



Financing cantons' expenditure: how does fiscal equalisation work ?

El model de finançament dels cantons de Suïssa:
característiques generals i anivellament fiscal

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Comunitats autònomes: finançament,
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1. Key facts

Three layers of government

- 2,700 municipalities (local level)
- 26 cantons (States), regional level
- The Confederation, the federal or central level

High degree of fiscal federalism/highly decentralised country

- Decentralising taxing power
- Decentralised spending
- In contrast to other European countries where we have a system of centralised financing with decentralised spending



Symmetric federalism

- Same responsibilities and taxing power for all cantons whether large or small ; same responsibilities for all municipalities within a canton
- Highly fragmented structure (26 cantons, 2700 municipalities)
- Large differences in size
- System cannot work without extensive horizontal cooperation
 - Many horizontal agreements between cantons (convention for the use of a facility located in another canton or for the funding of a common facility)
 - Numerous horizontal cooperation agreements between municipalities
- Extensive autonomy of cantons, degree of autonomy of municipalities varying from canton to canton



2. *Tax assignment*

Key feature

- Decentralised financing: extensive revenue-raising power is devolved to cantons and municipalities
- The primary taxation power is held by the cantons
- The Confederation derives its power to levy taxes from the constitution (a constitutional provision is required)



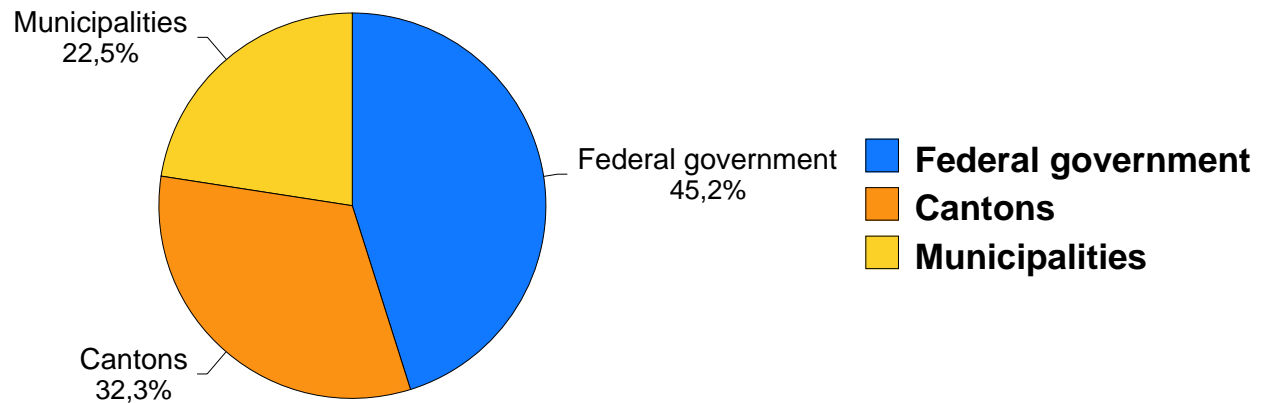
Taxes levied at the three government levels

Taxes on income and wealth	Taxes on goods and services
Federal government	
Individual income tax Corporation income tax (tax on net profit) Withholding tax	VAT Stamp duties “Sin taxes” (tobacco, alcohol) Mineral oil tax Motor vehicle tax Custom duties
Cantons (26)	
Individual taxes (income and wealth) Corporation taxes (income and capital) Inheritance tax (Limited) capital gain taxes Real estate tax Property transfer tax	Motor vehicle tax Entertainment taxes Tax on hydraulic power stations
Municipalities (2700)	
Individual taxes (income and wealth) Corporation income tax (tax on net profit) Inheritance tax (Limited) capital gain taxes Real estate tax Property transfer tax	Entertainment taxes



Structure of tax revenues

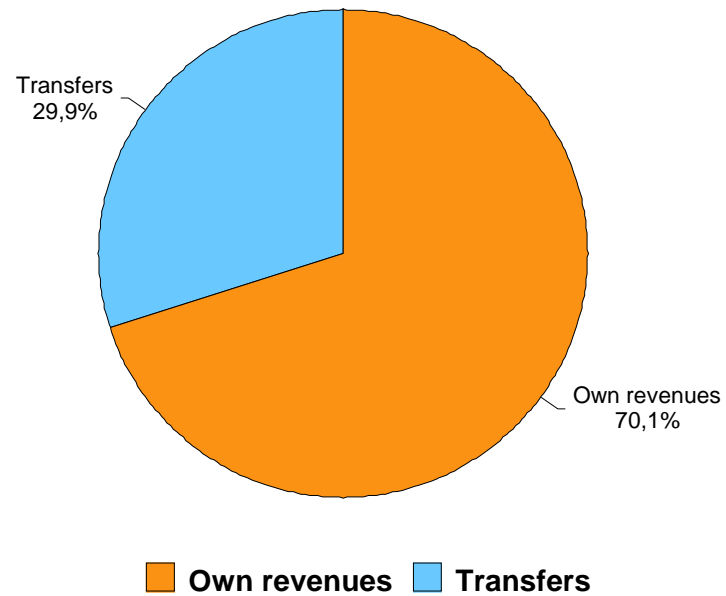
Tax revenues at the three government levels





Structure of revenues

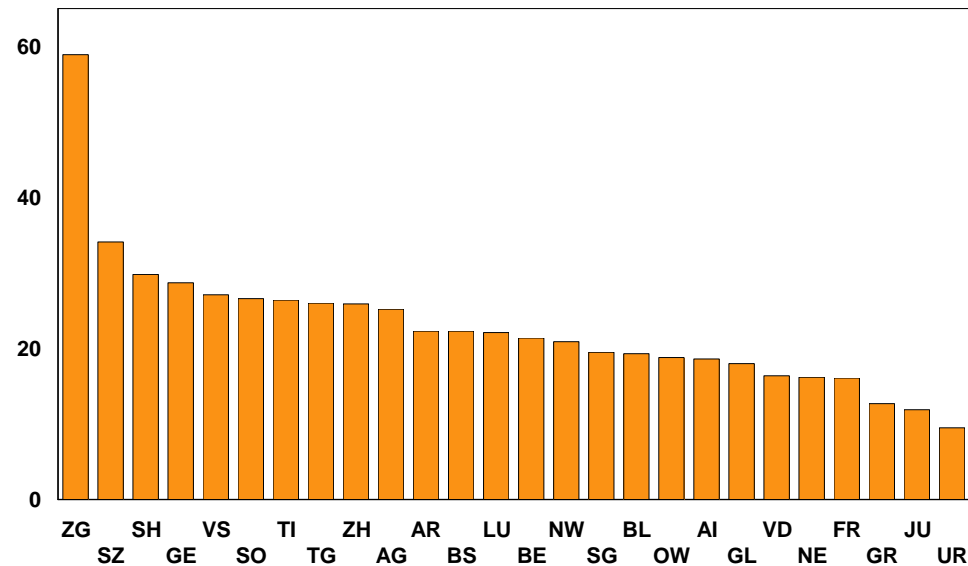
Origin of cantons' revenues





Financing cantons' expenditure: origin of the resources

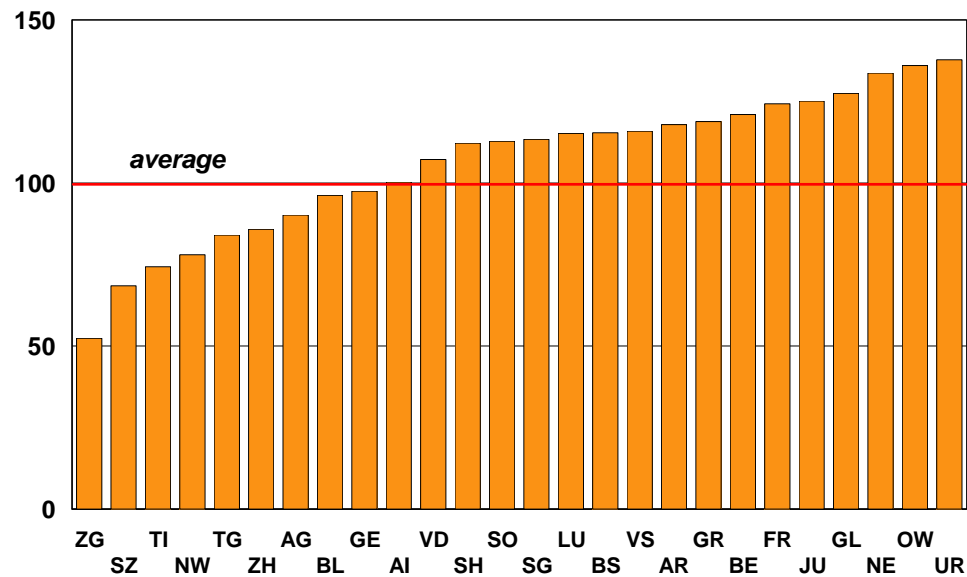
Unconditional transfers as a percentage of total transfers





Variability of tax burden across cantons

Overall tax burden index





Tax competition

- Cantons are competing for good taxpayers (individuals and corporations)
- Tax burden (corporate tax but also individual income tax) influences firms' choice of location
- Several cantons have reduced their tax burden in recent years
- One canton had introduced a regressive income tax to attract high income tax payers (Supreme court recently ruled this tax as unconstitutional)



3. *Present equalisation scheme*

Federal revenue sharing and equalisation transfers are based on the “financial capacity” of the cantons

Aim of the equalisation programme

- To reduce financial inequalities between cantons
- No quantitative objective
- Not possible to decide if the programme will succeed or fail

Instruments

- Transfers from the Federal Government to the cantons are linked to the financial capacity of the recipients
- Cantons' contribution to three federal programmes (social security) linked to their financial capacity
- Revenue sharing : arrangement based on cantons financial capacity



The key parameter of the system is the way to measure financial capacity of the cantons

- Formula is the result of a bargaining and lobbying process
- The economic foundations of the instruments are weak (not evidence-based)
- It is unclear what the index really measures



Index of fiscal capacity

- Fiscal capacity does not only depends on cantons' tax resources
- Needs influence the tax burden (parameters are not independent)

$$\text{Financial capacity} = \text{financial resources} * \frac{1}{\text{financial needs}} * \frac{1}{\text{tax burden}}$$

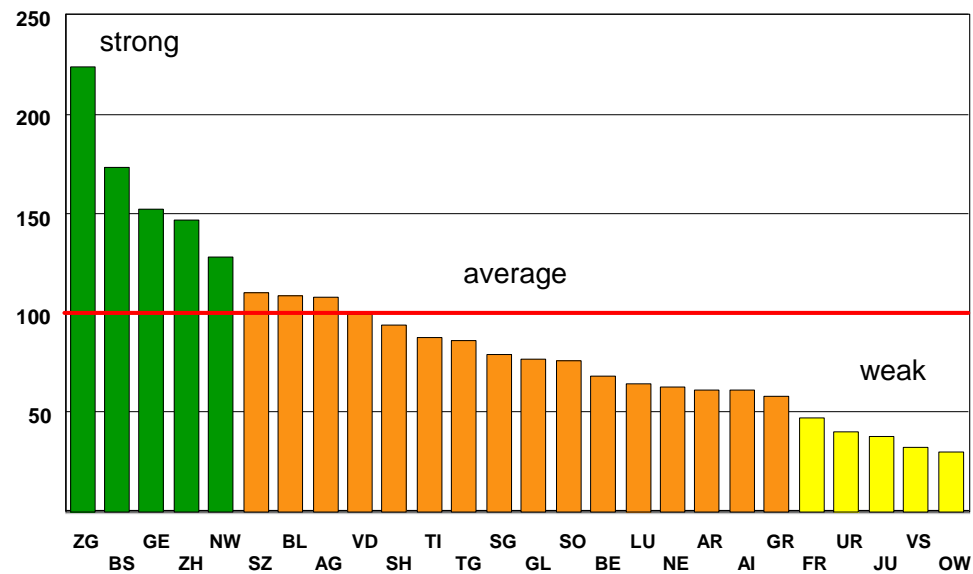
- Average financial capacity is 100
 - Index < 60 weak canton
 - Index > 120 strong canton



- Fiscal capacity is a mix between the “national income” of the cantons and the standardised tax revenue of both the cantons and the municipalities
- Tax burden : it is a comprehensive index for all taxes levied by the cantons and the municipalities
- Financial needs : based on 1) population density and 2) the proportion of agricultural land located in the mountains (above 800 m)
 - Is density positively or negatively related to expenditure (or is the relation U-curved)? No one knows, and no one cares.
 - Expenditure for agriculture accounts for 4.4% of total (cantons’) expenditure and only a small part is associated with topography: this factor is nonsense, but nobody cares.



Financial capacity index (present system)





Comments

- The “needs” variable is not evidenced-base
- Differences in tax burden are largely explained by expenditure policy
- Per capita expenditure vary largely across cantons :
 - What is due to expenditure policy (variable under control of authorities)
 - What is due to external conditions (not under control of authorities)
- If needs assessment, it should be evidenced-based
- Needs and tax burden are not independent : a canton with higher needs also has a higher tax burden
- The cost of reducing taxes is high : the canton loses some of its tax revenues and receives less grants from the Federal Government
- Inefficiency is rewarded : more expenditure, more grants



Revenue sharing

- Two federal taxes : Federal direct tax (individuals and corporations) and withholding tax
- Profit of the National Bank
- Financial capacity is an equalisation parameter in the formula

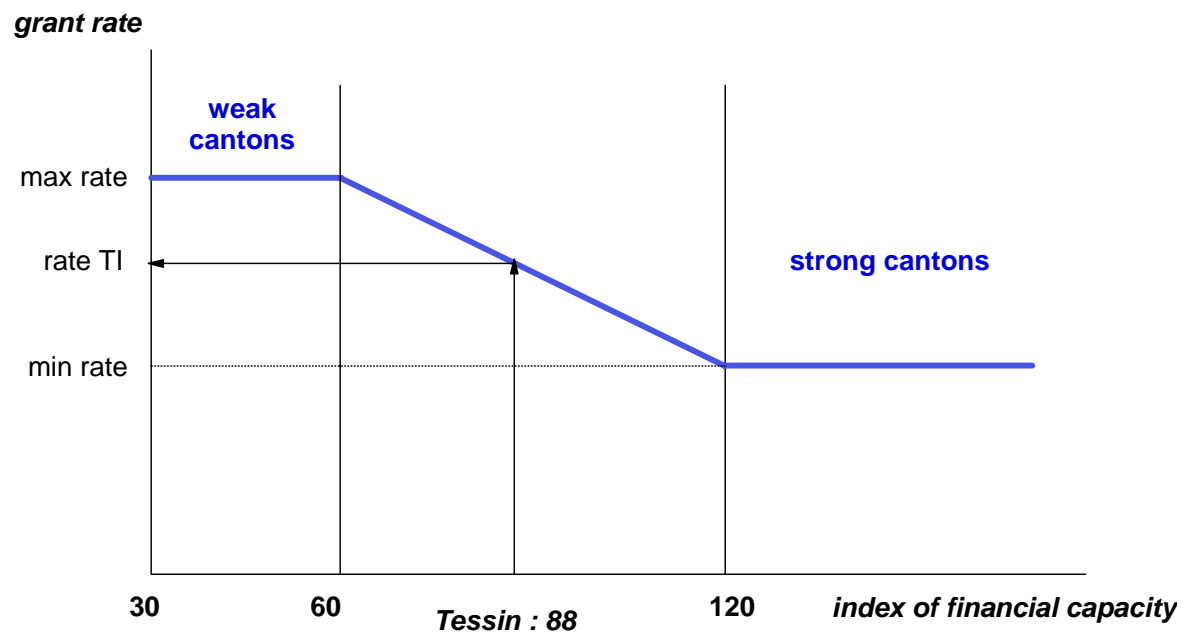


Equalisation supplement in the grant-in-aid supplement

- The grants are given as a percentage of the total expenditure (with matching requirement)
- Each grant has its own formula (often only one person in the country knows how to calculate the grant)
- Grant rate varies according to the financial capacity of the recipient
 - Minimum rate for strong cantons (index > 120)
 - Maximum rate for weak cantons (index < 60)
 - Rate between the minimum and the maximum rate for cantons with fiscal capacity between 60 and 120 (linear or exponential interpolation)



Resources equalisation scheme





4. Shortcoming of the present arrangement

Design of the equalisation system

- Weak and somewhat unpredictable equalisation effect
- Weak cantons cannot afford to pay their own contribution
- High risk of fiscal illusion (grant rate up to 90%)
- Design of intergovernmental transfer provides little incentive to contain demand for services and costs
- Financial capacity index
- Reducing tax burden in the cantons means less money from the centre

Neuchâtel a relatively weak canton spends CHF 16,400 per capita (canton and municipalities);

Zurich a strong canton spends CHF 14,600 per capita;

Through the equalisation system, Zurich is financing part of the spending of Neuchâtel. It sounds too good to be true.



Expenditure assignment

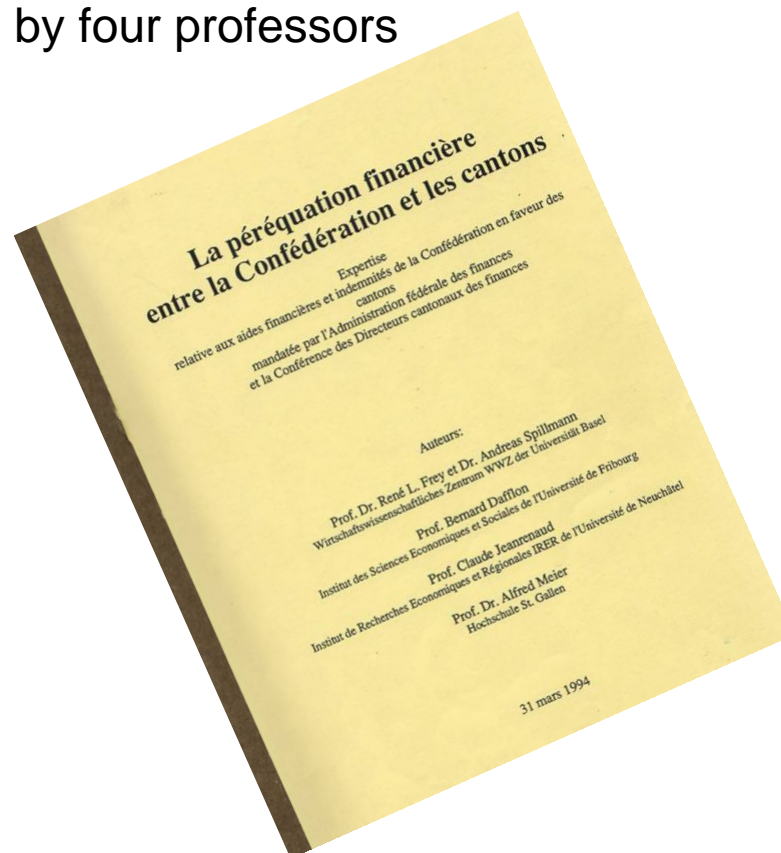
- Autonomy of the cantons is eroding (often, cantons simply implement a policy decided by the central government)
- Too many shared responsibilities (i.e.: dilution of responsibilities)
- Too many subsidies (i.e.: less autonomy for sub-central government)
- Grant rate often too high (as high as 90%): a source of inefficiency
- Spillovers and free riding
 - Small cantons (some with low tax rate) benefit from the services and the facilities provided by large cantons



5. New fiscal equalisation scheme (2008)

A will to change the design of the intergovernmental transfer system (1994)

- Finance ministers (Federal and cantons) have funded a study conducted by four professors

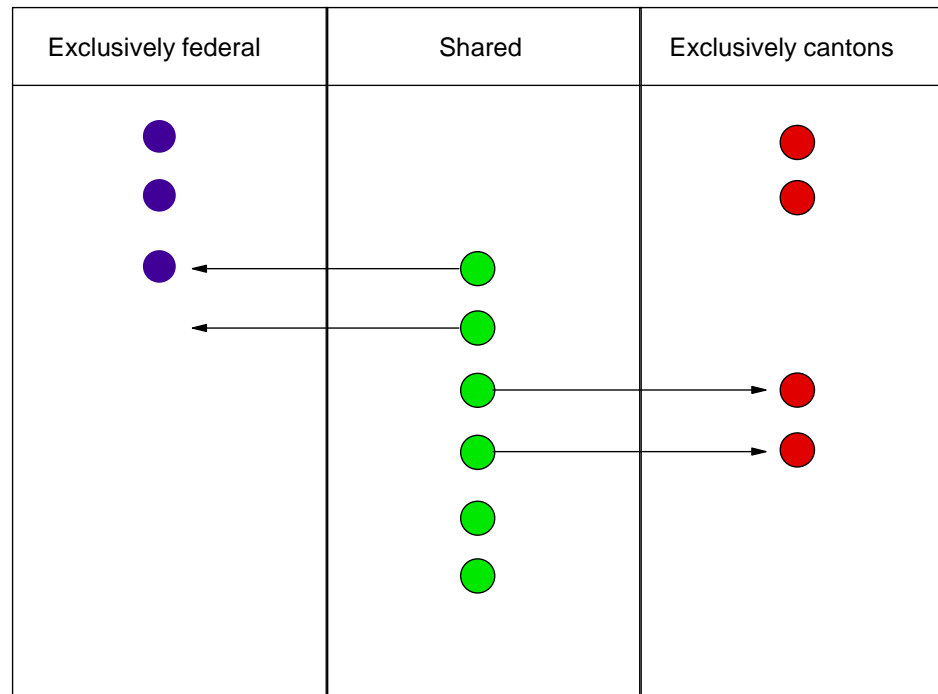




From “marble cake” to “layer cake”

- A new division of fiscal responsibilities
- More exclusive responsibilities, less shared fiscal tasks
- I.e.: less conditional (earmarked) federal transfers

Disentangling responsibilities





- About 30 shared tasks are reassigned
 - 7 shared tasks will become exclusive federal tasks
 - 10 shared tasks will become exclusive cantonal tasks
 - 16 tasks remains as shared responsibilities
- New exclusive federal task : national highways (construction and maintenance)
- New exclusive cantonal task : scholarships (primary and secondary education) [grant-in-aid from the centre will disappear]
- Shared tasks : new grant design, new ways of sharing responsibilities
 - Block grants (for a programme) instead of numerous grants for very specific tasks [**more freedom for the cantons**]
 - Grants linked to the achievement of a specified objective (not to the amount spent) [**market-based instrument, more efficiency**]



- Shared tasks : strategic/operational approach:
 - Federal Government : strategic level (strategic goals and planning)
 - Cantons: operational level (free to choose the ways and means to achieve the goals)
- A move in the direction of contract federalism :
 - The beneficiary accepts certain obligations in exchange for grant entitlement
 - It is not a formal contract (no judicial sanctions, no clause allowing parties to breach the contracts)
 - One pilot project : forestry (shared responsibility between Federal Government and cantons)
 - Federal Government defines the strategy and the objectives for each product
 - “Protection forest” is one example of a product
 - Grants based on results (not on spending)
 - Grant design: grant based on the work done by the cantons (unit of output)
 - Cantons: submit implementation programmes to the Federal Government
 - Agreement on the programme – a kind of contract between the Federal Government and the canton – and decision on the federal funding



Incentives for horizontal cooperation

- Anti free riding measures
- Cantons can be forced to participate in an intercantonal convention or agreement (**forced-riding**)



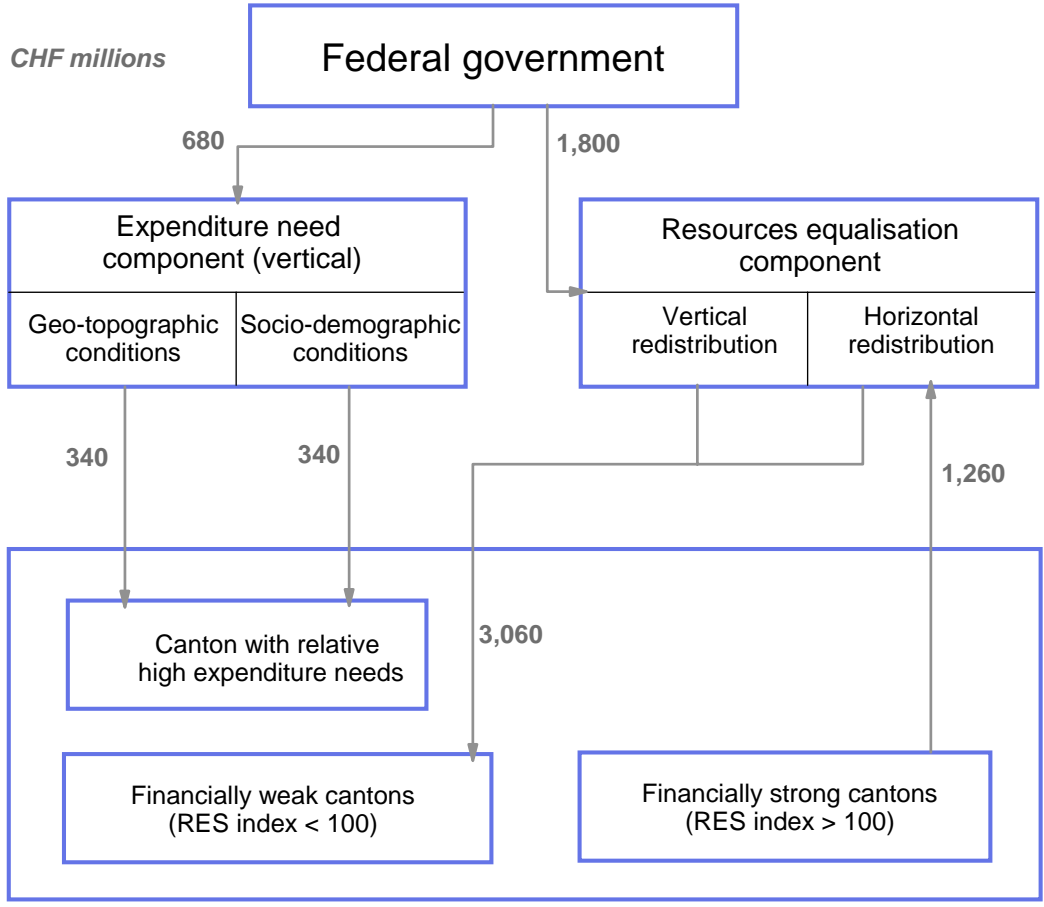
New equalisation scheme

Overview

- More general grants : the beneficiary is not required to use them for a particular project or programme
- Less specific grants: only for the programme for which the responsibilities are shared between and Federal Government
- General grants related to the financial capacity of the beneficiary (index of tax resources)
- Specific (block) grants not related to financial capacity of the beneficiary



Overview of the equalisation scheme

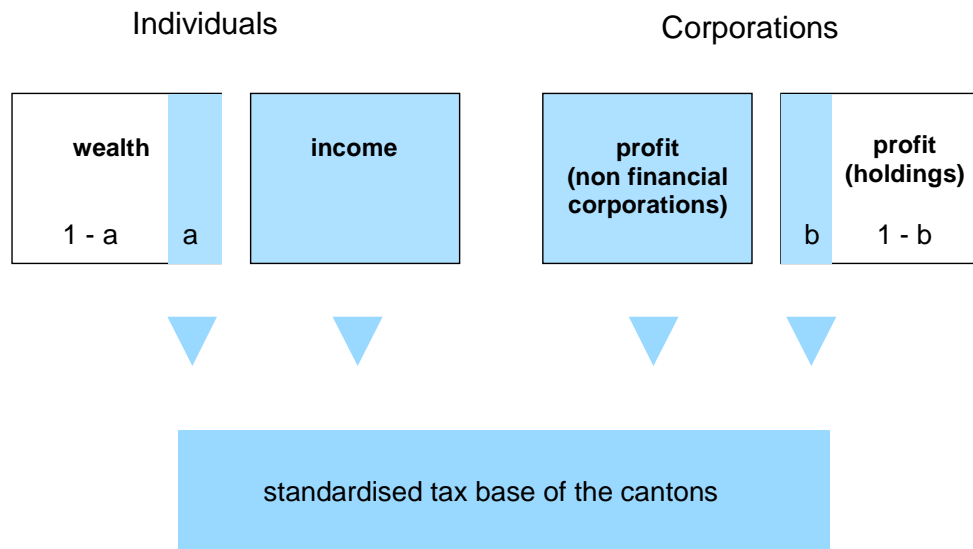




Resources equalisation

(about $\frac{3}{4}$ of total redistribution effort, 72.5%)

Cantons standard tax base assessment



$a < 1$: return on wealth (without dividend and interest)

$b < 1$: correction factor as holding are taxed at a lower rate



- Index of the tax base of the cantons (100=average for the 26 cantons)
- Does not reflect the amount of taxes per capita which could be raised using a common tax schedule (standardised tax revenues)



hypothesis : taxes are proportional

- Resources index : consolidated tax base of the canton per capita divided by the consolidated tax base per capital for all cantons (based on federal tax)
- Three direct taxes levied by the cantons : individual income tax (minus zero-bracket amount), individual wealth tax (wealth increase only), corporate profit tax



■ Resource index formula

$$CTB = \frac{I + a \cdot W + (P - PF) + (Phold * b)}{\text{Population}}$$

- CTB* : consolidated tax bas
I : taxable income (individual income tax)
W : taxable wealth (individual wealth tax)
a : coefficient representing the expected capital gain on wealth
P : corporate profit tax
PF : profit derived from participations
Phold : profit from holding corporations
b : coefficient whose purpose is to take the special fiscal treatment of holding corporations



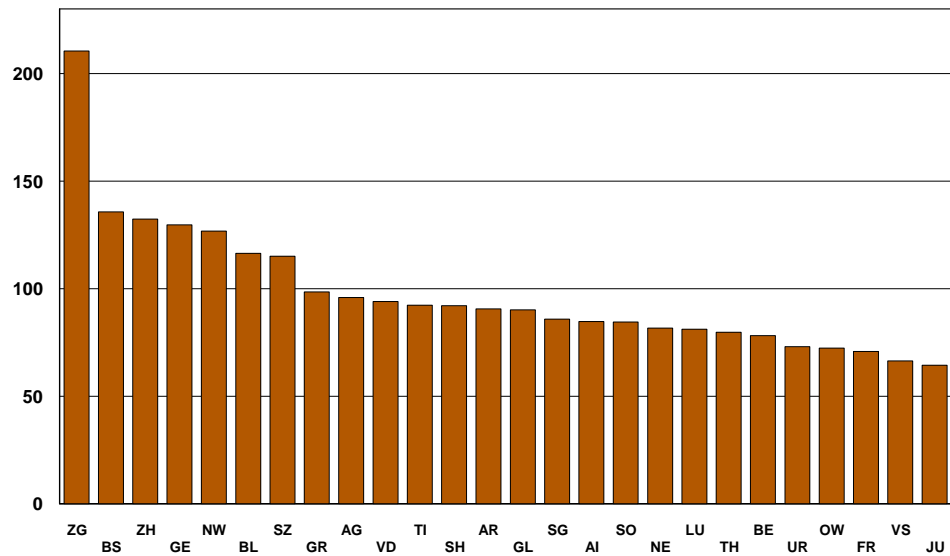
Comments

- Implicit hypothesis : tax rate is constant (proportional tax)
- Fiscal resources index cannot be manipulated by the cantons (really?)
- No standardised tax schedule used
- Reflects the inequalities of the resources across cantons, but not the revenue-raising potential



Resources index of the cantons

Resource index (new equalisation system)



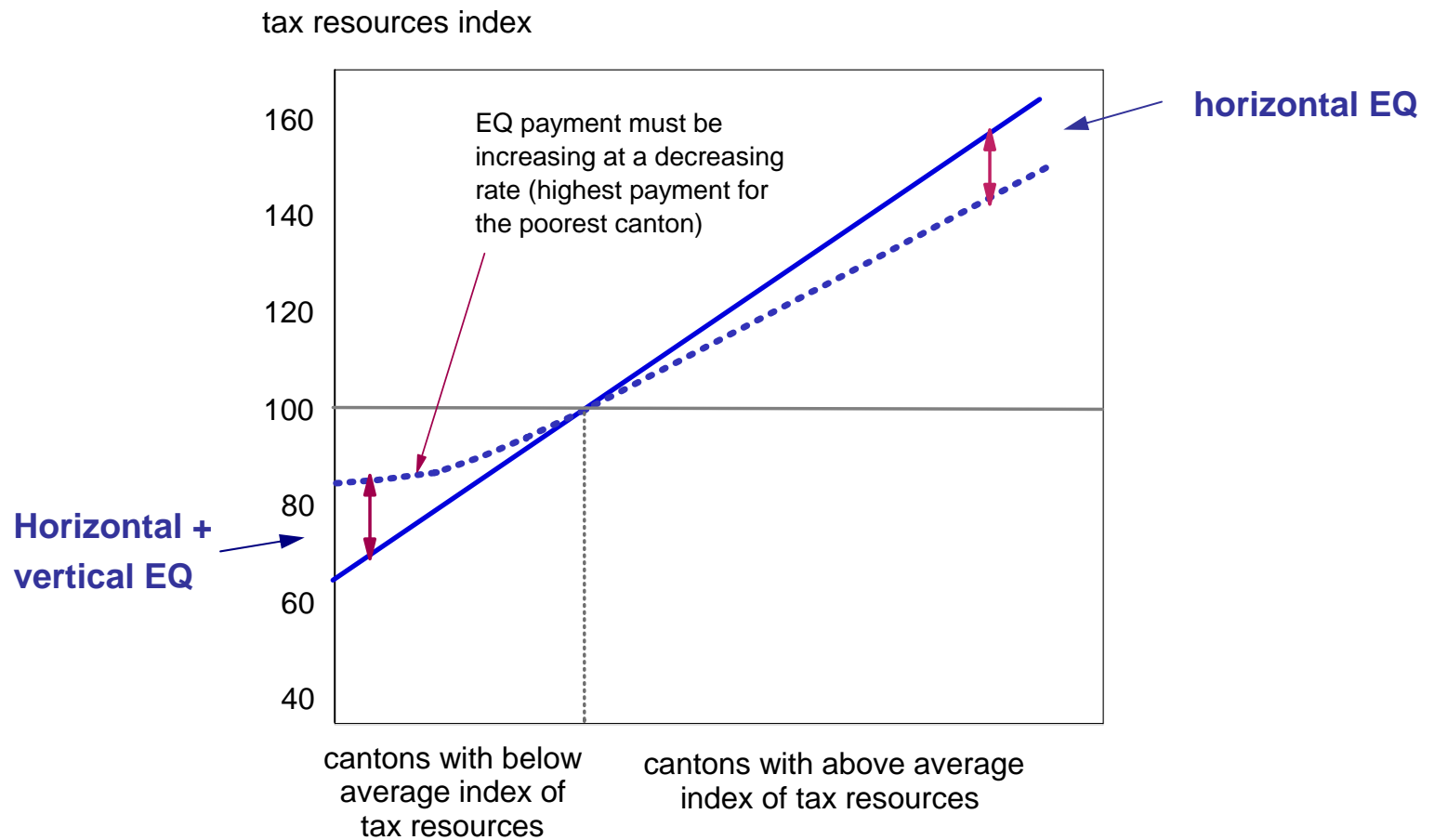


How does resources equalisation works?

- Each canton should reach a minimal index of resources of 85 points
- To achieve this goal, 3.2 billions (value for 2006) must be devoted to redistribution
- The redistribution is both vertical (Confederation to weak cantons) and horizontal (from rich cantons [index above 100] to below average cantons [index below 100])
- The gap is filled with transfers from the centre (1.8 billion) and from the cantons with above average index of resources (0.7 billion)
- Cantons with an index below 100 receive an equalisation transfer
- Cantons with an index above 100 contributes to the equalisation fund



Resources equalisation scheme





Compensation for higher needs

(about one quarter of the total redistribution effort, 27.5%)

- Funded by the Federal Government
- Needs assessment : normative approach, not based on empirical evidence

“There is no scientific objective way of saying which factors justify which level of expenditure and at the end it is a matter of political Judgement” (UK Treasury Committee on the Barnett formula).



- Geo-topographic conditions
 - Altitude
 - Population density
 - Settlement structure (dispersed, concentrated)
 - Topographic characteristics (declivity variation)
- Socio-demographic characteristics of the population
 - Population structure (2/3) [**client group method**]
 - Aging, prevalence of poverty, integration of foreign born population
 - Urban centres (1/3)



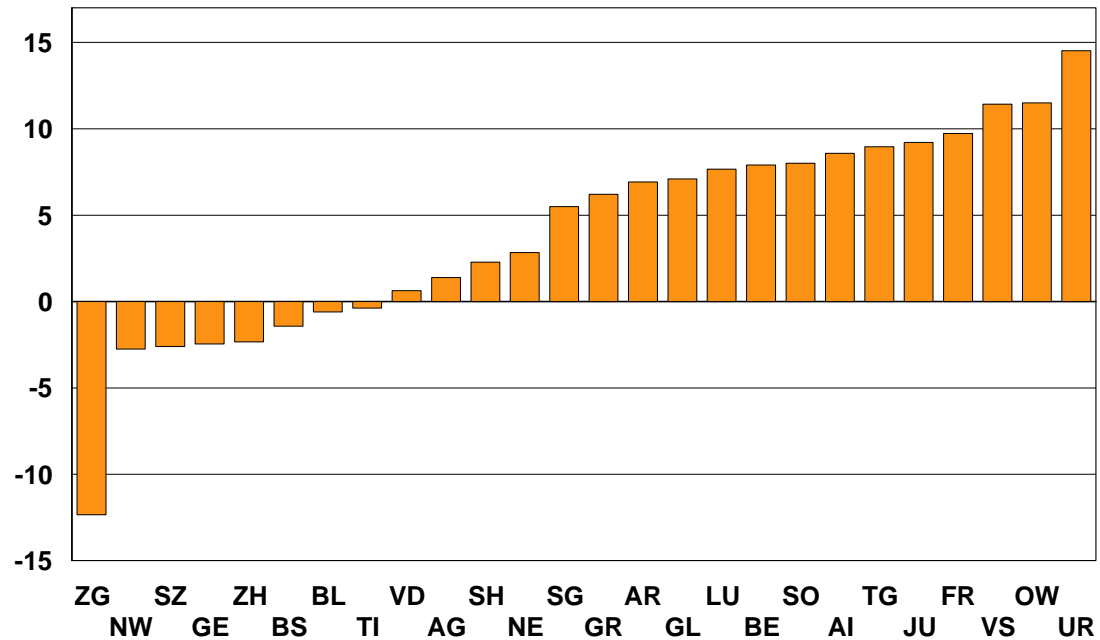
Transition between the present and the new system

- The new system must be beneficial or neutral for the weak cantons
- No political success if there are too many losers
- Weak cantons will receive a compensation if they receive less with the new system
- These compensation transfers will gradually disappear (after 24 years)



Impact of new equalisation system

Equalisation transfers and needs compensation,
% of total expenditure





6. Discussion