

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

**NOVEDADES DEL
FEDERALISMO COMPARADO**NOVEDADES DEL
ESTADO AUTONÓMICONOVEDADES
PARLAMENTARIASACTUALIDAD
IBEROAMÉRICANACRÓNICA
INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012

CRÉDITOS

INFORME

**THE EFFECTIVENESS OF THE 2008 REFORM OF FISCAL FEDERALISM
IN SWITZERLAND: RECORD OF THE FIRST PERIOD, 2008 – 2011, AND
EXPECTATIONS FOR THE SECOND PERIOD, 2012 – 2015¹**by **Gebhard Kirchgässner**University of St. Gallen, Swiss Institute for International Economics and Applied
Economic Research, Leopoldina and CESifo**ABSTRACT**

It is first discussed why a fiscal equalisation system is necessary for Switzerland. The reason for this are asymmetries, mainly in size, but also in location, between the different cantons. Then, the current Swiss situation is presented, before the new system is described which effectively consists of two parts: the first one newly assigns the different tasks to the different governmental levels and organises the cooperation between the national and the cantonal governments as well as among the cantonal governments, while the second one reorganises the financial flows between the different levels. Then, the results of the just expired first period of the new system from 2008 to 2011 are presented, as well as the changes decided for the second, new period, which will last from 2012 to 2015. Today, we can assess that the system has reached some of its objectives, in particular, that the financial autonomy of the cantons has been strengthened and that they have sufficient minimal financial equipment. But contrary to the aims differences in the fiscal potential of the cantons did not decrease, they even increased during the last four years.

RESUMEN

En primer lugar, el presente texto analiza porqué es necesario un sistema de compensación fiscal para Suiza. Las razones se pueden encontrar en las asimetrías, principalmente en el tamaño, pero también en la ubicación geográfica, de los diferentes cantones. En segundo lugar, se presenta la situación actual de Suiza y posteriormente se estudia el nuevo sistema que en la práctica consta de dos partes: la primera hace referencia a la asignación de nuevas responsabilidades a los diferentes niveles de gobierno y a la cooperación entre el nivel nacional y los gobiernos cantonales, así como entre los gobiernos cantonales, mientras la segunda parte hace referencia a la reorganización de los flujos financieros entre los diferentes niveles. A continuación, se presentan los resultados del primer periodo de funcionamiento del nuevo sistema de 2008 a 2011, y los cambios que fueron aprobados para el segundo periodo 2012-2015. Hoy en día, podemos considerar que la reforma del sistema ha conseguido algunos de sus objetivos, en particular, la autonomía fiscal de los cantones se ha fortalecido y tienen suficientes recursos financieros disponibles. Sin embargo, contrario a las expectativas, las diferencias en el potencial fiscal de los cantones no han disminuido, sino que incluso han aumentado durante los últimos cuatro años.

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS****1. INTRODUCTION**

After World War II, in many countries there was a tendency towards centralisation. Sometimes it was openly proposed, but often it was a more creeping process. More recently, however, attempts to strengthen federal structures or even introduce them in former unitary countries are observed. Even countries like the United Kingdom or Spain gave their sub-federal units (states) relative independence which sometimes is even much stronger than in traditional federal states like Germany or Austria. And we also observe that in other continents rather a further development than a withdrawal of federal structures, at least as far as the countries can be considered as being democracies.

Despite the fact that Switzerland still has a very much decentralised structure and is still more strongly oriented towards the concept of a competitive than that of a cooperative federalism, it also experienced some creeping centralisation. Some of this centralisation was objectively justified, but other parts are highly questionable and should perhaps be reversed. Thus, at the beginning of the nineties, a reform of the Swiss Federal system seemed to be appropriate. Moreover, it became more and more clear that the old fiscal equalisation system was not only rather intransparent but also provided sometimes perverse incentives. This did not only hold for the financial relations, but also for the assignment of political tasks to the different governmental levels and for the (necessary) cooperation between the cantons and the federal government as well as among the cantons. Thus, the need for a reform became more and more obvious.¹ But, as not only the Swiss development teaches us, a general awareness of the necessity for a reform and its successful carrying out and finishing are two rather different things.

A rather special feature of the Swiss system is the large fiscal autonomy the cantons (and, somewhat more restricted) the local communities have. There is a highly progressive federal income tax, but its amount is relatively small, and even the marginal tax rate is not above 13 percent. (The maximum average tax rate is 11 percent.) The reason for this restraint of the federal level is the fact that the income tax is mainly a cantonal tax; apart from some antecessors a general federal income tax did not exist before the Second World War.² And the property tax is still an exclusively cantonal one. According to the tax harmonisation law there is some harmonisation of the tax base. The cantons decide on the (progressive) tax schedule and the concrete tax rates while the local communities (and in many cantons also the official Christian churches) lay a surcharge on the cantonal taxes. Thus, there exist 26 different cantonal tax regimes in Switzerland, which implies that there is strong tax and not only expenditure competition between the cantons. As will be shown below, this results in considerable differences of the tax burdens for companies as well as for individuals between, for example, low-tax cantons like Zug or Schwyz and 'tax-hells' like Jura or Valais. These discrepancies have even increased in recent years. The existing equalisation system was apparently unable to prevent this. Thus, not only from a theoretical perspective, but also from the deficiency of the actual results a reform seemed to be necessary.

But why do we need a fiscal equalisation system at all? In a Tiebout-world, for example, such a system would never be necessary. But we do not live in a Tiebout-world with its symmetry assumptions, because the cantons differ considerably, in particular with respect to their size and their locations. And this might, as will be shown below, justify the existence of such a system, but if and only if it is effective in reaching the objective of (some) equalisation. Apparently, the old Swiss system was rather deficient in this respect.

1. The deficiencies of the old system are described, for example, in R FISCHER, T. BELLJEAN and J. FIVAZ (2003).

2. For the history of the fédéral direct income tax see, for example, C. STOCKAR (2006)

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

Before presenting the concept of the new Swiss fiscal equalisation system we will, therefore, first discuss why such a system is necessary for Switzerland (*Section 2*). Then, the current Swiss situation is presented (*Section 3*). *Section 4* describes the new system which effectively consists of two parts: the first one newly assigns the different tasks to the different governmental levels and organises the cooperation between the national and the cantonal governments as well as between the cantonal governments, while the second one reorganises the financial flows between the different levels. *Section 5* shows the results of the just expired first period of the new system from 2008 to 2011, as well as the changes decided for the second, new period which will last from 2012 to 2015. The paper concludes with a short assessment of the new system (*Section 6*).³

2. ON THE NECESSITY OF A FISCAL EQUALISATION SYSTEM IN ASYMMETRIC SITUATIONS

It is debated in the literature whether fiscal competition and, in particular, tax competition, has positive or negative consequences overall. Theoretical considerations alone do not give a clear answer.⁴ The big advantage compared to a unitary system, what has already been emphasised by A.C. TIEBOUT (1956), is that political decisions are more in line with the preferences of the citizens. The main problem is, however, that a 'race to the bottom' might occur which leads to a too low degree of government activity. This holds primarily for redistribution,⁵ but might also hold for the supply of public goods, as H.W. SINN (1997, 2003) emphasised more recently. On the other hand, there is an additional positive effect that the citizens are better able to control their government and, therefore, to tame 'Leviathan'.⁶ Whether the positive or the negative effects dominate is, therefore, first of all an empirical question, but also very much depends on the design of the federal system, in particular on the distribution of tasks among the different governmental levels.

When discussing this problem, nearly all theoretical models consider symmetric situations, i.e. the different governmental units have the same size and in the beginning the same amount of production factors.⁷ Differences result primarily from the differing preferences of the individuals, and according to these preferences the citizens sort themselves to find their optimal locations. This rather optimistic picture is, however, hardly compatible with the reality in real federal systems. Problems arise usually by disparities, i.e. in asymmetric situations, be it due to different historical conditions as, for example, in Germany, or due to different endowments with natural resources as, for example, in Canada, or due to different locational conditions as emphasised by the New Economic Geography, or, what is most relevant in Switzerland (but also highly relevant for international tax competition) due to the different size of the governmental

3. This paper is partly based on G. KIRCHGÄSSNER (2010) where the new Swiss fiscal equalisation system is described in more detail.

4. A survey of the results of the theoretical models is given in L.P. FELD (2000, pp. 25ff.).

5. See for this already G. STIGLER (1957) as well as, for example, the overview in D.E. WILDASIN (1997).

6. See for this already G.M. BRENNAN and J.M. BUCHANNAN (1977, 1980).

7. There are two exceptions. First, the New Economic Geography, going back to P. KRUGMAN (1991, 1991a), where the role of low taxes as compensations for the disadvantages connected with locations at the periphery (compared to locations in agglomerations) is discussed (see, for example, R.E. BALDWIN et al. (2003, pp. 365ff.), or R. BORCK and M. PFLÜGER (2006)). Second, there is a literature about tax heavens (see, for example, M. DESAI, C.F. FOLEY and J.R. HINES (2006, 2006a), D. DHARMAPALA (2008), D. DHARMAPALA and J.R. HINES (2009), or J. SLEMROD and J.D. WILSON (2009)). While the former has some relevance for Switzerland, because cantons at the periphery might try to attract taxpayers by low tax rates, the latter aspect is, at least for the fiscal relations within Switzerland, totally irrelevant.

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

units. S. BUCHOVETSKY (1991) as well as J.D. WILSON (1991) have shown that small units can have an advantage in the tax competition game compared to large units.⁸

Starting from the situation of a social optimum with identical tax rates a small unit, as in Switzerland, for example, the canton Zug, can improve its situation by reducing tax rates and, therefore, attracting additional tax payers. If the large cantons like, in Switzerland, Bern or Zürich, would reduce their taxes to the same extent, nobody would win: both had still identical tax rates, but lower financial means. The large cantons will, however, not fully adjust; they will reduce their tax rates to a smaller extent than the smaller cantons. The logic behind this is that, by reducing tax rates, a large canton will lose quite a lot of revenue from those taxpayers already located in the canton and will – in relative terms – not gain very much from those taxpayers moving into the canton. The opposite holds for the small canton. In the new equilibrium, both will have lower tax rates than in the beginning, but the tax rate of the smaller unit will be lower than the one of the larger unit. Moreover, despite the lower tax rate, the smaller unit will have higher public expenditure per capita, and also higher welfare compared to the larger canton, and the welfare gains of the smaller unit cannot compensate for the losses of the larger one.⁹ The condition that this effect occurs is that the difference in size between the small and the large canton (or country) is large enough. In principle, this result holds for all taxes which are instruments in the tax competition game, but while it relates in international tax competition mainly to corporate income taxes, it is within Switzerland also highly relevant for personal income taxes because one can, for example, work in the large canton Zürich and reside in the small canton Zug.

If all units would (more or less) meet the symmetry conditions of the theoretical models, we would not need a fiscal equalisation system. Those areas where we would be afraid of a race to the bottom, especially redistribution and national public goods, could be assigned to the central level, and there might be competition in other areas, primarily with respect to the allocation of regional and local public goods. However, if we have tax competition between units of very unequal size, a fiscal equalisation system becomes necessary in order to prevent the country from breaking apart.¹⁰ This certainly holds for Switzerland, where the relation of the size of the population between the smallest canton, Appenzell Inner Rhodes, and the largest one, Zürich, is about 1 to 88. In a democracy, this might have two consequences: the splitting up of the country into different smaller, but unitary organised countries or the abolition of the federal structure or, at least, of tax competition. The latter one might be the Swiss solution, because, due to the existence of direct political rights, people can abolish or at least restrict tax competition between the cantons by a constitutional initiative, should the discrepancies become too large.

This was an important issue in the referendum campaign for the new fiscal equalisation system in 2004. The left-wing parties argued against this system (with several arguments). They wanted to restrict tax competition between the cantons, to get a more harmonised system. The chances to reach this objective are the smaller the better the fiscal equalisation system reaches its goals. Thus, the other parties which were in favour of the reform pointed to the fact that, due to the increasing discrepancies between the cantons, its failure would increase the chances that a more harmonised tax system would be accepted by the Swiss electorate.¹¹

8. See for this also A. HAUFLE (2001, pp. 74ff.).

9. One might even say that the smaller units exploit the larger ones.

10. In 2006, the Swiss Socialdemocratic Party started an initiative in order to restrict tax competition. On November 28, 2010, it has, however, been rejected by the Swiss voter with 58.4 per cent of the votes.

11. For the effects of fiscal equalisation in a system of asymmetric tax competition see also C. GAIGNÉ and S. RIOU (2007), or J. HINDRICKS, S. PERALTA, and S. WEBER (2008).

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

NOVEDADES DEL
FEDERALISMO COMPARADONOVEDADES DEL
ESTADO AUTONÓMICONOVEDADES
PARLAMENTARIASACTUALIDAD
IBEROAMERICANACRÓNICA
INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012

CRÉDITOS

The problem of any fiscal equalisation system is, however, that the incentives to keep track of the own tax basis are reduced. This holds for those governmental units which receive money from this system, but also for those which have to pay into the system. This problem can be somewhat mitigated if the distributed money stems (at least partially) from central tax revenue, because the 'rich cantons' will still have incentives to take care of their tax basis. For the poor cantons, however, it still holds that the corresponding incentives are the lower the stronger the equalisation is. Germany is a rather negative example in this respect. The German Constitutional Court declared in several decisions that even a very far reaching equalisation is constitutional.¹² Moreover, there was a partial bailout of two smaller states, Saarland and Bremen, in 1992. This seduced some states to follow a non-sustainable policy.

3. THE SWISS SITUATION

As mentioned above, in the Swiss federal system, the fiscal autonomy of the sub-national units, the cantons and local communities, is especially pronounced.¹³ They are responsible for all tasks that are not explicitly assigned in the constitution to the national level. They also dispose of the required tax autonomy in order to raise the necessary revenue to fulfil these tasks. This allows every single canton and every single local community to balance and to individually fix the appropriate amount of public expenditure. This results in considerable disparities between the cantons. In 2007, the last year when the old fiscal equalisation system was in effect, for example, a married couple with two children and a gross labour income of 100'000 CHF had to pay 4'019 CHF income tax in Zug, but in Delémont in the canton Jura with 11'587 nearly three times as much. With a gross labour income of 1 Million CHF the relative difference becomes smaller, but the absolute difference with 165'948 CHF much larger.¹⁴ But despite the fact that the tax burden is so much higher, the tax revenue per capita is considerable smaller in the canton Jura: in 2007 it was 6'471 CHF compared to 10'576 CHF in the canton Zug.¹⁵

The situation of the total burden by cantonal, local and Church taxes is displayed in the index of total tax burden which has been officially calculated until 2006. The values for this last year are given in *Figure 1*.¹⁶ There are huge discrepancies. In Zug, the canton with the lowest (average) burden, the index number is just above 50, whereas in Uri, the canton with the highest burden, the index is just below 140. Also, it has to be taken into account, that these are average figures for the cantons; the picture is somewhat different (and the discrepancies are even larger) if we consider single local communities. Zug, for example, allows only minor differences among its local

12. See the decisions of the Constitutional Court of February 20, 1952 (1 BvF 2/51), of June 24, 1986 (2 BvF 1, 5, 6/83 und 1, 2/85; E 72, 330 II), of May 27, 1992 (2 BvF 1, 2/88, 1/89 und 1/90; E86, 148, II) and of November 11, 1999 (2, BvF 2, 3/98 1,2/99; BverfGE 101, 158).

13. For descriptions of the Swiss fédéral system see, for example, V. BOGDANOR (1988) or D. STARK (1999), in comparison with Germany G. KIRCHGÄSSNER and W.W. POMERHNE (1992) as well as A. JÖRG (1998), and in comparison with other fédéral countries W.W. POMMERHNE (1977) or R. BIRD (1986).

14. Source of the data: FÉDÉRAL STATISTICAL OFFICE, *Charge fiscale en Suisse: Chefs-lieux des cantons – Nombres cantonaux 2007*, Bern 2008, p. 19. – If we only count the burden by cantonal, local and Church taxes, i.e. without the rather progressive fédéral income tax, the tax burden is in Delémont for an income of 100'000 CHF approximately about 3.3-times as high as in Zug and for an income of 1'000'000 CHF about 2.6-times as much.

15. Source of the data: FÉDÉRAL STATISTICAL OFFICE, *Finance publiques en Suisse 2007*, Bern 2009, p. 153.

16. Source of the data: FÉDÉRAL STATISTICAL OFFICE, *Annuaire statistique de la Suisse 2012* (CD-ROM) *Charge fiscale selon les cantons, évolution de l'indice global* (Table. je-d-18.02.02.03.12). – This index was used for the old fiscal equalisation system. As will be explained below, the new system does no longer refer to the actual tax burden but to the revenue potential. Thus, this index is no more necessary for official purposes and these data are, therefore, no longer provided by the Fédéral Statistical Office.

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

NOVEDADES DEL
FEDERALISMO COMPARADONOVEDADES DEL
ESTADO AUTONÓMICONOVEDADES
PARLAMENTARIASACTUALIDAD
IBEROAMERICANACRÓNICA
INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012

CRÉDITOS

communities. Schwyz, on the other hand, with a rather loose cantonal equalisation system, allows some of its local communities like Freienbach or Wollerau to have even lower tax rates than the local communities in the canton Zug. These low-tax and mostly rich cantons and local communities have to be contrasted with the cantons Uri, Obwalden, Neuchâtel, Glarus, Jura and Fribourg, where the tax burden was above 120 percent of the national average in 2006. These cantons and their local communities are mostly relatively poor. Because the income of their citizens is low compared to those in other cantons, they have to have comparatively high tax rates in order to raise the revenue necessary to fulfil their constitutional tasks.

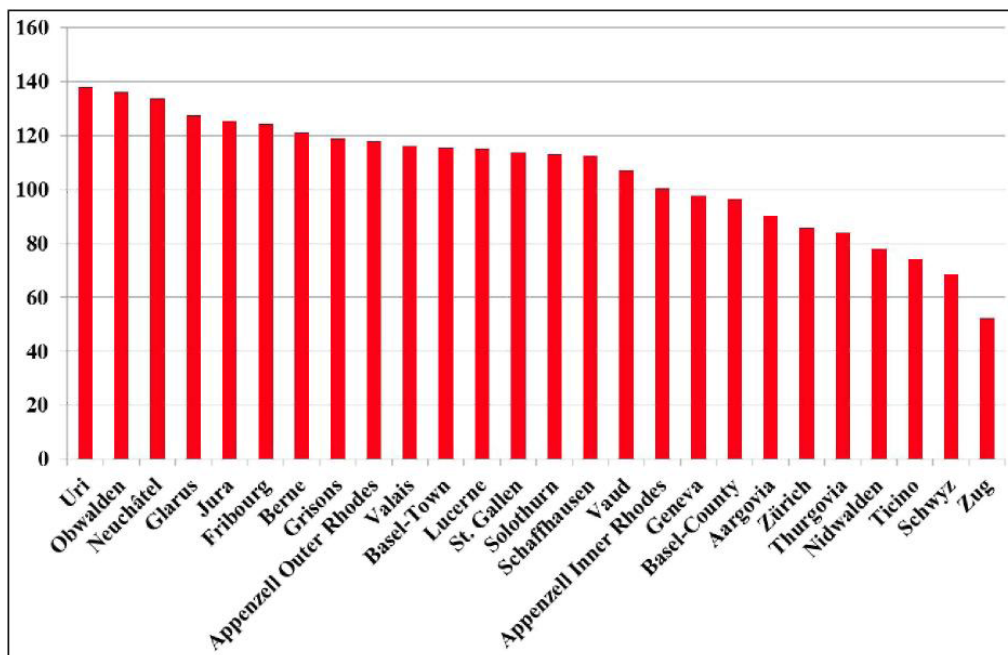


Figure 1: Index of the tax burden in the Swiss cantons, 2006 (0= 100)

There is a special feature of the Swiss tax system which encourages small cantons to reduce their tax rates. In the old system, 30 per cent of the collected federal direct income tax went directly back to the cantons. Thus, as long as lower tax rates attract additional taxpayers, part of the revenue shortfall due to reduced cantonal rates is compensated by higher grants from the federal government. In this way, the rich canton Zug got by far the highest per capita transfers from the federal government; its amount was in 2006 three times as much as the national average and it covered about 25 percent of the expenditures.

Thus, contrary to Germany where there is too much equalisation, a major problem of the old Swiss system is that it did not equalise enough. Moreover, there were cantons like Vaud that got much more money than they should. Third, this system was not transparent; it was difficult to assess its real effects. One of the reasons for this was that the compensatory payments were partly depending on the actual tax revenue which made them easily manipulatable by the cantons. Finally, the system restricted the autonomy of the cantons to a degree that is unnecessary. Taking all these effects together, there was no doubt that a reform became necessary. This was also undisputed in the referendum campaign. It was disputed however, to which level the different tasks, in particular the responsibility for the disabled, should be assigned as well as to what extent the rich cantons should carry burdens in order to disburden others.

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS****4. THE DESIGN OF THE NEW FISCAL EQUALISATION SYSTEM**

There were two main objectives that should be reached with the new fiscal equalisation system. First, following the subsidiarity principle, the tasks of the different governmental levels should be more disentangled, in particular between the national and the cantonal level. In the former system, the different governmental levels shared the responsibility in most policy fields and often so in a rather intransparent way. Thus, wherever common tasks are still necessary, it was intended to have a clearer assignment of the responsibilities to the different levels as well as more transparent procedures. Second, the financial potential of the cantons should be more equalised. Somewhat more detailed, the following objectives were aimed at:

- (i) Strengthening of the financial autonomy of the cantons.
- (ii) Reduction of the differences in the fiscal potential of the cantons.
- (iii) Preservation of the national and international competitiveness of the Swiss cantons (mainly with respect to their tax system).
- (iv) Provision of a sufficient minimal financial equipment of the cantons.
- (v) Equalisation of excessive financial burdens due to socio-economic and topographical reasons.
- (vi) Provision of an appropriate burden-sharing between the cantons.

In order to reach these goals, the new equalisation system employs four instruments:

- (i) Disentangling of tasks and financing.
- (ii) New forms of collaboration and financing of joint tasks.
- (iii) New forms of inter-cantonal collaboration.
- (iv) A new fiscal equalisation in the strict sense, i.e. new compensation payment to and between the cantons.

In the following, we first discuss the new assignment and responsibility regulations¹⁷ and second the fiscal equalisation in the strict sense.

4.1. The Assignment of and Responsibility for Tasks

18 tasks with previous common responsibility have been entangled in the new system: seven are now solely the responsibility of the national and 11 of the cantonal level.¹⁸ Among those for which the federal government is responsible are now, for example, the financing of the individual benefits of the first column of the Swiss old age pension system as well as the benefits of disabled persons (both in addition to the contributions of employers and employees) as well as the construction and maintenance of motorways. The cantons are solely responsible, for example, for the second-level education as well as grants-in-aid for the building and running costs of homes and professional schools for disabled persons. Among those 17 tasks where there is still common responsibility, are, among others, educational grants at the university level, subsidies to reduce health insurance premia, or public transport in agglomerations. In these areas, the federal government's task is, in principle, only the strategic leadership, while the cantons have

17. A more detailed description of this part of the NFA is given in B. DAFFLON (2004) or in CH.A. SCHALTEG-GER and R.L. FREY (2003).

18. See for this also NFA Feuilles d'information 2 and 9, (http://www.efv.admin.ch/f/dokumentation/zahlen_fakten/finanzpolitik_grundlagen/finanzausgleich/index.php) (31/03/12).

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

the operative responsibility. Most projects in these areas are financed by global grants from the federal government depending on the results to be achieved.

Due to the fact that many Swiss cantons are rather small but still have – at least compared to states in most other federal countries – rather large responsibilities, in many cases collaborations between two or more cantons are necessary. Moreover, the large agglomerations as, in particular, Zürich, Basel and Geneva, already provided in the past services from which other cantons profited without having been forced to contribute to their financing.

There has already been some collaboration between cantons in some of these areas before. In particular, there are conferences of the cantonal ministers whose decisions are effective in all cantons. These collaborations are, however, mainly optional; it was impossible to force single cantons to carry the financial burdens caused by them to other cantons. This has been changed. The federal parliament is now able to declare general agreements or other inter-cantonal treaties as generally binding and to commit single cantons to join these. This is to assure a fair distribution of services and services in return, or benefits and costs of public activities between the cantons. Those cantons which receive services get co-determination rights in return. This new provision allows considerable interferences into the autonomy of the cantons and represents, therefore, a massive change of the Swiss federal system.

4.2. The Fiscal Equalisation System in the Strict Sense

The new fiscal equalisation system in the strict sense consists of three elements. The first one is resource equalisation. All cantons should have a necessary minimum amount of fiscal means in order to be able to properly fulfil their tasks assigned to them by the constitution. The second element is the sharing of special burdens of some cantons caused by their socio-demographic situation or by the geographic and topological structure. The final element, called hardship compensation, is a compensation for temporary financial losses caused by the transition from the old to the new system.

The core of the new equalisation system is, of course, resource equalisation. For this it is first of all necessary to assess the financial capability of every canton. This is done by a resource index. It is based on the taxable income as well as the wealth of the individuals, but also on corporate profits. The weighted sum of these three elements constitutes the resource potential of the canton and, divided by the size of the population, the resource potential per capita. Comparing this with the average resource potential per capita in Switzerland which gets an index value of 100 leads to the index value of every single canton. Cantons with an index value above 100 are said to be strong with respect to resources while those with an index value below 100 are considered as being weak with respect to resources. The first group pays into the system, the second one receives revenue from the system. The payments are to be designed so that every canton has free financial means of at least 85 percent of the national average.

The main advantage of the new system is, however, not so much that the equalisation is now fairer (which is, of course, also important), but that the incentives are different. The basis of the new index is the situation of the canton with respect to the direct federal income tax. In contrast to the old system, the level of the cantonal taxes or tax rates does no longer play a role. Thus, manipulations of the own tax revenue do not have any direct effects on the received grants. There are, of course, indirect effects; the situation of a canton in the inter-cantonal tax competition has implications for the tax base of the direct federal income tax. But these indirect effects do hardly give the cantons the possibility to manipulate the grants they receive. In particular, a reduction of the

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

cantonal taxes will not trigger an increase of the grants; if there is an effect, it goes in the opposite direction. Insofar, the incentives for the cantons to take care of their tax basis are not affected. This is a great improvement compared to the old system.

This equalisation is, however, not only financed by the contributions of the donor cantons but also by the federal government. During the first four years, i.e. from 2008 to 2011, the whole amount was 3.16 Billion CHF; the federal government paid 1.8 Billion CHF and the donor cantons 1.26 Billion CHF.¹⁹ The contribution of the federal government is paid from the revenue of the federal direct income tax. Of the 30 per cent of the revenue of this tax that goes back to the cantons, in the new system only 13 per cent is directly redistributed today, while the remaining 17 per cent go into the equalisation system. Thus, the rich cantons do not necessarily have to pay more money to the other cantons, but they get less money directly from the federal government. For some cantons, in particular Zug, this results in a significant higher net contribution.

The cantons differ, however, not only with respect to their resource potential, but also with respect to the costs for the services they have to provide, be it, that they have a considerably higher demand for some services, be it, that it is more expensive to provide these services. The first factor mainly relates to agglomerations with their social and demographic problems, the second factor to the topography of the canton. To compensate for these extra burdens, the second element 'burden sharing' or 'cost equalisation' has been included into the system.²⁰ This is divided into two parts. The first covers additional burdens due to geological and geographic factors, i.e., it captures the effects due to mountain areas. To compensate for these burdens, during the first four years, the federal government paid 341 Million CHF per year to the cantons. The same amount of money was paid by the federal government to compensate for socio-demographic burdens, i.e. to cover the additional burdens of agglomerations.

An immediate transition to the new system would have created quite a lot of losers, even among those cantons that are (according to the resource index) financially weak. The reason is that some cantons received higher grants under the old system than they deserve under the one. Under these conditions, the new system would hardly have had any chance in the referendum. A referendum was, however, mandatory because the introduction of the new system required a constitutional change, and in Switzerland every such change is subject to a mandatory referendum. In order to avoid this and not to risk the whole project, the hardship compensation has been added as the third element. The idea behind is that every financially weak canton should, at least in the beginning, have some relief, whatever its position in the old system was.

For the first eight years, i.e. until the end of 2015, the payments were fixed. Then, the amount of money for hardship compensation will be reduced by 5 percentage points every year. Thus, the new standard situation will be reached in 2035 only. In the beginning, the total amount was 430.5 Million CHF, 287 Million CHF were paid by the federal government and 143.5 Million CHF by the cantons. The latter had to be paid on a per capita basis and was about 19.5 CHF per capita. However, when the new system was installed, the canton Vaud improved its financial situation and, in 2009, crossed the 100 per cent index line of the resource potential; it therefore switched from a recipient to a donor canton. As a consequence, it is also no longer entitled to benefit from the hardship compensation fund. This reduced the total amount to be spent to 366 Million CHF and, correspondingly, the per capita payment to about 16.7

19. See: Arrêté fédéral concernant la détermination des contributions de base à la péréquation des ressources et à la compensation des charges (RS 613.22). (<http://www.admin.ch/ch/f/sr/6/613.22.de.pdf> (31/03/12).)

20. The latter term is used, for example, by B. DAFFLON (2004).

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMÉRICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

CHF.²¹ It still holds, however, that two thirds of the contribution to this fund comes from the federal government and only one third from the cantons.

Economically, this part of the new equalisation system is the most problematic one. It is, however, a political concession to these cantons. Given the large majority in the referendum on November 28, 2004, one might ask whether these concessions have really been necessary, in particular to such a large extent. It has, however, to be taken into account that a rejection by the electorate would have had the consequence that these cantons would have received their –from today's point of view – unjustified grants on and on and these grants might even have increased. Insofar, these concessions seem to be justified in order to get a second best solution and not to endanger the whole project.

5. EXPERIENCES FROM THE FIRST PERIOD FROM 2008 TO 2011.

While the general architecture of the NFA is fixed in the constitution, the details described above, fixed in the corresponding law, did only cover the first four years from 2008 to 2011. Thus, in 2011 the parliament had to decide on how to proceed for the new legislative period from 2012 to 2015. Background information for the discussion in the parliament was given by the government in a report covering the experience of the first years (FEDERAL COUNCIL SWISS (2010)) as well as in a 'message' accompanying the proposal for revising the law (FEDERAL COUNCIL SWISS (2010a)).²² The basic proposal of the government consisted in keeping the structure unchanged but actualising the amounts of money to be spent.

Two themes dominated the parliamentary discussion. First of all and most importantly, the donor cantons wanted to limit their contribution.²³ In the current system, the lower limit of 85 per cent of the national average of the tax potential which should be guaranteed to the poorest cantons determines how much the rich cantons have to pay; this regulation is inconsistent with the demand of an upper limit for these cantons. Nevertheless, these cantons demanded such an upper limit. They criticised that some of the recipient cantons, in particular Obwalden, became enabled by the new fiscal equalisation system to also follow a low-tax strategy and, therefore, became a competitor for the 'old' low-tax cantons. Thus, they tried to prevent this, be it by a lower limit for the tax rate of the recipient cantons or by a reduction of the transfers to these cantons with low tax rates. All of these proposals have been rejected by the majority of representatives of the recipient cantons in the parliament. The last two proposals had, of course, additionally violated the whole rationale of the Swiss system of cantonal tax competition; with few limitations the constitution guarantees the cantons the right to decide on their own income and property tax schedules.

The second theme was the splitting up of the resources for the burden sharing between the agglomerations and the 'mountain cantons'. There was a report by ECOPLAN (2010) which showed that the burdens of the agglomerations are much higher than those of the mountain cantons. Thus, a splitting of three to one quarter might be more appropriate than the 50:50 split in the first period. Nevertheless, the parliament decided in this case against a change as well.

21. See for this FÉDÉRAL COUNCIL SWISS (2011, p. 148).

22. See also FÉDÉRAL COUNCIL SWISS (2011).

23. See FÉDÉRAL COUNCIL SWISS (2010, pp. 148ff).

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

NOVEDADES DEL FEDERALISMO COMPARADO

NOVEDADES DEL ESTADO AUTONÓMICO

NOVEDADES PARLAMENTARIAS

ACTUALIDAD IBEROAMERICANA

CRÓNICA INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS: ENERO-MAYO 2012

ACTIVIDADES PREVISTAS: JUNIO-DICIEMBRE 2012

CRÉDITOS

The question is, however: how far did the NFA succeed in meeting the intended objectives. The most important objective was to lift the resource endowment of each canton to 85 per cent of the national average at the minimum. *Figure 2* shows the results for the years 2008 and 2010. ²⁴ In 2008, this objective was clearly achieved. In 2010, the picture was somewhat different. Three cantons, Valais, Jura and Uri had a resource endowment slightly below this benchmark. Thus, the distribution of the transfers had to be slightly changed for the second period. On the other hand, *Figure 2* also shows that payments the major donor cantons had to make were rather moderate; they did not impair their position largely above the national average.

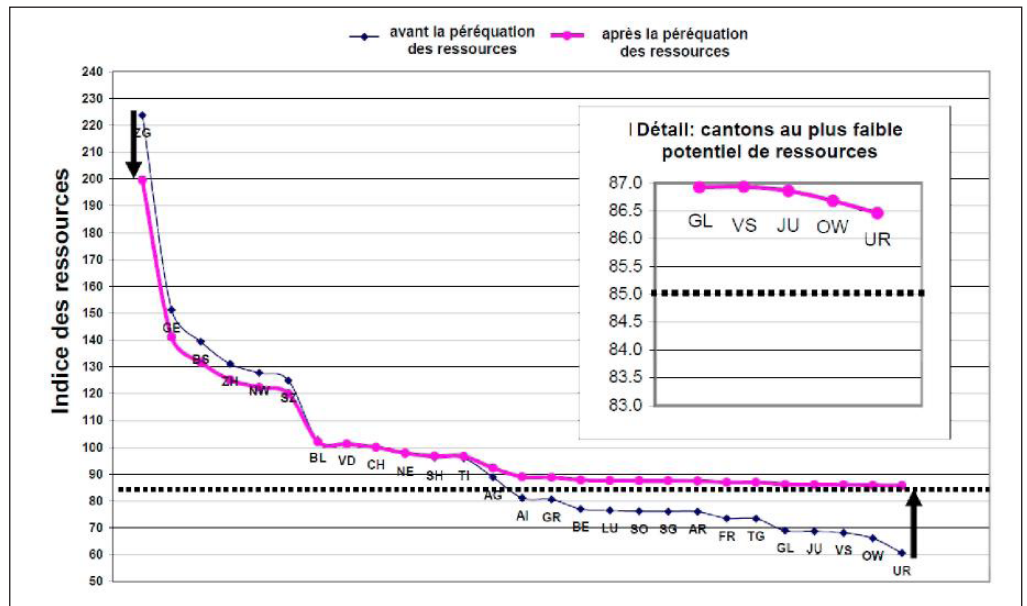


Figure 2a: Resource index before and after resource equalisation, 2008

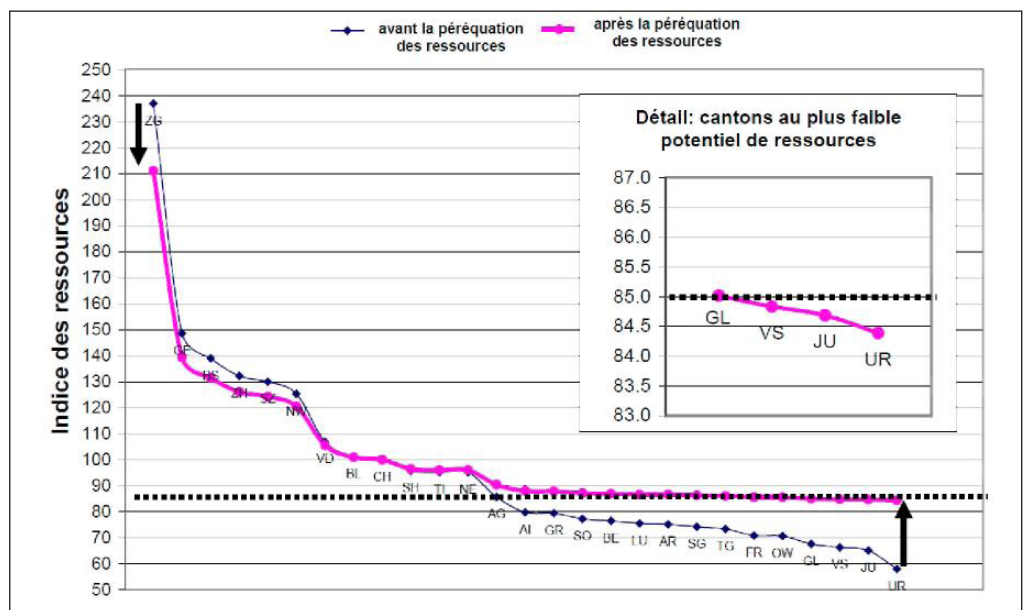


Figure 2b: Resource index before and after resource equalisation, 2010

24. Source of Figure 2: FÉDÉRAL COUNCIL SWISS (2010, p. 74f.). The abbreviations for the cantons are given in the Appendix.

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

NOVEDADES DEL
FEDERALISMO COMPARADONOVEDADES DEL
ESTADO AUTONÓMICONOVEDADES
PARLAMENTARIASACTUALIDAD
IBEROAMERICANACRÓNICA
INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012

CRÉDITOS

The main question is, however, whether the poor cantons were able to improve their situation. We can check this if we compare the index values for the first period with those of the second period. The picture is mixed. While Obwalden with its low-tax strategy was able to improve its situation quite a lot by 15 index points, the situation of the poorest canton, Jura, deteriorated by 4.9 points.²⁵ But the strongest improvement had the two small rich cantons Zug and Schwyz with 26.3 and 24.6 index points, respectively. As small neighbours of Zürich they can follow a low-tax strategy and at the same time profit from the supply of services in the agglomeration of Zürich. Thus, the span in the resource potential of the Swiss cantons increased considerably over these four years.

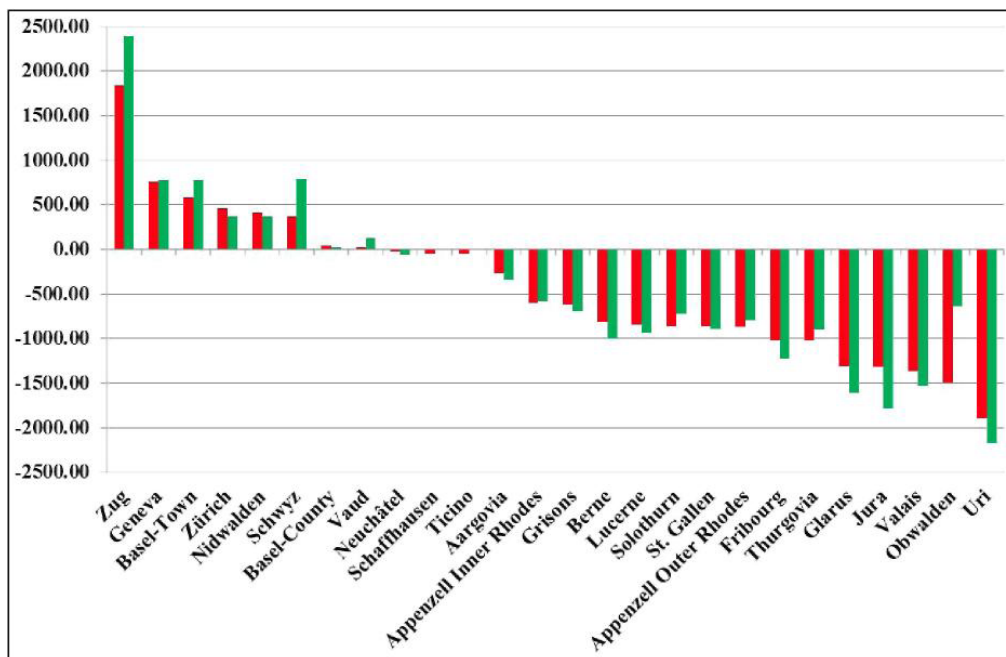


Figure 3: Contributions or transfers 2009 (red) and 2012 (green), respectively (CHF per capita)

Figure 3 shows the contribution of the donor cantons and the transfers of the recipient cantons in the old (2009, red) and the new (2012, green) period, i.e. how this results in actual payments. Due to economic growth, the whole amount of redistribution increased from 3177 Million CHF in 2009 to 3573 Million CHF in 2012. The order with respect to the resource potential did hardly change: the correlation between the two series is 0.974. There are nevertheless some major changes: Zug and Schwyz have to pay considerable more into the system, 554 CHF per capita or 419 CHF per capita, respectively. On the other hand, Jura and Glarus get considerable more out of the system: 458 CHF per capita or 297 CHF per capita. The largest change results, however, for Obwalden: it gets 857 CHF less out of the system than before. In this case, the new fiscal equalisation system works in the intended direction: by lowering the tax rates Obwalden was able to increase its resource potential so that it needs less subsidies from other cantons and the federation. The same holds, however to a much less extent, for the recipient cantons Solothurn, Schaffhausen, Appenzell Inner Rhodes, Appenzell Outer Rhodes, St. Gallen, Thurgau and Ticino, while the situation deteriorated not only in Jura but also in Berne, Lucerne, Uri, Glarus, Fribourg, Grisons, Aargau, Valais and Neuchâ-tel. So far, the latter ones benefited only indirectly from the new system: they got more transfers than they

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

NOVEDADES DEL
FEDERALISMO COMPARADONOVEDADES DEL
ESTADO AUTONÓMICONOVEDADES
PARLAMENTARIASACTUALIDAD
IBEROAMERICANACRÓNICA
INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012

CRÉDITOS

ever received in the old fiscal equalisation system. Nevertheless, while the provision of a sufficient minimal financial equipment of all cantons has nearly been reached, the reduction of the differences in the fiscal potential of the cantons has clearly failed or, to state it more politely, not yet reached so far.

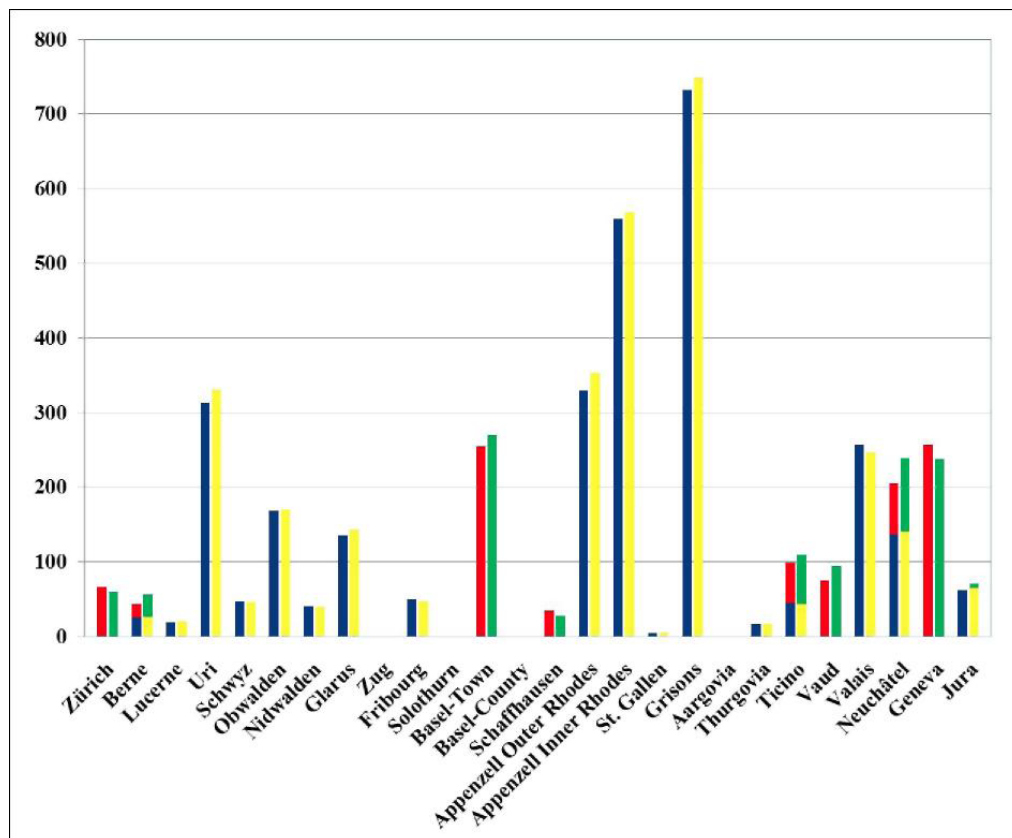


Figure 4: Transfers for agglomeration costs in 2009 (red) and 2012 (green) as well as for topographical burdens in 2009 (blue) and 2012 (yellow) (CHF per capita)

The development of cost compensation is shown in Figure 4. The total amount to be spent increased from 2009 to 2012 from 702 Million CHF to 738 Million CHF, i.e. by about 5 per cent. As mentioned above, despite a report that clearly showed that a different splitting of this amount would make sense, the parliament stuck to the old structure. Because there were no major changes in these burdens, there are only minor changes in the transfers as well. The main beneficiaries of the compensation of topographical burdens are Grisons, Appenzell Inner Rhodes, Appenzell Outer Rhoden and Uri, while the main beneficiaries of agglomeration costs compensation are the two town cantons, Basel-Town and Geneva. There are four cantons which get no money at all from these funds: Zug, Solothurn, Basel-County and Aargovia.

That there is hardly any change from the first to the second period of the NFA holds even more for the hardship compensation shown in Figure 5. When the new system was introduced, it was decided that the transfers for each canton should remain constant over the first eight years. Thus, there are only some very minor changes due differences in the deployment of the population. As Figure 5 shows, there are two cantons, Neuchâtel and Fribourg, which benefit quite lot. They receive 623 CHF and 505 CHF per capita, respectively. Three cantons get reasonable payments, among them the low-tax canton Obwalden. There are three other cantons which receive rather marginal payments out of this fund. All others have to pay into it. Their contributions are, however, rather small

PORTADA

SUMARIO

PRESENTACIÓN

ÁREAS DE ESTUDIO

NOVEDADES DEL FEDERALISMO COMPARADO

NOVEDADES DEL ESTADO AUTONÓMICO

NOVEDADES PARLAMENTARIAS

ACTUALIDAD IBEROAMERICANA

CRÓNICA INTERNACIONAL

AGENDA

ACTIVIDADES REALIZADAS: ENERO-MAYO 2012

ACTIVIDADES PREVISTAS: JUNIO-DICIEMBRE 2012

CRÉDITOS

with today, approximately, 16 CHF per capita because, as mentioned above, two thirds of the money from this fund come from the federal government.

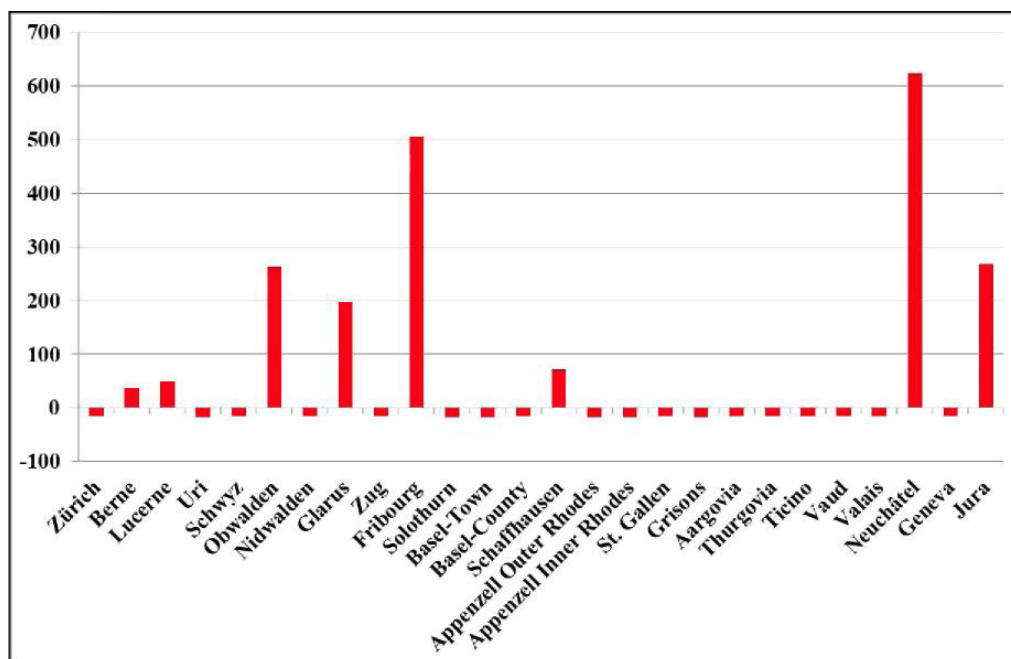


Figure 5: Contributions to and payments out of the hardship compensation (2012) (CHF per capita)

Another objective was to improve the efficiency of the public services. Such efficiency gains are, of course, difficult to estimate. The Federal Roads Office undertook an attempt for its field of responsibility. In the old system, the cantons were owners and operators of the highways, while the federation paid up to 97 per cent of the cost. Today, the whole responsibility is with the federation; only the completion of the highway net is a common task of the federation and the cantons. According to the estimate of the Federal Roads Office, the efficiency gain of this new arrangement was between 100 and 250 Million CHF for the year 2008.²⁶ Thus, while it is still too early to draw definite conclusions, the evidence available so far is at least pointing into the right direction.

6. CONCLUDING REMARKS

The reform of the Swiss fiscal equalisation system was a rather long process. First serious considerations and planning started in the federal finance administration in 1992. A first concrete proposal was presented in 1999. Aside from hardship compensation, it had already the structure of the concept in effect today. As prescribed by the constitution, there was the usual consultation procedure, and the proposal with all comments was published in March 2000. The cantonal finance ministers accepted the proposal after additional discussions and the inclusion of the hardship compensation in August 2001. At this time the only negative vote came from Zug.

Then, the parliamentary process started. A first step was to pass the necessary amendment of the constitution. The federal government presented its proposal in November 2001. The parliament accepted the reform with some minor revisions in October 2003. As mentioned above, there had to be a referendum, as for every change of the Swiss

26. See FÉDÉRAL COUNCIL SWISS (2010, p. 87ff.).

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

constitution. After intense public discussions, on November 28 2004, the Swiss citizens voted with 64.4 per cent for this reform.

Thus, after a political process which took altogether about 16 years, at the moment there are only four years to evaluate the new system. Nevertheless, when discussing the design for the next period from 2012 to 2015 we had to ask whether the hopes and expectations combined with this huge reform have been met. Several objectives have been reached. There has been a (partial) disentangling of the governmental tasks between the federal and the cantonal level. One might think that it should go even further, but it seems to be rather difficult if not impossible to gain a majority of the people, besides the fact that this disentangling is already rather extensive compared with other European countries: the Swiss cantons have much larger responsibilities and, in particular, financial leeway than, for example the 'Bundesländer' in Germany or Austria. The financial autonomy of the cantons has also been strengthened, and they have a sufficient minimal financial equipment at their disposal. The national and international competitiveness of the Swiss cantons has not been impaired by the introduction of the new system; if there is anything, it has been strengthened.

The picture is not so clear with respect to the other objectives mentioned above. Given the fact that – according to a serious estimate in the report by ECOPLAN (2012) – the financial burdens caused by adverse topography are much smaller than those caused by agglomerations, the burden sharing in this area is not satisfactory. Moreover, the differences in the fiscal potential of the cantons have not been reduced. Therefore, one might question whether the burden sharing between the cantons goes far enough and/or whether this fiscal equalisation system is the appropriate instrument to reach this goal.

Four years are, however, a too short time to draw strong and final conclusions about such a complex system. Thus, we have to wait for another four or even eight years before we can draw more compelling conclusions. There are, however, some observations which indicate that the NFA might finally reduce the differences in the fiscal potential at least somewhat. Already in 2011 but also in the current year 2012, several low-tax cantons face considerable deficits. The canton Schwyz, for example, had in 2011 a deficit of about 4 per cent of its revenue. To limit the deficit in order to have it below 5 per cent was only possible by considerably reducing in investment activity. For 2012, a deficit of about 8 per cent of its expected revenue is planned.²⁷ At the moment, this is no major problem for this canton because it has savings of more than 40 per cent of its revenue. Nevertheless, if this tendency continues, the savings will be eaten up and tax increases might become necessary. At least, it is not possible to make further tax reductions in the near future. There are several reasons for this development, but one of them is the fact that, due to the increase of their resource potential, Schwyz has to give more into the resource equalisation part of the fiscal equalisation system.

A somewhat more moderate but similar development takes place in the canton Appenzel Outer Rhodes. They had a small deficit in 2011, and budgeted for 2012 a deficit of about 3 per cent of their revenue.²⁸ This is the canton which today has the lowest corporate income tax in Switzerland: the cantonal tax is only 6 per cent. They might reduce it further, but this will hardly lead to additional revenue, even in the long-run. This is not

27. See: Staatsrechnung 2011 des Kantons Schwyz, p.4 (http://www.sz.ch/documents/Staatsrechnung2011_MM.pdf) as well as Voranschlag 2012, Kanton Schwyz, p.7 (http://www.sz.ch/documents/Voranschlag_2012.pdf) (04.04.12).

28. See: Staatsrechnung 2011: Kleineres Defizit dank höheren Steuereinnahmen, (http://www.ar.ch/aktuell/medienmitteilungen-der-kantonalen-verwaltung/detail/article/staatsrechnung-2011-kleineres-defizit-dank-hoeheren-steuereinnahmen/?no_cache=1&tx_ttnews%5Bpointer%5D=1&tx_ttnews%5BbackPid%5D=6152&cHash=f5582cc65e1a64c6f660af1f5f90920e), Budget 2012, p. 10f. (<http://www.ar.ch/departemente/departement-finanzen/wichtige-informationen/>) (04.04.12).

PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

particularly important for this canton because its corporate tax income is very small in any case. But it is obvious that using this instrument in the tax competition game is no longer possible for this canton.

Other low-tax cantons like Zug, Nidwalden, Obwalden and Appenzell Inner Rhodes are also budgeting deficits for 2012, and at least in some of these cantons the fiscal plans show increasing deficits for the following years. Thus, for the next years the time of considerable tax rate reductions seems to be over. Insofar as high-tax cantons are able to reduce their tax rates due to their transfers from the fiscal equalisation system, the divide of a pair of scissors might close somewhat again in the next years. Whether this will really happen remains to be seen, but there is at least some indication that it might go in this direction.

Taking all things together, today, we can say that the long but finally successful process to establish the new fiscal equalisation system brought Switzerland a large step forward. This system has fulfilled some expectations, whereas with respect to others it is still open whether this will be the case. To have more information about this will take several additional years. This is not only but also due to the fact that the transition period with the hardship compensation will last 28 years altogether; the system will be fully in effect in 2036. I do, however, not believe that we have to wait so long before we can draw more definite conclusions. But for the moment we have to be patient.

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PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

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PORTADA**SUMARIO****PRESENTACIÓN****ÁREAS DE ESTUDIO****NOVEDADES DEL
FEDERALISMO COMPARADO****NOVEDADES DEL
ESTADO AUTONÓMICO****NOVEDADES
PARLAMENTARIAS****ACTUALIDAD
IBEROAMERICANA****CRÓNICA
INTERNACIONAL****AGENDA****ACTIVIDADES REALIZADAS:
ENERO-MAYO 2012****ACTIVIDADES PREVISTAS:
JUNIO-DICIEMBRE 2012****CRÉDITOS**

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APPENDIX

<i>Abbreviations of the names of the cantons</i>					
Aargovia	AG	Grisons	GR	St. Gallen	SG
Appenzell Outer Rhodes	AR	Jura	JU	Ticino	TI
Appenzell Inner Rhodes	AI	Lucerne	LU	Thurgovia	TG
Basel-County	BL	Neuchâtel	NE	Uri	UR
Basel-Town	BS	Nidwalden	NW	Vaud	VD
Berne	BE	Obwalden	OW	Valais	VS
Fribourg	FR	Schwyz	SZ	Zug	ZG
Geneva	GE	Schaffhausen	SH	Zürich	ZH
Glarus	GL	Solothurn	SO		