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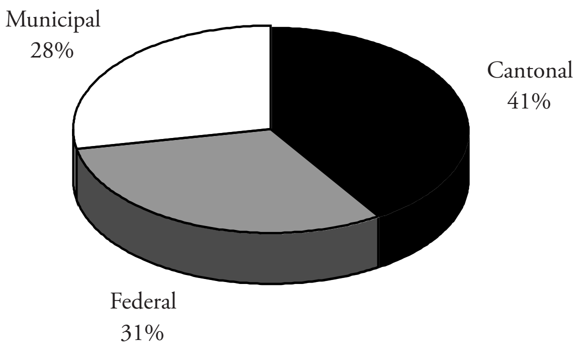
Tax Competition: The Swiss Case

1. Introduction

Originally a voluntary confederation of territories seeking freedom from neighboring kingdoms and empires throughout the centuries, Switzerland is still made up of 26 sovereign states, each with its own tax system, in addition to the central government. Although such heterogeneity might seem exotic at first glance in a country of 7.4 million residents, Switzerland has remained one of the richest countries in Europe since the late 19th century. Today it enjoys the greatest accumulated wealth per capita in the world, and unemployment, at around 2.5 per cent, is low. In 2006 Switzerland ranked first in the World Economic Forum's Global Competitiveness Report.

As is the case for most small countries, Switzerland's leading position can be explained by a long-standing openness toward global trade and investment, whereby substantial revenues are repatriated from abroad. (Significantly, Swiss companies employ over 2 million people abroad, which is more than half of Switzerland's domestic working population of 3.6 million; Swiss National Bank, 2006.) But some of the features of the Swiss system—in particular institutional diversity and the ensuing tax competition—also play some

Figure 1:
Significance of the Three Levels og Government
(% of tax revenues) 2006



part in enhancing prosperity, in particular by providing taxpayers with more choice and better protection of their property rights.

2. Swiss Fiscal Federalism

Swiss fiscal federalism is the opposite of what federalism implies in many other countries. Political authority is built from the bottom up. The Swiss federal government derives its legitimacy from the 26 cantons, not the other way round. As a result, the central government only plays a subsidiary role, carrying out limited competencies that account for less than one-third of total taxes and spending.

The 26 cantons enjoy actual tax sovereignty, while the central government can only levy taxes provided for in constitutional provisions, whose legitimacy is derived from a majority of both cantons and voters. Not only does the central government obtain its legitimacy from the cantons, but its power to tax is limited in time. Its ability to levy income taxes and the value-added tax, i.e., 60 per cent of its tax revenues, is regularly reassessed by means of referenda (the last time in 2004) and currently applies until 2020, when a new referendum with a double majority of cantons and voters will be required.

In some instances, even if a majority of voters at the national level supports a particular policy, it may be turned down because majorities in smaller cantons decide the other way. The voice of the smallest canton, Uri, which has 35,000 residents, counts just as much as the voice of the biggest one, Zurich, with 1.3 million residents. Cantonal sovereignty therefore tends to limit the "tyranny of the majority", and protects the rights and freedom of choice of residents in smaller jurisdictions.

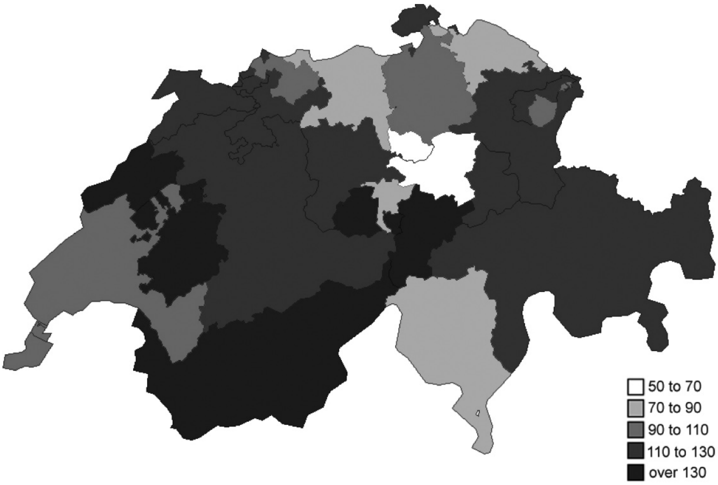
At the local level, approximately 2,800 municipalities also enjoy various degrees of sovereignty according to their canton's constitution. Cantons, including municipalities, play by far the most significant role in the tax system. For the most part spending decisions are made at the level at which taxes are levied; there is little disconnection between tax sovereignty and spending.

3. Tax Competition: Substantial Positive Effects

Cantonal autonomy in tax matters is a well-established principle. It reflects different policy priorities by cantonal governments, different preferences by residents, and the recognition that tax competition plays a positive role in keeping tax rates and public spending in check. In each canton, voters, the parliament, and the government decide on the tax burden and public spending.

Direct democracy by referendum plays a central role in policy making. Between 2004 and 2007 voters approved modest to substantial tax reductions in a period of strengthening economic growth in more than half of all cantons. This will lead to a visible reduction of taxes as a share of GDP in coming years. Pressure for tax increases remains high at the central government level, although it is not clear whether politicians will be able to levy more revenue. In 2004, voters overwhelmingly rejected—by a two-to-one majority—a government proposal to raise value-added tax by 1.8 percentage points.

Figure 2:
Switzerland's tax map: Cantonal Tax Burden Index



Average for the whole of Switzerland = 100; reference year: 2005.
Source: Swiss Federal Department of Finance/Institut Constant de Rebecque

The sometimes purported fear of a "race to the bottom" proves to be unfounded. The central government and the cantons provide high-quality infrastructure, and voters can approve and reject public projects, including the tax revenues necessary to finance them. Tax competition therefore ensures greater diversity, choice, and efficiency. This has been theoretically and empirically substantiated (Feld, Kirchgässner and Schatteggger, 2003; Alesina, 2002). As individuals and businesses choose their location freely, politicians and administrations are forced to offer an attractive combination of public services for the lowest possible tax burden.

Another advantage of small-scale tax competition is that it allows comparisons of government performance. Residents can evaluate policy results in their jurisdiction compared to others. The proximity of political structures also allows greater control, and tax competition increases the quality of political decision-making.

The innovation potential and the experimentation of innovative policy solutions are also rewards inherent to tax competition. Over time, better practices are implemented and emulated, and others abandoned. This mostly happens through a "trial and error" process; it does not follow a plan designed from above. Institutional diversity and competition also mean that progress is not linear. Consequently, differences in tax burdens are often important.

The experience of Swiss cantons and the multitude of mini-States such as Dubai, Hong Kong, Liechtenstein, Monaco or Singapore with less heavy taxation, all among the most prosperous countries in the world, shows that there can be no "economies of scale" in the field of taxation: generally, the closer the decisions of a jurisdiction are taken to the residents and the easier it is for them to potentially move to a jurisdiction close to their current place of residence, the more policies will tend to correspond to the residents' real needs and preferences. Dubai, for instance, one of the most dynamic international economic locations despite its unenviable geographic position, does not apply any tax, but only charges user fees for services provided. Some Swiss cantons have introduced degressive tax scales, whose rates are graduated so that they decrease as the taxed amount increases.

Switzerland's fiscal diversity allows comparing the results of different tax policies between almost identical jurisdictions, for example in the case of the adjacent cantons of Nidwalden and Obwalden. In the former, which pursued one of the most attractive tax policies for many years, GDP per capita is now 44 per cent higher than in the latter, which until 2006 had the highest tax burden in Switzerland and could only survive through central government subsidies. Thanks to a diversity allowing the tax burden to vary that much between two adjacent valleys, Obwalden's mistaken policy was finally recognized as such and its consequences remained limited to a relatively small jurisdiction, whose most productive residents could easily exile. Under fully centralized government, however, it would have been much more difficult, with only international comparison helping, to identify and remedy the effects of a punitive tax policy assorted with subsidies.

As with international indicators, for example the measure of economic freedom or the size of government, the adverse relationship between taxes and prosperity is evident in the case of the Swiss cantons (see next page). High-tax cantons tend to have lower income per capital than low-tax cantons, where more capital is available for productive uses. Of course there are other factors and exceptions reflecting local particularities, such as the extremely productive worldwide pharmaceutical industry in high-tax Basel-City.

4. Limits to Tax Diversity

Cantonal sovereignty in fiscal matters is not without limits, however. In 1977, voters accepted a law harmonizing the tax base. Cantons remain free to set tax rates, deductions, and other rules, and could theoretically implement a zero per cent capital tax, but not formally abolish the capital tax. This has been criticized as an undue limitation on the process of trial and error underlying all institutional innovation (Curzon-Price, 2005).

As in most other federally organized states, including Germany or the United States, Switzerland implements an inter-cantonal transfer program purportedly designed to reduce differences between cantons. In fact, since its start in 1959 this program only exacerbated differences, as cantons on the receiving end made no efforts to improve policies, and in particular to cut taxes, counting on subsidies instead. However, this situation recently improved following a 2004 reform creating enhanced incentives for better tax policies and tax reductions in subsidized cantons.

Also, while it is indisputable that tax competition is a powerful instrument against excess taxation, it would be careless to consider it as equivalent to market competition. Indeed, in the private sector, competition implies that each producer and consumer can conclude a trade wherever they are. This is all the more true in a world in which the costs of trade have strongly decreased and where information can be available in real time from anywhere. Individuals thus can use their freedom of choice without restriction. In tax matters, on the other hand, the individual is subject to a monopolistic power of coercion on his place of residence (Salin, 2007).

Cantonal Indicators

	Tax Burden Index	GDP per capita CHF	Population
Switzerland	100.0	52,657	7,415,102
Zug	52.4	92,168	105,244
Schwyz	68.5	49,336	135,989
Ticino	74.3	40,577	319,931
Nidwalden	78.0	68,450	39,497
Thurgovia	84.0	44,230	232,978
Zurich	85.8	67,375	1,261,810
Argovia	90.2	48,153	565,122
Basel-Country	96.2	51,917	265,305
Geneva	97.5	61,223	427,396
Appenzell IR	100.3	45,429	15,029
Vaud	107.2	51,474	647,382
Schaffhausen	112.2	53,916	73,788
Solothurn	112.8	45,873	247,379
Saint-Gall	113.4	44,103	458,821
Lucerne	115.2	42,592	354,731
Basel-City	115.4	107,592	186,753
Valais	115.9	36,850	287,976
Appenzell AR	117.9	43,488	52,841
Grisons	118.8	45,946	187,812
Bern	121.0	44,845	955,378
Fribourg	124.3	38,760	250,377
Jura	125.1	38,762	69,091
Glarus	127.5	69,865	38,317
Neuchâtel	133.7	48,401	167,910
Obwalden	136.0	38,562	33,162
Uri	137.8	44,374	35,083

Source: Swiss Federal Office of Statistics

5. Personal Taxes

Switzerland's fiscal diversity is evident in all areas, and it is particularly true for the personal income tax, where the tax burden can differ up to multiples of 3 depending on the location (Bessard, 2007a). For example, a single person with a CHF 50,000 (USD 41,300) annual income will pay 5.17 per cent in taxes in the canton of Zug and 12.85 per cent in the canton of Neuchâtel. A married taxpayer with two children with a CHF 100,000 (USD 82,600) annual income will pay 3.54 per cent in taxes in the canton of Zug and 11.78 per cent in the canton of Neuchâtel, or three times as much. Yet there are still residents living in such places. This clearly emphasizes that taxes are but one factor in the choice of a location.

How progressive the system is also depends on the canton. For example, the difference between the tax rates for a retired person's income of CHF 50,000 and CHF 100,000 ranges from 2.16 per cent in the canton of Zug to 10.53 per cent in the canton of Geneva. For that category of taxpayers, Geneva's tax system is therefore five times more progressive than that of the canton of Zug.

Within cantons, the tax burden also varies significantly depending on the municipality, although differences may be more significant in some cantons than others. As an illustration of those differences, below are the actual tax burdens in the best and worst municipalities in the five most and five least fiscally attractive cantons for the same taxable income of CHF 200,000 (USD 165,300) of a married resident without children:

Canton	Lowest-Tax Municipality		Highest-Tax Municipality	
Zug	Walchwil	CHF 16,460	Unterägeri	CHF 19,340
Schwyz	Wollerau	CHF 12,760	Steinen	CHF 23,800
Nidwald	Hergiswil	CHF 20,320	Beckenried	CHF 26,800
Appenzell IR	Appenzell	CHF 22,440	Oberegg	CHF 27,520
Zurich	Zollikon	CHF 21,060	Winterthur	CHF 28,380
Geneva	Collonge-B.	CHF 31,580	Onex	CHF 35,600

Fribourg	Givisiez	CHF 31,660	Romont	CHF 39,420
Jura	Courroux	CHF 35,060	Courgenay	CHF 38,900
Bern	Muri	CHF 30,800	Lauterbr.	CHF 40,160
Neuchâtel	Marin-E.	CHF 37,300	Couvet	CHF 41,620

The differences are the most dramatic in the canton of Schwyz, where a taxpayer may pay almost twice as much (or as less) in taxes depending on where he lives. Differences between municipalities are also above average in the canton of Bern. Across Switzerland, the same taxpayer based in Couvet, Neuchâtel will pay 3.2 times more taxes than another based in Wollerau, Schwyz and 2.5 times more than one based in Walchwil, Zug.

The evidence suggests that the income tax rates in cantons are lower, the lower the tax rates of their neighbors (Feld and Reulier, 2005). As mentioned, some cantons apply degressive rates from certain income brackets, whereby marginal rates decrease as income rises. In other words, the tax system in some cantons rewards people for being more productive. The marginal tax rate on the most successful taxpayers in the canton of Zug, for instance, is only 11.5 per cent. By contrast, those higher-income taxpayers would face a marginal tax rate of 29.8 per cent in the canton of Geneva.

At the federal level, a steeply progressive but relatively low-rate income tax has been levied since 1941. This tax was intended as a temporary measure to finance Switzerland's defense efforts in World War II, but has never been discontinued, as it appears to be often the case with "temporary" taxes.

Wealth Tax

All cantons and municipalities levy a wealth tax at progressive, flat, or degressive rates (depending on the canton) in conjunction with the personal income tax. No such tax exists at the federal level. Wealth up to a certain threshold (from about CHF 50,000 to about CHF 200,000 depending on the canton) is tax-exempt. All debt can be deducted from taxable wealth. Although often rightly criticized as an unnecessary penalty on savings and capital accumulation, the wealth tax is generally viewed as a compromise in exchange of exempting private capital gains from the income tax; the wealth tax is designed to be low enough to approximate a tax on capital earnings. The differences in tax burdens between cantons are substantial. The top marginal tax rate varies between 0.18 per cent (canton of Nidwalden) and 1 per cent (canton of Geneva). For taxable wealth of CHF 1 million (USD 826,000), the effective tax rate varies between 0.172 per cent (canton of Nidwalden) and 0.697 per cent (canton of Fribourg).

Taxation According to Expense: A Swiss Peculiarity

Those residents who do not earn any regular income within Switzerland and have not done so for the previous 10 years can ask to be fully exempted from income and wealth taxes and pay instead a lump-sum tax based on their expenses in Switzerland. Returning Swiss citizens may benefit from this option up to the end of a current tax period, whereas non-Swiss nationals can benefit from it indefinitely. As a general rule, the tax is calculated as at least five times the rental value of the resident's house or twice residential expenses if the taxpayer lives in a hotel. International double tax treaties generally apply in order to take into account taxes paid on income and wealth abroad.

Although this system has been criticized as a privilege for wealthy foreigners seeking to avoid ordinary taxation in their own countries, strict conditions apply and may substantially vary, as always, depending on the canton. Currently, only approximately 3,600 residents benefit from this system (compared to a total population of 1.6 million non-Swiss permanent residents in Switzerland).

What is the rationale behind such a system? For a very long time Switzerland has considered itself as a refuge for persecuted people around the world, not least for victims of confiscatory taxation in neighboring countries with predatory socialist governments. In parallel, because of the high level of safety and quality of life generally available in Switzerland, the country attracts wealthy individuals from industry, sport, or the arts who choose it as a permanent residence, either for retirement or for living, earning revenues abroad that are difficult to assess for tax purposes. One of the latest such moves happened in December 2006, when star singer Johnny Hallyday loudly left France, where up to 72 per cent of his income was taxed away by the government, to settle down in the Alpine resort of Gstaad, in the canton of Bern.

Estate and Gift Tax

Almost all cantons apply estate and gift taxes, with the exception of Schwyz, which levies neither, and Luzern, which does not levy any gift tax. However, spouses and direct descendants (children) do not pay any tax in most cantons; only 5 cantons tax estates and gifts to direct heirs and only one (Jura) to spouses. No such tax exists at the federal level, although its introduction is sometimes debated, but generally dismissed as it would require the unlikely approval from a double majority of voters and cantons.

The widespread practice of exempting direct heirs is a result of intense pressure from some pioneer cantons where older taxpayers took residence after retirement in order to avoid estate taxes. In 8 cantons, estates and gifts to direct ascendants, i.e., parents are also tax-exempt. The systems, rates, and possible deductions vary significantly depending on the canton. Tax-exempt amounts for direct descendants, for example, range between CHF 5000 (USD 4,100) and 250,000 (USD 207,000) among the 5 cantons still taxing such estates. Tax rates (progressive or flat depending on the canton) vary depending on the degree of kinship. For brothers and sisters and an estate of CHF 500,000 (USD 413,000), they vary between 5 per cent (Nidwalden) and 21.8 per cent (Appenzell A. Rh.); for non-family-related beneficiaries, the same estate will be taxed between 14.2 per cent (Zug) and 53.7 per cent (Geneva), or almost four times as much depending on the canton.

Payroll Levies

Payroll levies amount to 12.1 per cent in Switzerland, which is low in comparison to most other industrialized countries. Such levies are fully tax-deductible. Most of it (10.1 per cent) goes to a compensation fund for basic pay-as-you-go pensions; the remaining 2 per cent finance the unemployment insurance fund. Half of this burden is paid directly by employers; however, this is merely an illusion since these costs are as a matter of fact deducted in full from the employee's salary.

Self-employed taxpayers must pay a rate of 9.5 per cent on their income for basic pensions; they are exempted from unemployment insurance. For incomes below CHF 50,000 (USD 41,300), lower rates (from about 5 per cent to about 9 per cent) apply. Although the rates have not changed since 1975, pay-as-you-go pensions in Switzerland are not immune from demographic pressure. Payroll levies now finance about 80 per cent of pension expenses; the rest is subsidized by the central government (17 per cent) and the cantons (3 per cent). Since 2000, an additional value-added tax percentage point has been levied for this purpose. The dispersion tends to hide the true costs of the program. In addition, as there is no cap on the labor income subject to payroll levies, they amount to an additional flat income tax, in particular for higher-income taxpayers.

Since 1985, salaried taxpayers have also been required to participate in a capitalized pension system from an income threshold of about CHF 20,000 (USD 16,500). Although this is run by the private sector and cannot be classified as a tax, the system is heavily regulated by the federal government and requires an additional payroll levy of about 12.4 per cent (varying depending on the pension fund), half of which is paid by the employer. For fully private retirement accounts, the law provides income tax exemption and deductibility of about CHF 6,000 (USD 5,000) a year for salaried taxpayers and about CHF 30,000 (USD 24,800) for self-employed taxpayers.

6. Corporate Taxes

Diversity among cantons is just as dramatic for corporations. Corporate income is taxed both at the federal and cantonal levels. The central government applies a flat rate of 8.5 per cent on net profit. The tax burden is itself tax-deductible together with the cantonal tax, resulting in an effective rate of about 6.7 per cent on average. Things are more complex at the cantonal level. The cantons tax corporate profits at flat, progressive, or two-level rates (depending on the canton) averaging 14.6 per cent, resulting in an overall corporate tax rate of 21.3 per cent, with significant differences between cantons. Cantonal rates vary not only according to the absolute profit, but also to the return on capital. For example, a corporation with capital of CHF 2 million (USD 1,652,000) and a return of 4 per cent, i.e., with net income of CHF 80,000, will pay a profit tax of 5.53 per cent in the canton of Zug and 15.98 per cent in the canton of Geneva, or almost three times as much. If the same corporation has instead a return of 50 per cent, or CHF 1 million, the profit tax ranges between 9.02 per cent in the canton of Zug and 18.9 per cent in the canton of Basel-Land.

Swiss cantons also levy a capital tax at flat rates, except in four cantons that apply two-level rates. No such tax is levied at the federal level. Rates vary substantially depending on the canton. Lower rates apply for holding companies (which are also exempt from income tax). The least competitive cantons generally do not serve as locations for any larger corporations, but the tax is deemed particularly harmful for small and medium-sized businesses. Some cantons are currently slashing their rates in moves to become more competitive and promote economic growth.

Recent capital tax reductions (implemented by January 1, 2007):

Canton	Old rate	New rate	Canton	Old rate	New rate
Zug*	0.0075	0.002	Thurgau	0.1	0.03
Aargau	0.25	0.125	Thurgau*	0.05	0.001
Uri	0.425	0.2	St. Gallen	0.03	0.02
Uri*	0.05	0.01	St. Gallen*	0.005	0.001
Schwyz	0.08	0.04	Obwalden[a]	0.3 to 0.4	up to 0.24
Schwyz*	0.005	0.0025	Obwalden*	0.04	0.001
Nidwalden	0.035	0.025			

All rates in per cent

* for holding companies

[a] rates vary depending on the municipality

The lowest-tax cantons allow Switzerland to remain relatively competitive internationally. The canton of Zug, for example, is on par with Ireland. In addition, the cantons can provide full tax exemption for a period of up to 10 years for newly established companies; some cantons, in particular fiscally less attractive ones, implement these tax holidays aggressively in order to attract investments on their territories, including from abroad, in the hope that these companies will bring jobs and sooner or later more tax revenue.

Swiss corporate structures, some of which are outlined below, are in increasing demand by international businesses for all kinds of support activities, including group management (worldwide or for the Europe, Middle-East and Africa region), banking and asset management, trading, research and development, and consulting. International tax planning has been facilitated by a corporate tax reform in 1997 that has increased the country's attractiveness. Switzerland has no controlled foreign corporation legislation so that profits from foreign subsidiaries are tax-exempt before distribution. Neither is there a "subject to tax" requirement for foreign subsidiaries in order to be tax-exempt in Switzerland. Thanks to an extensive treaty network, including with the European Union, dividends, royalties and interests paid to affiliated companies are mostly tax-exempt.

Holding companies. If two-thirds of a company's assets are financial participations in affiliated companies (at least 20 per cent owned, directly or indirectly, by the holding company), it will be fully exempt from income taxes at cantonal and municipal level. At the federal level, all dividend income from underlying investments is also tax-exempt. In many cases, the effective income tax is nil; it is almost never greater than 2 per cent. At cantonal level holding companies must nonetheless pay a capital tax on net assets at a flat rate of 0.001 per cent (as applied in the most competitive cantons).

Domiciliary companies. When at least 80 per cent of business income is generated abroad, a company qualifies as a mixed company, whereby only the part of foreign-source income attributable to management activities in Switzerland is taxed (at the same reduced rates as applied to holding companies). Up to 95 per cent of income can be tax-exempt as a result, on the basis of case-specific tax rulings. Such structures are used in particular by international trading companies.

Service companies. Such companies provide affiliated entities with assistance in administrative, financial, technical, or scientific matters. They require a minimum invoicing of these services for tax purposes, in order to achieve taxable profits equal to at least 5 per cent of expenses. Case-specific tax rulings can be obtained.

Principal headquarters. Favorable tax rulings are also provided to principal structures acting as centers for international activities, whereby the Swiss company acts as the principal in a commissioner or contract-manufacturer structure. Principal headquarters take on operating risks and the legal ownership of products in addition to management, control, and administrative functions. Profits from foreign affiliated companies are tax-exempt in Switzerland.

Finance branches. Generally designed as subsidiaries of foreign holding companies, finance branches deal with lending, cash management, foreign exchange hedging, netting, and reinvoicing. There is a minimum funding requirement of CHF 100 million (USD 82.6 million). Reduced tax rates also apply.

7. Value-Added Tax

Switzerland replaced its former turnover tax with a value-added tax in 1995, following belatedly the widespread adoption of the VAT in the European Union (Switzerland has sometimes the reputation of repeating other countries' mistakes 20 years later). Businesses with turnover of less than CHF 250,000 (USD 207,000) are tax-exempt. For businesses with a turnover up to CHF 3 million (USD 2.5 million), simplified filing is available. Generally viewed as a tax on consumption, the VAT is in fact levied at all stages of production and distribution and on imported goods. Exports are tax-exempt. Other exempted sectors include healthcare, social services, education and learning, cultural goods and services, insurance services, money market and capital market transactions (excluding wealth management and debt recovery), real estate sales and rentals.

The standard Swiss VAT rate is 7.6 per cent, contrasting with the minimum unified rate of 15 per cent in the European Union. A reduced rate of 3.6 per cent applies to hotel and holiday rental services. Another reduced rate of 2.4 per cent applies to food and catering services, medicines, books, media services, and the press.

Despite its textbook reputation as a simple and harmless tax, the VAT proves to be extremely complex and harmful in practice, and Switzerland is no exception. Efforts are currently undertaken to simplify the system, as compliance costs have steadily risen (Spori, 2006). Regulations amount to about 2500 pages, and the VAT is viewed as a high-risk tax by business (Taddei, 2003; Honauer, 2004). Moreover, although many economists view consumption taxes as less harmful than others, the value-added tax tends to have the same negative economic impact (Rothbard, 1994). For labor-intensive sectors it amounts to an additional tax on income, and in many instances the VAT amounts to a hidden tax on investments. (Up to 54 per cent of the VAT falls on investments; cf. Schafroth, 2003.) As a result, some economists fear that a reallocation of the tax burden in favor of the VAT would lead to proportionally greater economic damage (Aregger and Beck, 2004). Attempts in Switzerland to shift a greater part of the tax burden to consumption have failed in part because voters generally fear that higher consumption taxes will be used to finance bigger government, but also because they are aware that taxes on consumption reduce a taxpayer's disposable income and thus his incentive to earn and ability to save. More specifically, consumption taxes drive a wedge between the pre-tax income and post-tax consumption (including deferred consumption through savings).

The evidence indicates that governments generally favor consumption taxes not because they are believed to be economically less destructive, but because they are easier to enforce. (The VAT was conceptualized in 1954 by the French bureaucrat Maurice Lauré in order to optimize tax collection and improve government surveillance over producers; cf. Delorme, 2004). Politicians also like consumption taxes since they often are hidden from taxpayers, thus reducing resistance to increases in tax rates.

8. Swiss Bank Secrecy: A Human Rights Issue

Switzerland is famous (or, in high-tax nations, infamous) for its financial privacy laws. These laws are a relevant part of the Swiss tax system in that tax authorities do not have access to any financial information not expressly declared by taxpayers. However, there is an anonymous withholding tax levied on interest and dividend income paid to residents, who have the option of claiming a full refund when filing their tax returns.

Swiss legislation distinguishes between tax "subtraction", an administrative offense, and tax fraud, a criminal offense. Tax subtraction occurs when a taxpayer forgets to declare or conceals income or wealth; tax fraud implies the deliberate falsification of records. This distinction reflects the need for a higher level of government legitimacy in the eyes of citizens and results in higher levels of tax morale (Feld and Frey, 2006). Switzerland therefore does not recognize ordinary tax evasion as a crime and consequently does not assist foreign governments in prosecuting taxpayers in such cases.

Bank secrecy laws in Switzerland underscore the principle of self-declaration in a contract-like relationship between citizens and government and reflect a moral imperative that individuals have a right to privacy and are the legitimate owners of their property. Indeed, the laws were significantly strengthened in 1934 to protect German Jews seeking to protect their assets from Nazi expropriation. Today, bank secrecy performs in part the same role, providing a safe refuge for victims of religious persecution, ethnic discrimination, political harassment, fiscal oppression, government instability, and crime.

Switzerland's financial privacy laws are the source of international controversy because some taxpayers in high-tax nations place their assets in Swiss financial institutions, and Switzerland does not recognize ordinary tax evasion as a criminal offense. (The Swiss financial center is the world's leader in international private wealth management, with a market share of 28 per cent; cf.

Donzé, 2007.) Working through international bureaucracies such as the European Commission and the Organisation for Economic Cooperation and Development, politicians from high-tax nations are seeking to eviscerate privacy laws so that they can track—and tax—this flight capital. In response to this pressure, the Swiss government introduced in 2005 a withholding tax on undeclared savings income paid to European Union residents. Financial institutions serve as intermediaries and transfer the tax anonymously to the Swiss government, which transfers 75 per cent of the proceeds to the respective E.U. governments. This has only whetted the appetites of high-tax governments, however, and intergovernmental exchange of taxpayers' personal financial information remains a declared goal of the E.U. and other bureaucracies.

Although the withholding tax compromise is less onerous than the E.U. originally demanded, and even though it has many loopholes, the Swiss withholding tax enabled the introduction of the E.U.'s Savings Tax Directive, causing money to flee Europe, notably to Asian jurisdictions. Defenders of tax competition in Switzerland and elsewhere argue that high-tax nations should fix the flaws in their own tax regimes rather than engage in efforts to undermine the financial privacy of their residents and the sovereignty of nations with more responsible fiscal policy.

9. The Road Ahead

Over time tax competition in Switzerland has led to many favorable developments and prevented costly policy mistakes. For taxpayers, decentralization on a small scale means greater choice and pressure on government authorities to spend tax money wisely as "voting with the feet", i.e., moving out of a jurisdiction, is an easily enforceable threat. Decentralization and tax competition also mean that tax authorities are easily accessible and generally taxpayer-friendly. Switzerland is probably the one of the few countries in the world where rankings on the "customer-friendliness" of tax authorities are regularly published in the press, whereby unfriendly cantons are named and shamed. There is absolutely no doubt that this is Switzerland's greatest strength.

The Swiss tax system is also one of the last barriers against the E.U.'s plans to harmonize and centralize corporate taxation (Bessard, 2007b). Switzerland remains a bastion of institutional diversity and competition. Although the E.U. regularly criticizes the Swiss cantons for their attractive tax policies, it has little leverage, in particular because Swiss cantons contribute to boost prosperity in Europe by allowing better protection of productive capital that will be reinvested in E.U. countries.

The greatest flaw in the Swiss system, however, is the expansion of the central government in the second half of last century. The federal personal income tax, for example, which is a remnant of defense efforts in the 1940s, should have been abolished long ago. Despite the advantages of national and international tax competition, and although the tax burden is roughly 25 per cent below the E.U. average, Switzerland's tax burden has continued to rise, reaching 30 per cent of GDP today, or 150 per cent of the level prevailing in 1970. As in all democracies where government functions have been ceaselessly extended, Switzerland faces significant challenges in the near future. The pressure for higher taxes is particularly acute in the pension system and other social subsidy programs, where spending serves to buy votes and is politically toughest to oppose. It is therefore possible that in coming years, the burden of taxation will increase at the federal level.

Yet there are good reasons to remain optimistic. More cantons are doing their homework and implementing tax reforms that reduce taxes, in particular on corporations and more productive residents, thereby improving incentives. International tax competition also poses limits to potential bad policies and tax increases. And Switzerland usually ends up implementing the right reforms when it is urgent to do so, for example by providing holding and administrative companies with an attractive tax framework and turning the nation into one of Europe's top locations.

Like in many other public policy sectors, the future of the Swiss tax system will ultimately depend on the climate of opinion. No tax reform can be implemented without the implicit or explicit approval of voters and, for federal issues, the approval of cantons.

Will the Swiss resist renewed internal calls to "harmonize", i.e., centralize and unify the tax system? Will they resist criticism from the European Union and high-tax neighboring countries? If they do, it is likely that Switzerland's tax system will continue to innovate and strike a fairly reasonable balance between inevitable demands for government services and the moral and economic imperative to minimize the tax burden.

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