas any of the latter does not know what the competitors are offering. Hence, as is emphasised in the 1998 OECD report, the lack of co-operation between local governments is such that fiscal competition is overall detrimental for the general government sector, in terms of fiscal revenues and economic development (Organisation for Economic Co-operation and Development, 1998, p. 33). Moreover, on the assumptions of unchanged policies and of a balanced budget requirement, any fiscal bonus granted to a firm (or to a targeted group of firms) is bound to be compensated by an increased tax burden for other firms or individuals. This compensation introduces a system of implicit grants which threaten fiscal justice.

5.3.3. Out of the dilemma

As far as fiscal competition is concerned, two suggestions may be put forward at the policy level.

In the short run, an authoritative, independent observatory should be established for the general government sector, in order to collect all regional (cantonal) and local (communal) decisions granting any fiscal bonus or other specific advantages to firms. This public agency would be in charge of examining the consequences of such fiscal practices in terms of resource allocation and distribution, without imposing a penalty during an initial period of (say) five years. It would also elaborate policy guidelines aiming at (1) avoiding the prisoner’s dilemma that up to now characterises fiscal competition between local governments, (2) consolidating the ranking of the Swiss economy with respect to international competition, by an overall fiscal policy which is both consistent and co-ordinated at the three government levels (i.e. the federal, cantonal and communal levels), (3) contributing to establishing a world-wide policy agreement on fiscal competition, where controls and penalties are clearly indicated. The old-fashioned concept of local autonomy ought therefore to be revised and adapted to a globalised economic system.

In the long run, a real fiscal harmonisation on business taxation should be put into practice. In fact, the fiscal harmonisation provided by the law of 14 December 1990 between the Swiss
cantons – which has become fully operational in January 2001 – has no effect on fiscal competition, because tax rates are excluded from the harmonisation process. If an effective fiscal harmonisation is to see the light in Switzerland, a structural reform ought to be implemented, giving rise to a unique tax, a unique tax rate and a unique fiscal authority. A less rigorous solution would allow cantons to have a limited room for manoeuvre, say a margin of ±10 per cent with respect to the tax rate. Fiscal federalism would be kept safe by distributing fiscal revenues between the federal, cantonal and communal government levels, according to an equalisation formula which is sanctioned by law and is not negotiable during annual budgetary discussions (Council of Europe, 1998, p. 23).

5.4. Fiscal burden in the Cantons

It should be clear, at this stage, that tax harmonisation does not imply perfect uniformity in the rates and forms of taxation across the jurisdictions. The consequences of cantonal, and to some extent communal, tax autonomy is that the tax burden can differ substantially from one jurisdiction to another according to their view about the tax system, the combination of the ability-to-pay and the benefit principles, and the progressiveness of the rate schedules. Additional reasons are that the Cantons provide varying levels of consumption of public services and have significant differences in the unit cost of providing public services at comparable minimum standards. The Cantons have also significant differences in levels of income and wealth (computed from Table 1, indices of per capita NIC in individual cantons vary between 70 points in Jura and 154 points in Zoug compared to an average of 100 points). It is in the nature of fiscal federalism that the use of non-benefit taxation by decentralised levels of government, cost differences in public provision and wide variations in NIC introduce disparities in the tax liabilities and, with it, some inefficiencies and inequalities. This is to be expected and can be accepted as far as "efficiency" is not only "economic" but refers to the general capacity of federal institutions to strengthen the system of checks and balances (as, for example, against autonomy; WISEMAN, 1990, p. 120) and as far as those disparities are not too blunt and remain within politically acceptable limits. But significantly higher tax rates (and maybe inferior public services) in some poorer jurisdictions may lead to the need for substantial equalisation payments (next section).

Table 9 gives the indices of tax burden for five categories of taxes in the Cantons and the communes, which together amount to about 90 per cent of total cantonal and communal fiscal revenues. Reliable measures of the relative cantonal and communal tax burden are needed for several reasons. First, the Cantons and the communes must know how much revenue they are capable of raising without too heavy a tax burden in comparison with one another. Second, it is also important to have an idea of the ability and willingness of the Cantons and the Communes to raise revenue and, in relation to the requisite of a current balanced budget, to develop warning-systems of financial stress. Third, if equalisation is needed - it is argued - the recipient governments should not receive financial aid without a minimum effort in taxation. But, however useful these data may be, one must be careful in interpreting tax burden. Two government units may differ in their tax burden indices not only because they wish to provide different levels of public service (the "choice" model), but also because they use relatively different amounts of debt and non-tax revenues (user charges); differences may also reflect lower financial capacity (in NIC per capita) or differences in the unit cost of provision of public services.

Table 9 shows that an individual can pay as much as twice or three times the amount of tax on the same income and wealth, depending on where he lives. Even neighbouring cantons sometimes have considerable permanent differences in tax burden (WEBER, 1992, p. 248): for example, in the Cantons of Zurich and Zoug for individual income taxation (77.2 and 54.1 points for a national average of 100), or Bâle-Ville and Bâle-Campagne (112.5 and 90.9 points). The same Table 9 presents two interesting further pieces of information:

(1) Max / min ratios differ from one tax source to another, and compared to the financial capacity of the Cantons. The min/max ratio is 2.2 for NIC per capita (table 1, column 7,
between the cantons Zoug and Jura), and 2.3 for the global indices of tax burden (table 9, column 7). But it varies between 2.50 and 6.59 for particular tax sources and the figures differ widely from one Canton to another for each sort of tax so that one may conclude that differences in the economic situation of the individual Cantons, expressed by NIC per capita, do not entirely explain differences in the tax burdens.

Consider, for example, the seven Cantons in the following abstract of Tables 1 and 9 with almost identical NIC per capita (just above 38'000 Sfr.)

<table>
<thead>
<tr>
<th>Cantons</th>
<th>NIC per capita</th>
<th>expenditures per capita</th>
<th>tax burden</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>income</td>
</tr>
<tr>
<td>Thurgovie</td>
<td>38 506</td>
<td>6 085</td>
<td>99.6</td>
</tr>
<tr>
<td>St-Gall</td>
<td>38 196</td>
<td>6 578</td>
<td>101.5</td>
</tr>
<tr>
<td>Lucerne</td>
<td>38 832</td>
<td>6 809</td>
<td>115.6</td>
</tr>
<tr>
<td>Grisons</td>
<td>38 878</td>
<td>9 536</td>
<td>80.0</td>
</tr>
<tr>
<td>Berne</td>
<td>38 758</td>
<td>7 257</td>
<td>122.8</td>
</tr>
<tr>
<td>Uri</td>
<td>38 348</td>
<td>11 385</td>
<td>90.7</td>
</tr>
<tr>
<td>Appenzell Rh. Int</td>
<td>38 735</td>
<td>6 883</td>
<td>108.5</td>
</tr>
</tbody>
</table>

- The indices of taxation of individual income and wealth in St-Gall, Berne, Appenzell Rh. Int. and Uri (indice for income taxes > indice for wealth taxes) present exactly the inverse tendency from those in Thurgovie, Lucerne and Grisons (indice income taxes < indice wealth taxes).
- Lucerne and Berne, which have heavier-than-average indices for income tax have adopted divergent practice for the taxation of wealth: the burden is around the average in Berne (103.5 points), but much higher in Lucerne (170.8 points).
- Although the interval between the indices of the tax burden on profit are not as large as those on income (from 90.2 to 105.3 points = 15.1 points, compared to 80 to 122.8 = 42.8 points), it is not clear to which extent there is an inverse relation between these two kind of taxation (such as "low income tax" ↔ "high profit tax").
- With 9 536 SFr. of per capita public expenditures, the indice of global tax burden in Grisons is at 90.6 points, whereas with 6'809 SFr. of per capita public expenditures, the indice of Lucerne goes up to 116.8 points. No direct relation between high per capita expenditures and a high tax burden can be explained.

The main conclusion is that Cantons with almost identical NIC per capita distribute differently the tax burden between each source of taxation compared to the average burden: but these differences reflect cantonal preferences in taxation more than disparities in income per capita or differences in per capita public expenditures.

(2) For each ratio, the min or max Canton of reference is a different canton, except for Nidwald and Zoug, which appear twice with the minimum. Cantons with minimum indices are: Zoug on income and profit, Nidwald on wealth and capital and Valais on motor vehicle. Cantons with maximum indices are: Jura on income, Valais on wealth, Neuchâtel on profit, Glaris on capital and Berne on motor vehicles. Valais has the highest fiscal burden on wealth and the lowest on motor vehicles. This seems to indicate that the Cantons have definitely different ideas, first, on the relative tax burden within each tax source that can be asked from their own taxpayer compared to the average taxpayer across the Cantons and, second, on the relative burden of taxation which can be asked from each revenue source. There is no nation-wide concept of uniformity of individual tax burden, as in the case of Germany for example.
6. EQUALIZATION

The differences in the Cantons in terms of size, geography, population and economic potential are so great that, without equalisation measures, fiscal federalism would perform under regional disparities which would be intolerable. Therefore, the federal government intervenes to correct the primary distribution of resources between the Cantons with three main policy measures: fiscal equalisation, agricultural aid policy and assistance to mountain areas, with the purpose of strengthening structurally weak regions. It is necessary, at this point, to stress the fact that, in Switzerland, there are no constitutional provisions and no claims from the cantonal governments or the citizenry that equalisations measures should compensate entirely for the differences between the Cantons in order to obtain identical economic or fiscal conditions. The pragmatic objective is to render regional disparities politically acceptable so that remaining differences do not endanger the cohesion of the Confederation.

According to the 1959 federal law on equalisation, the original objective was to enable the Cantons to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than in others. Equalisation related to policies aimed at correcting fiscal imbalance, whether it resulted from differences in the revenue-raising capacities of the Cantons or because, in some jurisdictions, the relative unit cost of providing some defined levels of services was above the national average. Eventually, the fiscal capacity approach dominated the other question of unit cost, in particular because of the difficulty in defining needs, average versus minimum provision and relative costs, which induced strategic behaviour of recipient governments. As a result, three out of four arguments in the formula for computing the financial capacity of the Cantons (see below) now refer to revenue-raising abilities. From the very beginning, equalisation has excluded differences in cantonal outlays for services other than or above minimum standards and differences in the progressiveness of the tax rate schedules that reflect the concept of income redistribution or the mix between benefit tax and ability-to-pay tax at cantonal level. At the local level, many cantons have introduced inter-communal equalisation, with similar ends and means.

The most direct means for reducing cantonal disparities is through fiscal equalisation measures, i.e. payments from the federal government to the Cantons with the purpose of reducing differences in fiscal capacity. There are, today, in Switzerland, three sets of policies which include equalisation components. But for the last twenty years they have not proved very efficient (DAFFLON, 1995): discussion are presently taking place to reform the whole system.

6.1. Financial capacity of the Cantons

All equalisation programmes have in common the fact that they relate to the financial capacity of the Cantons. The actual formula for computing the financial capacity of the Cantons has four components (table 10):

a) the NIC (National Income in the individual Cantons) per capita (column 2), as a measure of each canton’s financial resources. This component is weighted 1.5 times in the computation of the total index;

b) the inverse of the tax burden of the Cantons and the communes (column 3), as described

20 However, BLÖCHLIGER and FREY (1993, p. 231) note that there is no overall co-ordination of regional equalisation measures, and there are also a number of measures with indirect redistributive effects which exacerbate regional disparities. For example, though central government procurement is not intended to be redistributive in nature, it benefits mainly industrialised Cantons with already higher-than-average NIC (JEANRENAUD, 1985).

21 Other regional measures, mostly in the form of conditional grants, address either to individual or private firms within delimited regions or to the regions for themselves or for the communes within their jurisdiction. Regions do not necessarily coincide with cantonal frontiers. Usually, the regions group a number of neighbouring communes with some geographic similarities (all the municipalities in a valley, or alongside the same border of a river, for example). Some regions are intercantonal, which creates co-ordination problems when the respective cantonal Constitutions or laws do not contain identical rules. There is no automatic supra-cantonal rules to observe, so that co-operative federalism is negotiated from case to case.
in the previous section;
c) the per capita tax revenues of the Cantons and their communes, from different tax sources, weighted by the indices of tax burden in order to obtain comparable values (column 4). This component is also weighted 1.5 times in the total index;
d) an approximation of the Cantons’ expenditure requirements, taking into account the population density and the relative importance of each canton’s agricultural surfaces in the mountain and in the plain (column 5).

The average value of each component, for the 26 Cantons, is given the value of 100 points; all indices are proportionally calculated. The total index for each Canton is the weighted average (column 6), proportionally corrected in such a way that the lowest single index is given the value of 30 points (column 7). The cantons with more that 120 points are considered as having a high financial capacity; the cantons with 60 points and less a low financial capacity. The medium-capacity cantons stand between 61 and 119 points. With this formula, the min/max ratio is 6.877.6 points in 1998/99, from the Canton Jura with 30 points to the Canton Zoug with 206 points. The formula results in a relative expansion of the financial capacity scale in which the Cantons are positioned comparatively to their relative place with regard to per capita NIC (column 2), where the min/max ratio is 2.5 points between Zoug and Appenzell Rh.-Int. In consequence, the equalising effects of equalisation payments are reinforced.

6.2. Federal equalisation programmes

Three sets of federal equalisation programmes have been developed since 1959 for the benefit of the Cantons: (1) conditional federal grants-in-aid to the Cantons, (2) revenue-sharing of certain federal tax revenues, and (3) contributions of the Cantons to certain federal social security expenditures.22

6.2.1. Conditional (specific) federal grants-in-aid

Many items of cantonal expenditures benefit from federal specific grants. For most aided functions, the rate of grants has two components:

- a basic rate, $S_{i}^j \text{min}$ in the following formula, which may be said to represent the federal interest in minimum standard requirements for cantonal public services and which varies according to incentive or some other technical criteria (economies of scale, spillovers, congestion costs);
- an equalisation supplement, the second part [...] of the formula, inversely related to the index of financial capacity of the recipient canton.

This type of fiscal equalisation is mainly vertical, from federal to lower levels of government. It is regulated by many special law. The general grant formula for most granted functions is:

$$S_{i}^j = S_{i}^j \text{min} + \left[\frac{(120-E_i) \times \left(S_{i}^j \text{max} - S_{i}^j \text{min}\right)}{60} \times (S_{i}^j \text{max} - S_{i}^j \text{min})\right]$$

where

- $S$ = rate of grant
- $j$ = aided function
- $i$ = Canton $i = 1...26$
- $E$ = index of financial capacity
- $\text{max}$ = maximal rate of grant
- $\text{min}$ = minimal rate of grant
- $E_i = 120 \text{ for } E_i \geq 120$
- $E_i = 60 \text{ for } 30 \leq E_i \leq 60$

---

22 Intercantonal equalisation also exists, principally as contributions for regional spillovers. One example is the contributions of the Cantons without universities to the cantons with universities, in the form of a fix annual sum per student. At the local level, many systems of revenue sharing and grants-in-aid function between the Cantons (not all) and their communes. A number of Cantons have also developed horizontal equalisation mechanisms in which the fiscally strong communes provide direct support for the fiscally weak municipalities.
Example:
Consider a the basic rate of grant of 30% for a function "j" and a maximum rate of 45%. This means that a canton with a lower-than-high financial capacity would be entitled to receive an additional part of the 15% to the basic rate for equalising its position. The exact additional rate of grant is proportional to the difference between the two rates, here 15%, weighted by the relative position of the cantonal index of financial capacity between 120 and 60 points. A canton with 100 points would receive \((120-100)\times 15 = 5\%\) in addition to the basic rate of 30%, in all 35% of the recognised expenditure for the particular project in function "j". For \(E_i = 120\), the rate of grant is \(S_{\text{min}}\); for \(E_i = 60\), the rate of grant is \(S_{\text{max}}\).

6.2.2. Revenue sharing

The share of the Cantons in the federal government's tax revenue derives from several sources, but three revenue sharing programmes only have equalisation components: for the federal direct tax (FDT), the withholding tax (WT) and part of federal customs duties on petrol and motor fuel (DC). Historically, revenue sharing was generally implemented in order to compensate for fiscal imbalance when a cantonal revenue source was centralized (Customs, alcohol monopoly, coinage, stamp duties) or partly shared with the centre (direct and withholding taxation). With time, the main revenue sharing programmes have been connected with equalisation repayments.

- The Cantons receive 30 per cent of the federal direct tax IFD (income, corporate profits and capital). 17 per cent is allocated on the basis of origin, defined as the residence of the taxpayers, and 13 per cent according to financial capacity. The repartition take the form of an exponential formula

\[
P_{i}^{\text{IFD}} = 0,17 \cdot \text{IFD}_i + [2.71828^{-0.0192104} \times E_i \times \frac{H_i}{1000} \times 0,13 \cdot \text{IFD}_x]_i
\]

where \(P\) stand for the revenue sharing part of canton "i", with the number of population serving as a multiplicand.23

- They also receive 10 per cent of the withholding tax IA, net of collection costs: 5 per cent is allocated according to population, and 5 per cent is reserved to the cantons with indices of capacity \(E_i < 100\). The formula takes the forms \([100 - E_i]\) and \([100 - E_i]^2\), the number of population serving as a multiplicand:

\[
P_{i}^{\text{IA}} = 0,10 \cdot \text{IA}_i \times \left[ \frac{H_i}{2 \cdot H_i} + \frac{1}{4} \left( \sum H_i \times [100 - E_i] + H_i \times [100 - E_i]^2 \right) \right]
\]

- The federal government reimburses to the Cantons part of its revenue from customs duties and excises on petrol and motor fuel DC. Half of the receipts from the "normal" duties and the total so-called "supplementary" duties are exclusively attributed to road expenditures. 12 per cent out of this amount is reimbursed to the Cantons: as general payments for 93/100th and for international Alpine roads for 7/100th. Out of the 93/100th, 42/100th is allocated to equalisation, for the cantons with indices of capacity \(E_i < 100\). The formula takes the form \([(100 - E_i)^{1.4}\) with total cantonal expenditures on roads \(G\) serving as a multiplicand.

\[
P_{i}^{\text{DC}} = DC \times 0,93 \times 0,42 \times \left[ \frac{G_i \times (100 - E_i)^{1.4}}{\sum G_i \times (100 - E_i)^{1.4}} \right]
\]

6.2.3. Cantonal contributions to social security

The third category of transfer payments which include equalising components concerns the Cantons' contributions to three federal social security programmes: the old-age and survivors insurance (AVS), the disabled pension scheme (AI) and family allowance in agriculture (AFA). Total payments of the public sector are:

<table>
<thead>
<tr>
<th>programme</th>
<th>participation of the public sector</th>
<th>federal</th>
<th>cantonal</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVS</td>
<td>20 % of total expenditures</td>
<td>17 %</td>
<td>3 %</td>
</tr>
<tr>
<td>AI</td>
<td>50 % of total expenditures</td>
<td>37.5 %</td>
<td>12.5 %</td>
</tr>
<tr>
<td>AFA</td>
<td>total annual deficit</td>
<td>2/3 rd</td>
<td>1/3 rd</td>
</tr>
</tbody>
</table>

- For the AVS and AI, the formula for the cantonal payment CONT is based on the total amount of pensions paid AVS in a canton "i" weighted by the financial capacity of the canton in the form \[\frac{5}{7} (E_i - 100) + 100\].

\[
\text{CONT}^{AVS}_i = 0.03 \sum_i \text{AVS}_i \times \frac{\text{AVS}_i \times \left(\frac{5}{7} (E_i - 100) + 100\right)}{\sum_i \text{AVS}_i \times \left(\frac{5}{7} (E_i - 100) + 100\right)}
\]

- For the family allowance in agriculture, the cantons with a FDT per capita lower that 4/5th of the national average benefit from a reduction in their contribution proportional to the difference between this average and their own score \[\text{FDT}_i / \text{Hi}\].

6.3. Importance of the transfer payments

The importance of the three equalisation programmes is shown for 1998 in table 11. Payments from the federal government to the cantons were 8 591 millions SFr. or 18 per cent of total federal expenditures. This amount corresponded to 15 per cent of total public resources of the Cantons, or 6 per cent for specific grants, 9 per cent for revenue sharing. Cantonal contributions to the three mentioned programmes of federal social security expenditures amounted to 1 841 millions SFr. or 3 per cent of the Cantons' total expenditures. However, only parts of the payments include equalisation, also given in table 11. On the whole, they represent 2 937 millions SFr. or 34 per cent of total transfer payments from the federal government to the cantons and 147 millions SFr. or 8 per cent of total cantonal contributions to federal social security expenditures. For the 26 Cantons, the net equalising part amounts to 6 750 millions SFr. and corresponds to 12 per cent of total cantonal revenues.

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24 Financial transfers between the Confederation and the cantons in the domain of Social Security are rather complex and include several programmes, top-down or bottom-up, with or without equalising components. On this, see DAFFLON, 1999.
7. CONCLUSION

In conclusion, we may summarise the main features of public finance in Switzerland in the following points:

a) Total public expenditure without social security represented 32 per cent of GNP in 1997, without social security, which is moderate in comparison to other European countries.

b) Responsibility is shared between the three levels of government in almost all fields of public intervention, with the result that the budgets of the three levels of government are becoming increasingly entangled. However, the principle of subsidiarity is a strong guideline for the assignment of functions in the fiscal hierarchy, as the example of education expenditures shows. But creeping centralisation intervenes more and more in changing the "choice" role of sub-central jurisdictions in an "agency" role. At the local level, more populous municipalities are in a better position for resisting to this change.

c) The main revenue sources of the public sector are direct taxation on individual income and wealth and on corporate profits and capital, then expenditure taxes and user charges. But the respective proportions of these receipts vary for the three levels of government.

d) Cantons and communes have low dependence on transfer payments. 77 per cent of the Cantons' revenues and 84 per cent of the communes' revenues are own revenues. These figures contrast with a higher degree of centralisation in public expenditures.

e) Fiscal sovereignty belongs to the Confederation and the Cantons. Yet, its exercise is tempered by inter-jurisdictional competition and the mobility of taxable units, and limited by co-ordination and harmonisation practices and law. The communes have no authority over taxation, but have full fiscal flexibility.

f) Budget responsibility is required at the three levels of government. It means that current budgets should be balanced, borrowing can only finance investments and that only limited transfer payments are available. This is a classical approach to public finance. In addition, direct access to many revenue sources is essential.

g) In addition to cantonal disparities in economic potentials, the use of non-benefit taxation by decentralised levels of government, different cantonal ideas on tax equity and a fairly large amount of autonomy to decide and offer public services result in large differences in the fiscal burden of individuals in the Cantons as shown by the indices of cantonal fiscal burdens for various tax revenues.

h) Equalisation schemes intervene in order to compensate partly differences in the revenue-raising capacities of the Cantons. But the amounts of transfer payments to the cantons remain modest owing to the objectives of budget responsibility and financial autonomy of the various jurisdictions. There is no claim to obtain identical economic and fiscal conditions across cantonal and communal jurisdictions.

The Swiss experience introduces pragmatism in fiscal federalism. Financial and budgetary autonomy of decentralised governments permits them to engage in specific public policies, alone or in many forms of horizontal and vertical co-operation. Comparison and competition between the individual jurisdictions ensure that only those policies which are in the long term accepted by the population can be carried through. The correct solution is not declared ex ante as binding, but emerges ex post after a selection procedure, which, like a process of trial and error, has compared the various approaches with one another. This selection procedure means that policies in the most diverse areas can be continually reviewed, without it being necessary to specify in advance the right solution - which no one knows anyway (BLÖCHLIGER and FREY, 1993, p. 237). In this procedure, the elements of direct democracy and constitutional economics play a crucial role: constitutional guarantee in the vertical division of power, initiative and referendum, the principle of subsidiarity, fiscal sovereignty, access to many revenue sources, and a low dependence on (equalising) transfer payments are the indispensable ingredients of fiscal federalism.
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