

PROSPERITAS

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The Swiss Tax System - Key Features and Lessons for Policy Makers -

Relatively low tax rates, respect for financial privacy, and attractive business tax laws have given Switzerland a reputation as a tax haven. But Switzerland is only a low-tax nation compared to its European neighbors. Tax revenues consume nearly 30 percent of gross domestic product, which is higher than the U.S. tax burden. Set up as a federal system like the U.S., the 26 Swiss cantons are largely independent in setting their own taxes. But unlike the U.S., where the federal government now plays a dominant role in fiscal policy, the Swiss central government accounts for less than one-third of total taxes and spending. This decentralization is a key feature of the Swiss tax system. Effective tax levels may vary by as much as 300 percent from one canton to another. Tax levels may also differ significantly among municipalities, which are free to set their own rates. In recent years this highly decentralized setup has played an increasing role in keeping tax levels in check and introducing innovative tax reforms (in part because tax increases almost always require approval by voters), such as degressive marginal tax rates on higher income brackets. Although Switzerland has not been immune from public policy mistakes, the country has remained one of the richest in Europe since the late 19th century. Today it enjoys the greatest accumulated wealth per capita in the world, and unemployment, at around three percent, is low. This would seem to indicate that some of the features of the Swiss system – in particular radical decentralization and the ensuing tax competition – play some part in enhancing prosperity, in particular by providing taxpayers with more choice and better protection of their property rights.

by Pierre Bessard

THE TAX SYSTEM – AN OVERVIEW

Key Features:

- Taxes in Switzerland currently consume 30 percent of GDP (2005). While low by European standards, the aggregate tax burden has risen by about 50 percent since 1970 and about 15 percent since 1990.
- The central government raises about 30 percent of all tax revenues; the cantons about 40 percent; and the municipalities (based on the laws of their respective cantons or on their own rules) another 30 percent. Taxation in Switzerland is therefore overwhelmingly a cantonal issue and to a lesser extent a federal issue.

- At the federal level, the top marginal rate is 11.5 percent. Top marginal rates in the cantons range from about five percent (in degressive systems) to about 35 percent. The average overall federal-canton top marginal personal income tax rate is 37.8 percent.¹
- Personal capital gains are tax-exempt. However, all cantons levy a tax on wealth with top marginal rates varying from 0.18 to 1 percent depending on the canton.
- Corporate income is taxed at the federal level at a flat rate of 8.5 percent, but this federal tax can be deducted together with the cantonal tax when calculating taxable income, resulting in an effective rate of about 6.7 percent. The cantons tax corporate profits at flat, progressive, or two-level rates (depending on the canton). The average rate is 14.6 percent, resulting in an overall federal-canton corporate tax rate of 21.3 percent,² with significant differences among cantons; all cantons also levy a tax on corporate capital at flat rates generally below 0.1 percent.
- Corporate tax holidays may be available for up to ten years for newly established businesses. More favorable regimes apply for holding and administrative companies, making Switzerland a top headquarters location.
- The system is strictly territorial, meaning that the government does not seek to tax income that is earned – and generally subject to tax – in other jurisdictions.
- Value-added tax is levied at a standard rate of 7.6 percent, with reduced rates of 3.6 and 2.4 percent and tax-exempt status for specific sectors.
- Basic payroll deductions amount to 12.1 percent of income, half of it being retained and paid by employers. These tax-deductible levies mostly serve to finance basic pensions and unemployment insurance.
- Workers generally are required to participate in an occupationally-based system of private retirement savings.
- Voters are key players in policymaking. 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 federal level, though it is not clear whether politicians will satisfy their cravings for 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.

¹ Source: OECD Tax Database (2006).

² Ibid.

Key Observations :

- Switzerland has not enjoyed rapid growth in recent decades. Yet it still ends up in leading positions in income per capita, wealth per capita or competitiveness rankings. For example Switzerland ranks first in the 2006 World Economic Forum's Global Competitiveness Report. This is known as "the Swiss paradox" and can be explained by Switzerland's long-standing openness toward global trade and investment,³ whereby substantial revenues are repatriated from abroad.
- Switzerland's decentralized tax system makes any comprehensive or sweeping tax changes very difficult or lengthy to implement. This has proved a decisive advantage since harmful policies are often turned down by cantons and voters in referenda. Such failed initiatives include a plan in 2001 to introduce a personal capital gains tax, and another in 1977 to unify cantonal taxes and to introduce a federal wealth tax.
- International tax competition has long been a way of life for Switzerland, and national tax competition has been important for a number of smaller cantons in central Switzerland. However, national tax competition recently intensified following a 2004 reform of inter-cantonal financial equalization (a program similar to interstate fiscal transfers in the U.S) with improved incentives for better tax policies and tax reductions in subsidized cantons.
- A corporate tax reform in 1997 significantly enhanced the tax environment for holding and administrative companies, making Switzerland a favorite location for regional European or world headquarters. In addition to very low effective tax rates, Switzerland's tax laws do not include any controlled foreign corporation provision, so that profits from foreign subsidiaries are tax-exempt before distribution. Neither is there a "subject to tax" clause requiring income from foreign subsidiaries to be taxed abroad at a certain level 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.
- Swiss financial privacy laws are relevant to the tax system in that tax authorities do not have access to any financial information not expressly declared by taxpayers. In order to prevent tax evasion, however, the government imposes a refundable withholding tax on interest and dividend payments to Swiss residents, whereby financial institutions transfer the tax anonymously. The existence of bank secrecy also has important implications for the tax laws of other nations since Switzerland is a safe haven for foreigners seeking to escape oppressive levels of taxation. And because these nations have to worry that the geese with the golden eggs can fly across the border, they have much less ability to impose and enforce bad tax laws that discriminate against capital income.

³ Swiss companies employ over 2 million people abroad, which is more than half of Switzerland's working population of 3.6 million. Source: Swiss National Bank, "L'évolution des investissements directs en 2005", December 2006.

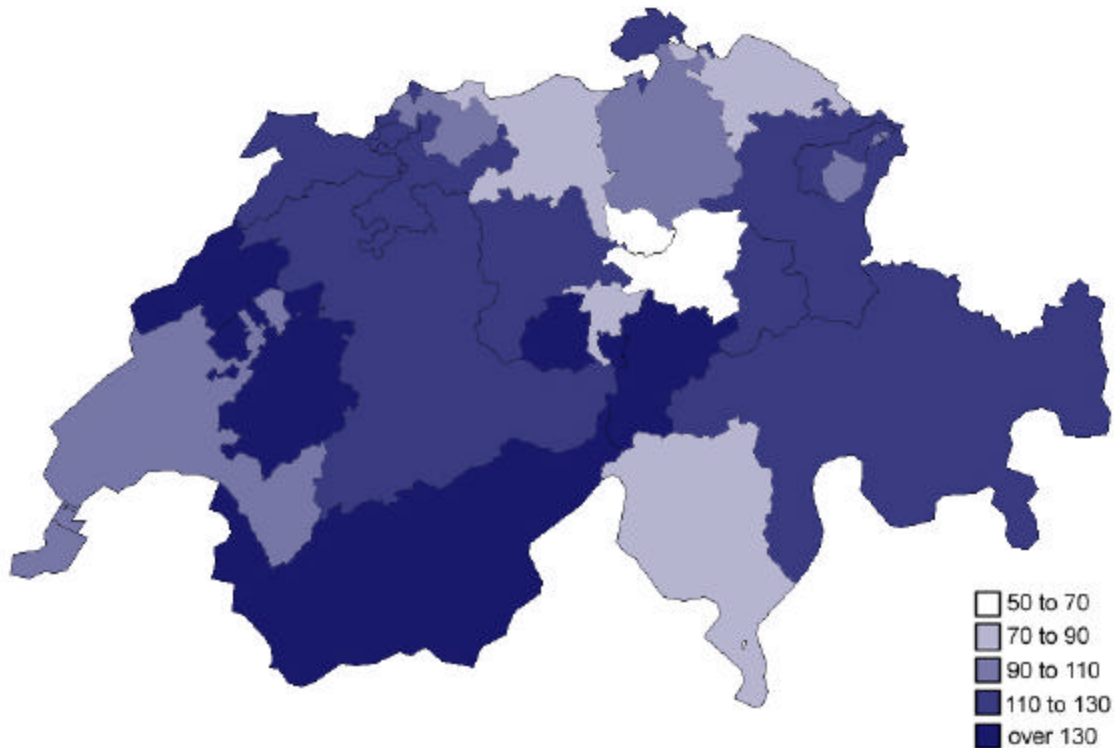
- Swiss legislation distinguishes between tax “subtraction”, an administrative offense, and tax fraud, a criminal offense. Tax subtraction occurs when a taxpayer forgets to declare or conceals income or wealth; tax fraud implies the deliberate falsification of records. This distinction reflects the need for a higher level of government legitimacy in the eyes of citizens and results in higher levels of tax morale.⁴ Switzerland therefore does not recognize ordinary tax evasion as a crime and consequently does not assist foreign governments in prosecuting taxpayers in such cases. As a compromise, since 2005 a withholding tax has been levied on some savings income paid to European Union residents.
- A new corporate tax reform being implemented in 2007 will reduce the double taxation of distributed profits at investor level for larger participations. Dividends are currently more heavily taxed in Switzerland than in most other European countries, favoring artificially high profit retention by corporations.
- Other weaknesses of the Swiss tax system include the federal income tax, meant as a temporary measure to finance defense efforts in World War II but still in place, and a federal stamp tax on some capital market transactions, which has driven several financial sector activities out of Switzerland. In addition, the cantonal taxation of capital and wealth can be especially punitive for small and medium-sized enterprises. And overall tax levels tend to be high in most cantons even if they compare favorably with the least attractive European countries.

⁴ Lars P. Feld and Bruno S. Frey, “Tax Evasion in Switzerland: The Roles of Deterrence and Tax Morale”, Institute for Empirical Research in Economics, University of Zurich, Working Paper No. 284, 2006.

A CLOSER LOOK AT THE TAX SYSTEM

Switzerland has no less than 27 different tax systems: one at the federal level and 26 at the cantonal level. For a country of 7.5 million residents this diversity makes it difficult to draw general conclusions, as tax burdens can vary considerably from one canton to another (see Figure 1). The cantons not only set their own tax rates and tax brackets; they each have their own filing requirements, deduction provisions, and institutional frameworks of rules to set and change tax laws. At the local level approximately 2800 municipalities also enjoy various degrees of sovereignty according to their respective canton's Constitution.

Figure 1. Switzerland's tax map: cantonal global tax burden index
(Average for the whole of Switzerland = 100; reference year: 2005)



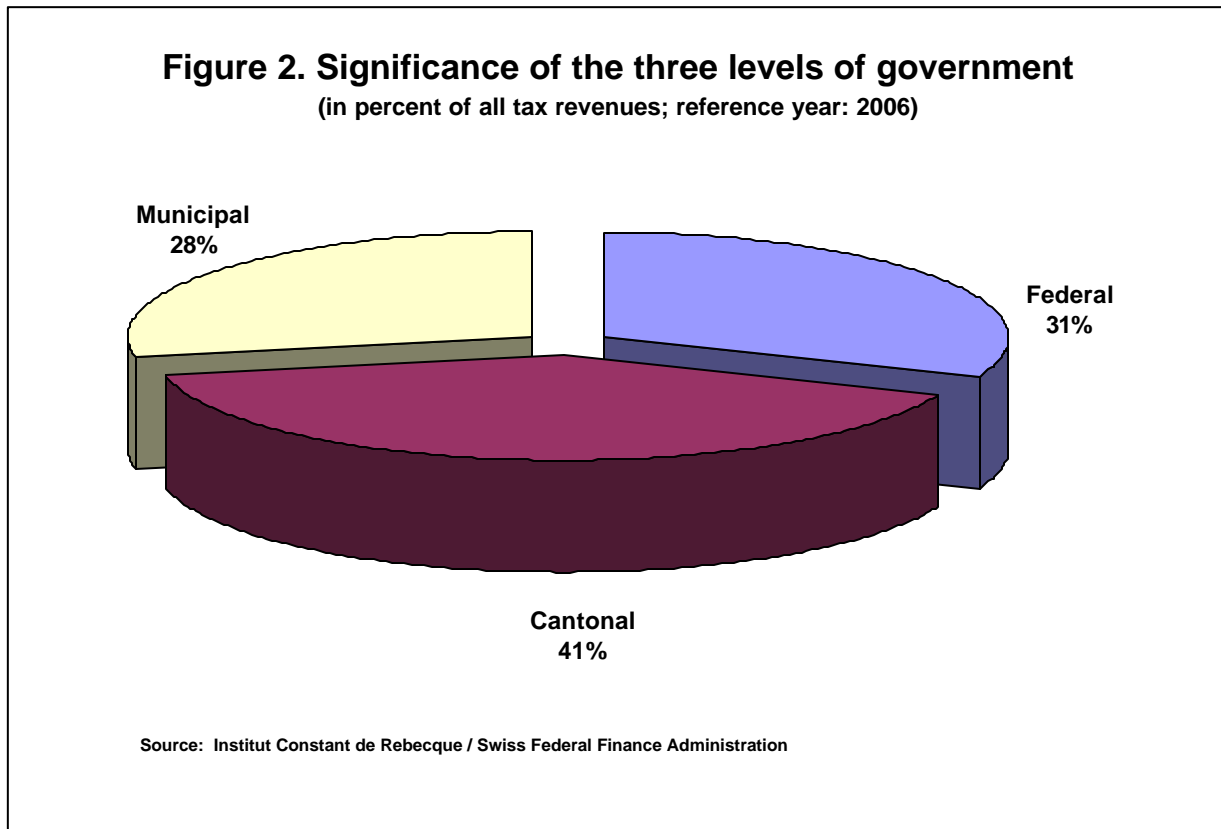
Source: Institut Constant de Rebecque / Swiss Federal Tax Administration

Three Tax Sovereignties

As sovereign states, the 26 cantons enjoy actual tax sovereignty and can levy any tax that the federal Constitution does not expressly forbid or reserve to the central government (such as the value-added tax). Municipalities also enjoy tax sovereignty as derived by the Constitution of their respective cantons. Since 2001, however, some procedural principles have been harmonized

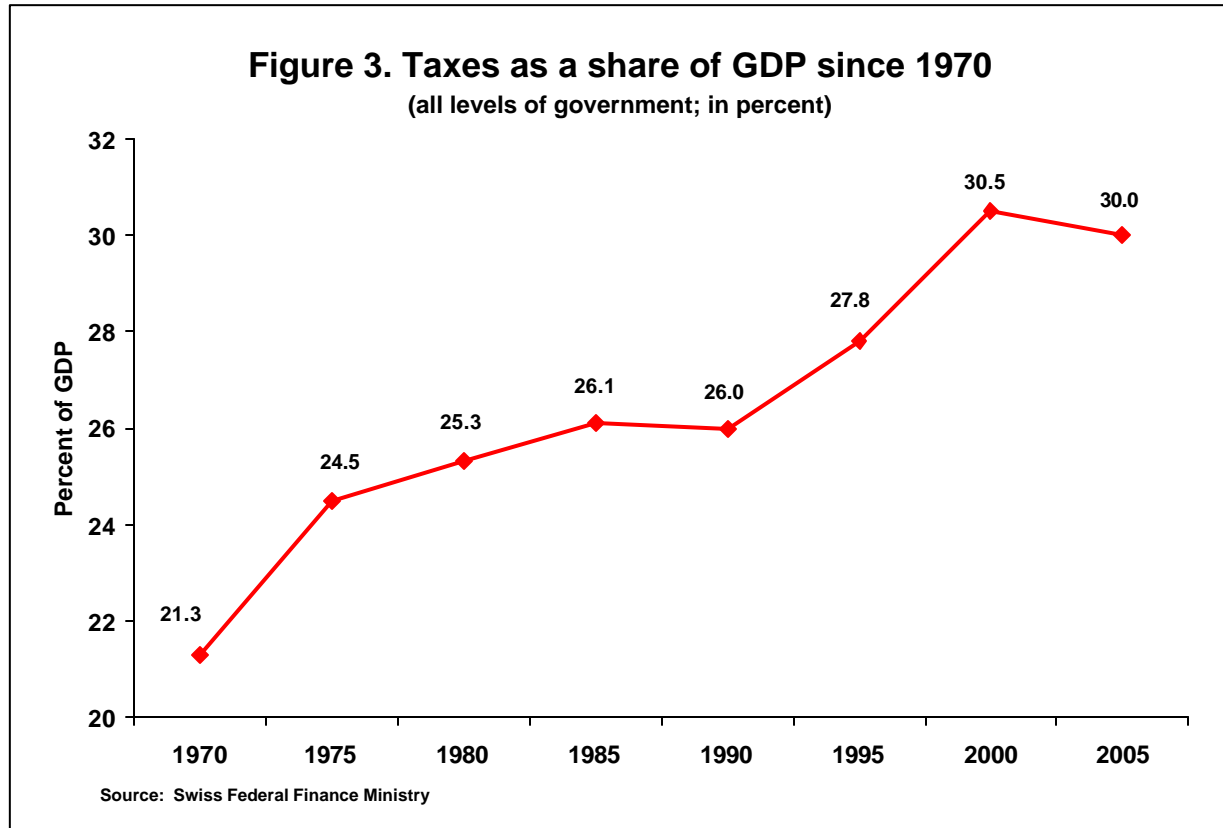
in a new federal law. This has been criticized as an undue limitation on the process of trial and error underlying all institutional innovation.⁵

Cantons, including municipalities, play by far the most significant role in the tax system. They collect almost 70 percent of all tax revenues, while the central government levies the rest. For the most part spending decisions are made at the level at which taxes are levied; there is no disconnect between tax sovereignty and spending authority.



Yet in spite of tax competition among cantons, the expansion of government has led to increasing levels of taxation in Switzerland, largely because of the extension and growth of welfare entitlement programs. In 2005, the total tax burden represented 30 percent of gross domestic product, up from 21.3 percent in 1970.

⁵ Victoria Curzon Price, “Un fédéralisme compétitif”, Institut Constant de Rebecque, 2005.



The Swiss Tax Regime

Switzerland has a federal system like the United States, but there are some important differences. In Switzerland, as discussed above, the central government plays a minor role. In the United States, by contrast, the central government is responsible for about two-thirds of taxes and spending (and often has considerable authority over the spending decisions of sub-national governments). In Switzerland, the central government imposes consumption taxes. In the United States, consumption taxes are almost exclusively imposed by sub-national governments.

One similarity to America is that Switzerland collects the greatest part of its tax revenues through income taxes. Consumption taxes, by contrast, make up only 21 percent of overall tax revenues. Since cantons do not levy any consumption tax and levy the bulk of income taxes, it is likely that direct income taxes will remain the largest source of government revenue – assuming that Switzerland’s decentralized system is not further eroded.

The Personal Income Tax: At the federal level, a 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. The federal income tax is levied by the cantons, which transfer 70 percent of it to the central government and keep 17 percent; the remaining 13 percent goes into the inter-cantonal equalization fund. The top marginal federal tax rate is constitutionally limited at 11.5 percent and can only be changed by

means of a referendum requiring approval from a majority of cantons and a majority of voters (otherwise known as a double majority). The top rate applies for income brackets in excess of CHF 700,000 (\$578,500).

All cantons also levy their own personal income taxes at rates that vary significantly depending on the canton. Overall, the effective average personal income tax rate *on average income* is 9.4 percent at cantonal level and 1.1 percent at federal level.⁶ Academic research suggests that cantons are aware of the need to be competitive. Cantons are more likely to have low tax rates if at least one neighboring canton has low rates.⁷ Some cantons even 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 percent. By contrast, those taxpayers would face a marginal tax rate of 29.8 percent in the canton of Geneva.

Private capital gains (on securities, art works, etc.) are *tax-exempt* at all levels of government. The personal income tax is therefore a tax on labor income. However, it should be noted that banks pay a withholding tax of 35 percent on interest income earned by account holders. The same withholding tax also applies on dividends and other forms of capital income. Taxpayers can get a refund on these tax payments, but only if they declare the underlying assets – a choice that could result in a higher wealth tax liability (see “Wealth tax” below).

How the Personal Income Tax Burden Varies Within Switzerland

The income tax burden differs up to multiples of 3 depending on the location. For example, a single person with a CHF 50,000 (\$41,300) annual income will pay 5.17 percent in taxes in the canton of Zug and 12.85 percent in the canton of Neuchâtel. A married taxpayer with two children with a CHF 100,000 (\$82,600) annual income will pay 3.54 percent in taxes in the canton of Zug and 11.78 percent in the canton of Neuchâtel, or three times as much.

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 percent in the canton of Zug to 10.53 percent in the canton of Geneva. For that category of taxpayers, Geneva’s tax system is therefore *five times* more punitive than that of the canton of Zug.

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

⁶ Source: OECD Tax Database (2006)

⁷ Lars P. Feld and Emmanuelle Reulier, “Strategic Tax Competition in Switzerland: Evidence from a Panel of the Swiss Cantons”, CESifo Working Paper No. 1516, 2005.

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 I. Rh.	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	Lauterbrunnen	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 half as much) in taxes. 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.

Differences between cantons reflect not only different public management practices but also spending priorities and democratic preferences in given jurisdictions. From 1959 until recently, a badly designed inter-cantonal financial equalization program gave the least competitive (and therefore less prosperous) cantons no incentives to reduce taxes as they received part of their budgets through transfers and were implicitly penalized for cutting taxes. This is now partly changing after a reform in 2004 that has improved incentives for tax reductions in subsidized cantons.

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 percent (canton of Nidwalden) and 1 percent (canton of Geneva). For taxable wealth of CHF 1 million (\$826,000), the effective tax rate varies between 0.172 percent (canton of Nidwalden) and 0.697 percent (canton of Fribourg).

Taxation According to Expense: A Swiss Peculiarity

Under some conditions, wealthy individuals who came to Switzerland from other nations may opt to pay a lump-sum tax based on their living expenses.

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 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 about 3,600 residents benefit from this system (compared to a total population of 1.6 million non-Swiss residents in Switzerland).

What is the rationale behind such a system? For a very long time Switzerland has seen 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 evaluate 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 percent 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 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 eight 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 (\$4100) and 250,000 (\$207,000) among the five 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 (\$413,000), they vary between five percent (Nidwalden) and 21.8 percent (Appenzell A. Rh.); for non-family-related beneficiaries, the same estate will be taxed

between 14.2 percent (Zug) and 53.7 percent (Geneva), or almost four times as much depending on the canton.

Payroll levies: Payroll levies amount to 12.1 percent in Switzerland, which is low in comparison to most other industrialized countries. Such levies are fully tax-deductible. Most of it (10.1 percent) goes to a compensation fund for basic pay-as-you-go pensions; the remaining 2 percent finance the unemployment insurance fund. Half of this burden is paid directly by employers; however, this is merely a political 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 percent on their income for basic pensions; they are exempted from unemployment insurance. For incomes below CHF 50,000 (\$41,300), lower rates (from about five percent to about nine percent) 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 percent of pension expenses; the rest is subsidized by the central government (17 percent) and the cantons (3 percent). 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 (\$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 percent (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 (\$5,000) a year for salaried taxpayers and about CHF 30,000 (\$24,800) for self-employed taxpayers.

Value-Added Tax: Switzerland replaced its former turnover tax with a value-added tax in 1995, following the widespread adoption of the VAT in the European Union. Businesses with turnover of less than CHF 250,000 (\$207,000) are tax-exempt. For businesses with a turnover up to CHF 3 million (\$2.5 million), simplified filing is available. Generally viewed as a tax on consumption, the VAT is 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 percent, contrasting with the minimum unified rate of 15 percent in the European Union. A reduced rate of 3.6 percent applies to hotel and holiday rental services. Another reduced rate of 2.4 percent applies to the following goods and services:

- food and restaurant and catering services
- medicines
- newspapers, periodicals, and books
- radio and television services

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.⁸ Regulations amount to about 2500 pages, and the VAT is viewed as a high-risk tax by business.⁹

Moreover, although economists often view consumption taxes as less harmful than taxes on income and profits, the value-added tax tends to have a negative economic impact over time.¹⁰ For labor-intensive sectors it amounts to an additional tax on income,¹¹ and in many instances the VAT amounts to a hidden tax on investments.¹² 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.¹³ 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. In addition, voters are aware that taxes on consumption also 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.¹⁴ Politicians also like consumption taxes since they often are hidden from taxpayers, thus reducing resistance to increases in tax rates.

Corporate Income Tax: Corporate income is taxed both at the federal and cantonal levels. The central government applies a flat rate of 8.5 percent on net profit. The tax burden is deductible together with the cantonal tax when calculating taxable income, resulting in an effective rate of about 6.7 percent on average.

Things get more complicated at the cantonal level. The cantons tax corporate profits at flat, progressive, or two-level rates (depending on the canton) averaging 14.6 percent, resulting in an overall corporate tax rate of 21.3 percent, 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 (\$1,652,000) and a return of 4 percent, i.e., with net income of CHF 80,000, will pay a profit tax of 5.53 percent in the canton of Zug and 15.98 percent in the canton of Geneva, or almost three times as much. If the same corporation has

⁸ Peter Spori, "Rapport final de l'expert chargé de la réforme de la TVA", Swiss Federal Ministry of Finance, 2006.

⁹ Marco Taddei, ed., "Les coûts administratifs imposés aux PME par la TVA", USAM, 2003; Niklaus Honauer, ed., "Wieviel ist die Mehrwertsteuer wert?", PricewaterhouseCoopers, 2004. Cf. also Jean-Raphaël Fontannaz, "Une bombe à retardement pour les PME", *Bilan*, April 2004.

¹⁰ Reiner Eichenberger, "Pourquoi la Suisse doit dire non à la hausse de la TVA", *L'Agefi*, April 5, 2004.

¹¹ Beat Kappeler, "Die Mehrwertsteuer als Jobkiller", *NZZ am Sonntag*, December 21, 2003.

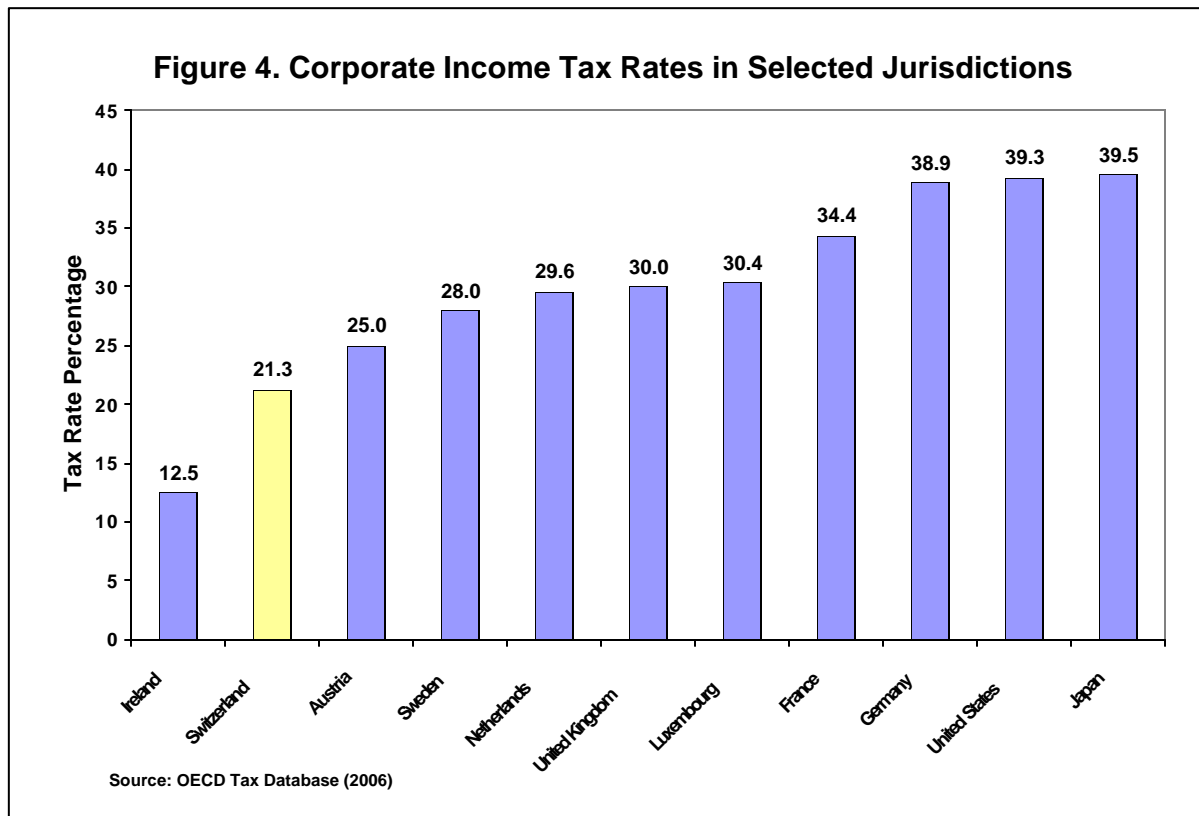
¹² Up to 54 percent of the VAT falls on investments; cf. Gerhard Schafroth, "Wer trägt die finanzielle Belastung und was sind die Nebenwirkungen einer Erhöhung der Mehrwertsteuer?", *SwissVAT*, 2003.

¹³ Christa Aregger and Alex Beck, "Mehr Wachstum dank Steuerumbau?", Credit Suisse Economic & Policy Consulting, 2004.

¹⁴ 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. Guy Delorme, "Instauration de la TVA", Direction des Archives de France, Délégation aux Célébrations nationales, 2004.

instead a return of 50 percent, or CHF 1 million, the profit tax ranges between 9.02 percent in the canton of Zug and 18.9 percent in the canton of Basel-Land.

The lowest-tax cantons allow Switzerland to remain relatively competitive internationally (Figure 2). The canton of Zug, for example, is on par with Ireland.¹⁵ 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 those otherwise applying higher tax rates, 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.



Corporate Capital Tax: 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 corporate 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 (see Table 1).

¹⁵ Martin Eichler, Christina Elschner, and Michael Overesch, “Effective Tax Burden of Companies and on Highly Qualified Manpower”, BAK Basel Economics, 2005.

**Table 1. 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 percent / * for holding companies / ^a rates vary depending on the municipality

Source: Institut Constant de Rebecque Research

Switzerland, A Headquarters Haven

Holding and administrative companies can obtain special tax rulings. With good planning, corporate taxes can be dramatically reduced or even eliminated, thereby preserving valuable capital for productive uses.

Swiss corporate structures 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. 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 percent 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 percent. At cantonal level holding companies must nonetheless pay a capital tax on net assets at a flat rate of 0.001 percent (as applied in the most competitive cantons).

Domiciliary/mixed companies. When at least 80 percent 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 percent 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/auxiliary 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 five percent 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 re-invoicing. There is a minimum funding requirement of CHF 100 million (\$82.6 million). Reduced tax rates also apply.

Stamp taxes. The federal government applies an issuance stamp tax of 1 percent on stock capital in the case of Swiss investments (from a threshold of CHF 1 million, or \$826,000), and of 0.06 or 0.12 percent on Swiss bonds depending on the type of bonds. These taxes can generally be avoided in case of reorganizations, mergers, or transfers of companies from abroad into Switzerland.

The federal government also levies a securities transfer tax of 0.15 percent on Swiss securities and of 0.3 percent on foreign securities. This has had the incongruous effect of driving the Swiss Stock Exchange, a private institution, to move some of its trading activities to London, and Swiss banks have also developed some of their activities in Luxembourg and London as a consequence of the tax. Because of competitive pressures, the Swiss government was forced to exempt Swiss and foreign mutual funds, foreign dealers, foreign corporations, and foreign banks from the tax.

Stamp taxes are generally viewed as particularly counterproductive, but short-term political considerations have prevented their discontinuation so far, although tax revenues amount to only 0.03 percent of the federal budget.

WHY THE TAX SYSTEM IS GOOD

Radical decentralization may be the best feature of the Swiss tax regime. It ensures ongoing competition among cantons to attract residents, although taxation is of course only one among many factors in the choice of a location. Over time tax competition 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 only country 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. The advantages of decentralization are theoretically and empirically substantiated,¹⁶ and there is absolutely no doubt that this is Switzerland’s greatest strength.

Another positive feature is that the Swiss system is strictly territorial, which means that income earned abroad by a Swiss individual or corporate resident is either tax-exempt by way of tax treaty or systematically exempt, as is the case for holding and administrative companies.

The Swiss tax system is also one of the last barriers against the E.U.’s plans to harmonize and centralize corporate taxation. 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.

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.

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. Indeed, the laws were significantly strengthened in 1934 to protect German Jews seeking to protect their assets from Nazi expropriation. Today, bank secrecy performs the same role, providing a safe refuge for victims of religious persecution, ethnic discrimination, political harassment, fiscal oppression, government instability, and crime.

¹⁶ Lars P. Feld, Gebhard Kirchgässner, and Christoph A. Schaltegger, “Decentralized Taxation and the Size of Government: Evidence from Swiss State and Local Governments”, CESifo Working Paper No. 1087, 2003; Bruno S. Frey, “Kantonsfusionen bringen nichts”, *NZZ am Sonntag*, July 21, 2002; Alberto Alesina, “The Size of Countries: Does it Matter?”, Harvard Institute of Economic Research Working Paper No. 1975, 2002.

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,¹⁷ and Switzerland does not recognize ordinary tax evasion as a criminal offense. Working through international bureaucracies such as the European Commission and the Organisation for Economic Cooperation and Development, politicians from some of these 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. Swiss financial institutions serve as intermediaries and transfer the tax anonymously to the Swiss government, which in turn transfers 75 percent 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 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, with Singapore being one of the main beneficiaries.¹⁸ Defenders of tax competition in Switzerland and elsewhere argue that high-tax nations should fix the flaws in their own tax regimes rather than engaging in efforts to undermine the financial privacy of their residents and the sovereignty of nations with more responsible fiscal policy.

WHY THE TAX SYSTEM IS BAD

Like all Western democracies, Switzerland has degenerated to some extent toward an extensive welfare state in the decades following World War II. Although many government activities and subsidies today could be discontinued or given back to the private sector,¹⁹ the lack of reforms on the spending side means that overall tax levels remain far too high, even if less so in the most competitive cantons.

Further, most cantons still impose progressive tax systems, needlessly punishing success. The wealth tax and the corporate capital tax, although levied at relatively low rates, penalize capital accumulation and cause high compliance costs for corporations.

The greatest flaw in the Swiss system, however, is the expansion of the central government in the last three decades. The federal personal income tax, which is a remnant of defense efforts in the 1940s, should have been abolished long ago, and so should have federal stamp taxes that penalize the country's important financial sector. The introduction of the value-added tax in 1995

¹⁷ Switzerland is the world's leader in international private wealth management, with a market share of 28 percent; cf. Steve Donzé, "Wealth Management in Switzerland", Swiss Bankers Association, 2007.

¹⁸ John M. Glionna, "Singapore, A New Home for Riches", *Los Angeles Times*, November 11, 2006.

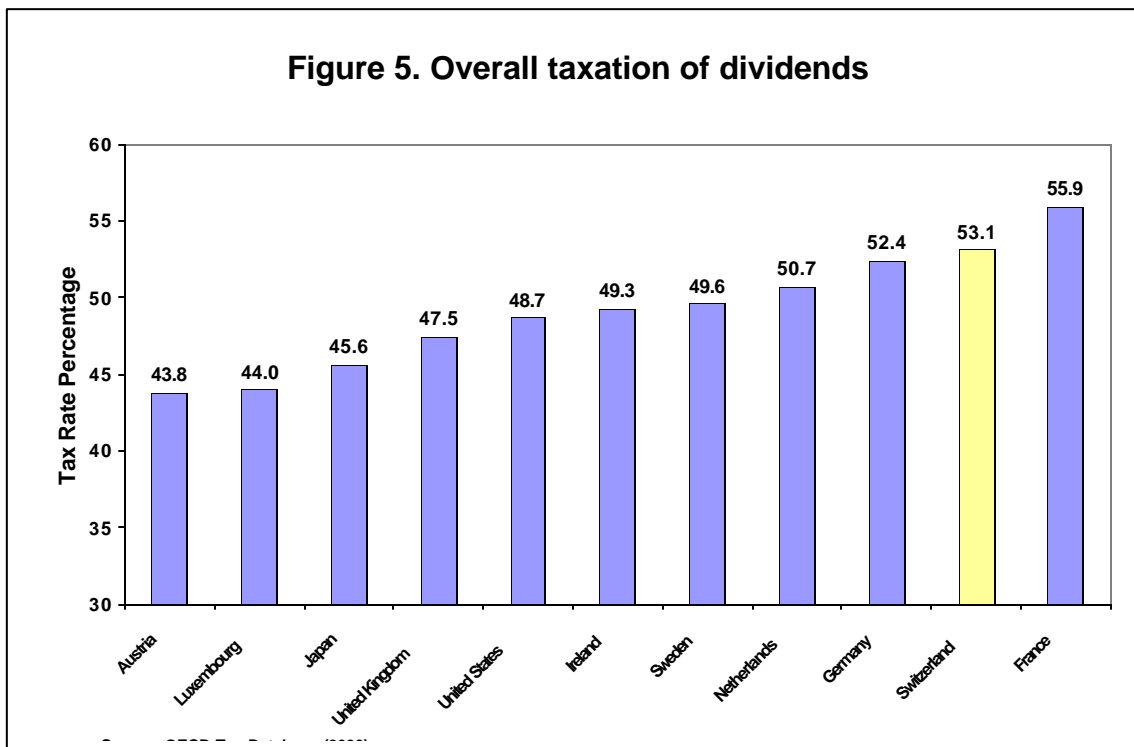
¹⁹ Institut Constant de Rebecque, "Comment le poids de l'Etat diminue la prospérité", 2006; Pascal Gentinetta et. al., "Concept des dépenses", *Economiesuisse*, 2002.

is an additional burden on productive behavior. It is unsurprisingly the central government's favorite tax because it is supposed to be easier to increase than direct income taxes.

FUTURE REFORMS FOR THE SWISS TAX REGIME

Ideally, the central government income tax should be abolished. This tax was supposed to be a temporary wartime measure, yet it is still in place more than 60 years later. Repealing this punitive levy will be a challenge in the best circumstances, but it will be impossible in the absence of much-needed reforms to control the growth of government. Even the Organisation for Economic Cooperation and Development has noted that Switzerland urgently needs budgetary restraint.²⁰ An aggressive effort to limit the growth of government would be desirable, both because it would reduce the misallocation of labor and capital and it would make repeal of the federal income tax more feasible.

A more modest reform is the attenuation of the double taxation of distributed profits (which currently are taxed first at the corporate level and a second time as dividends at the personal level). This process is just underway and is currently the most important reform issue in Switzerland. Many cantons have already taken steps to reduce double taxation, though the central government has yet to implement its planned reform. In this respect, Switzerland has been particularly unattractive until recently.



²⁰ Organisation for Economic Cooperation and Development, "Economic Survey of Switzerland 2005", Policy Brief, January 2006.

CONCLUSION

Despite the advantages of national and international tax competition, Switzerland's tax burden has continued to rise since 1970, reaching 150 percent of the level prevailing back then. As in all democracies where government functions have been ceaselessly extended, Switzerland faces huge challenges in the near future. The pressure for higher taxes is particularly acute in the pension system and other federal 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.

Institutional diversity and competition imply that setbacks and improvements are not linear. 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.

As 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., 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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