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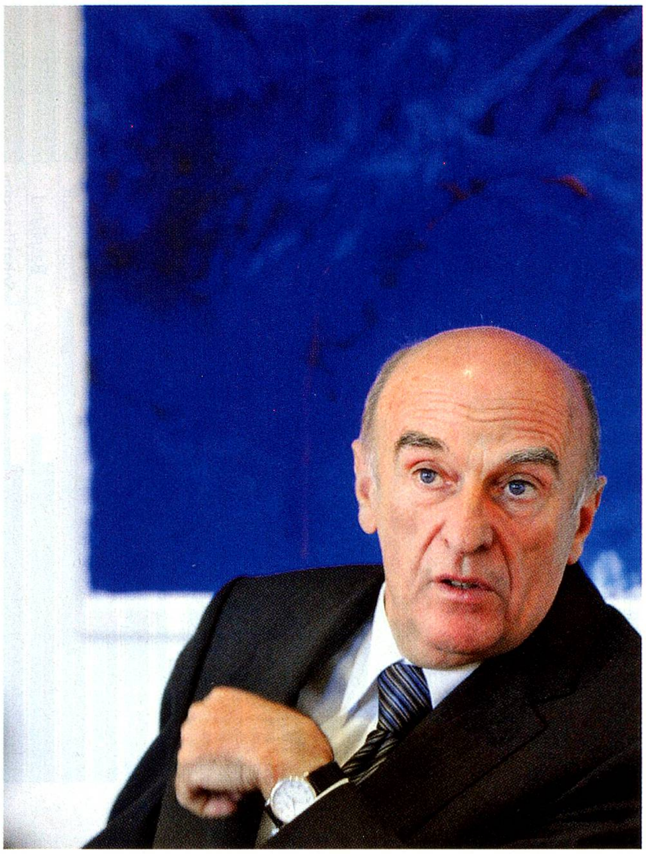
Proponents of tax cuts face a struggle

The Swiss people are becoming increasingly sceptical of lower corporate taxation. Yet, corporate taxes may fall further as a result of a tax dispute with the EU. Tax competition between the cantons is unlikely to abate either.
By René Lenzin

Europe looks enviously towards Switzerland. While the southern countries of the European Union, in particular, have been unable to find their way out of spiralling debt despite austerity measures and tax increases, Switzerland announces figures in the black year after year and is attracting more and more EU citizens seeking to take advantage of extensive employment opportunities and attractive salaries. This is despite the fact that the low euro rate is making business difficult for the Swiss export industry and especially Swiss tourism.



Hans-Rudolf Merz, former Federal Councillor and head of the Department of Finance. In 2008, he deliberately misled voters about the impact of tax cuts for companies

Most cantons have also regularly presented positive accounts in recent years even though they have cut taxes with almost equal regularity. The tax burden for private individuals fell significantly in all cantons between 2001 and 2011. Last year, companies also had to contribute less to the tax authorities than a decade ago, almost without exception. This is revealed by the comparison between the cantonal capitals that is carried out by the Swiss Federal Tax Administration every year. These figures illustrate not only the significant differences between the cantons but also the nationwide trend towards lower taxes (see charts on pages 18 and 19).

Financial equalisation as a softener

This trend is the result of tax competition, which is one of the peculiarities of Swiss federalism. Formally speaking, taxation is harmonised. Federal government stipulates the regularity at which specific taxes are to be levied. But the cantons are free to set the tax rates. An attempt to restrict tax competition was well defeated at the ballot box. 58.5 % of the electorate rejected the Social Democrats' so-called tax fairness initiative in November 2010. The only restrictive principle that applies is therefore the "ability to pay" enshrined in the constitution (Article 127) for which the Federal Supreme Court has established certain guidelines. It prohibits degressive taxation, in other words falling tax rates for high income. The Federal Supreme Court argued that in order to ensure tax fairness it was not sufficient for taxes to increase in absolute terms with rising income. People on higher incomes should pay proportionately the same amount as or more than people with low and average earnings.

Financial equalisation between federal government and the cantons on the one hand and among the cantons on the other serves to cushion tax competition in the interests of federal solidarity. The Federal Council and Parliament have just updated this "softener to federalism" with a fundamental reform. The new system of financial equalisation provides for a clearer distribution of responsibilities and allows the cantons greater freedom in the deployment of funds. Equalisation is no longer primarily based on the cantons' effective revenues but their resources potential. The thinking behind this is that cantons should no longer be able to reduce taxes in order to obtain greater funds from financial equalisation.

However, the new system has given tax competition additional impetus as the National Bank sold off 1,300 tonnes of excess gold reserves almost at the same time as its introduction. The cantons, as co-owners of the National Bank, received two thirds of the proceeds of 21 billion Swiss francs. Depending on their size and financial capacity, they obtained between 32 million (Appenzell Innerrhoden) and 2.35 billion Swiss francs (Berne). Small cantons with lower levels of debt were able to reduce taxes massively in some cases – for private individuals and much more so for businesses.

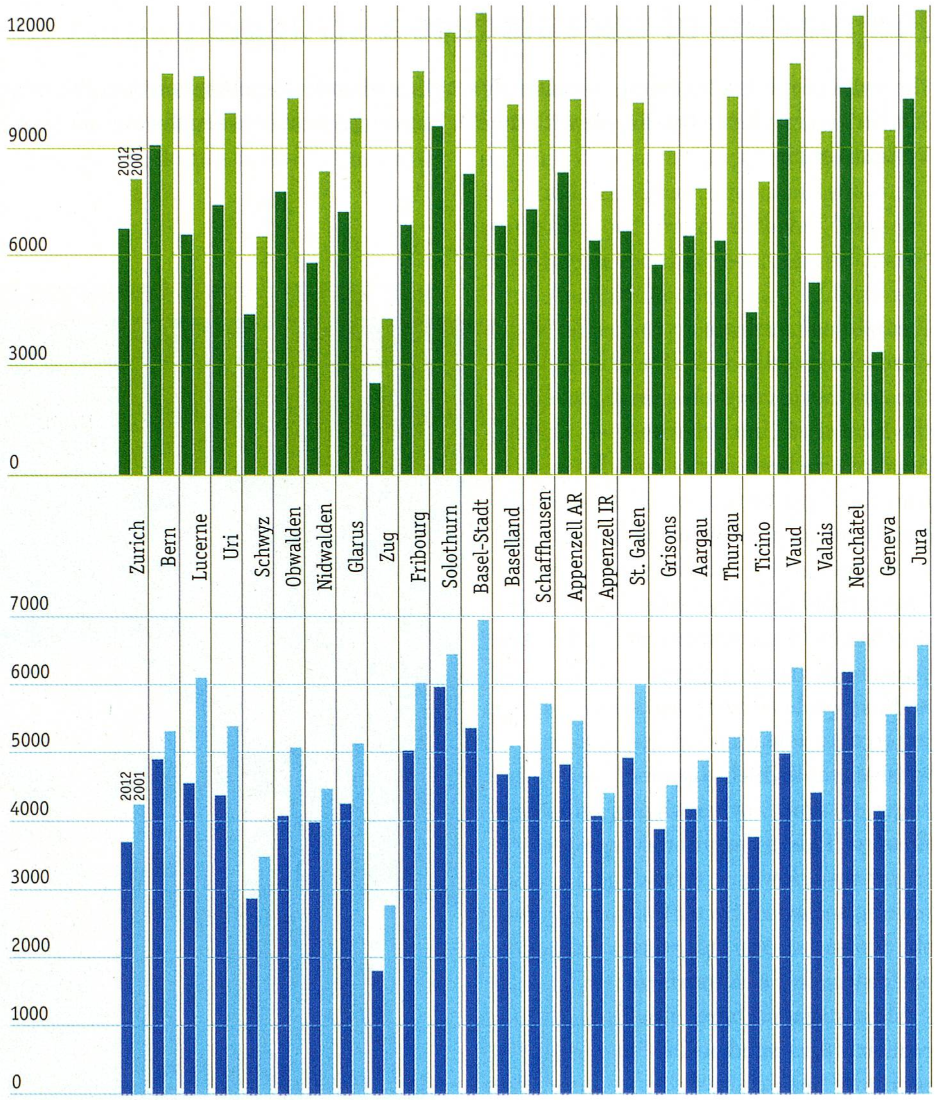
Two thirds will be in the red

But now the golden age of constantly lower taxation appears to be over, not least because the National Bank has cut ordinary dividend payouts owing to its interventions on the foreign exchange market to support the Swiss franc. Two thirds of cantons are projecting figures in the red for 2013. Most are putting together

Tax levels in the cantons – calculated for each cantonal capital

Married, 2 children, gross income CHF 100,000

Single, no children, gross income CHF 50,000



austerity packages, while some are also even planning tax increases. The electorate has also established limitations, rejecting further corporate tax reductions in Basel-Stadt and Zurich.

Federal government's corporate tax reform, which voters approved by the finest of margins in February 2008, may have contributed to the shift in opinion. It was presented to the electorate as a bill for small and medium-sized enterprises entailing manageable tax losses of less than a billion Swiss francs. It has nevertheless now emerged that the losses will be many times higher because the reform enables companies to enjoy tax-free repayment of capital. The Federal Supreme Court severely reprimanded the Federal Council for providing the people with incorrect information. The conduct of Federal Councillor Rudolf Merz, who evidently lied as head of the Department of Finance, was particularly outrageous. However, the Federal Supreme Court found that the referendum should not be held again for reasons of legal certainty. Together with the international financial crisis and the debate about excessive management salaries and bonuses, this reform has increased scepticism among the people about lower taxes for the business world.

The middle classes will bear the brunt

Yet, the next wave of tax reductions is imminent. This has been triggered by pressure from the EU to abolish the privileges that holding companies, investment companies and joint enterprises enjoy in Switzerland. In many cantons, such companies pay less tax on revenues generated abroad than on revenues from Switzerland. The EU regards this as a tax loophole that infringes the equal treatment principle. Switzerland has already declared its willingness to resolve this issue in dialogue with the EU.

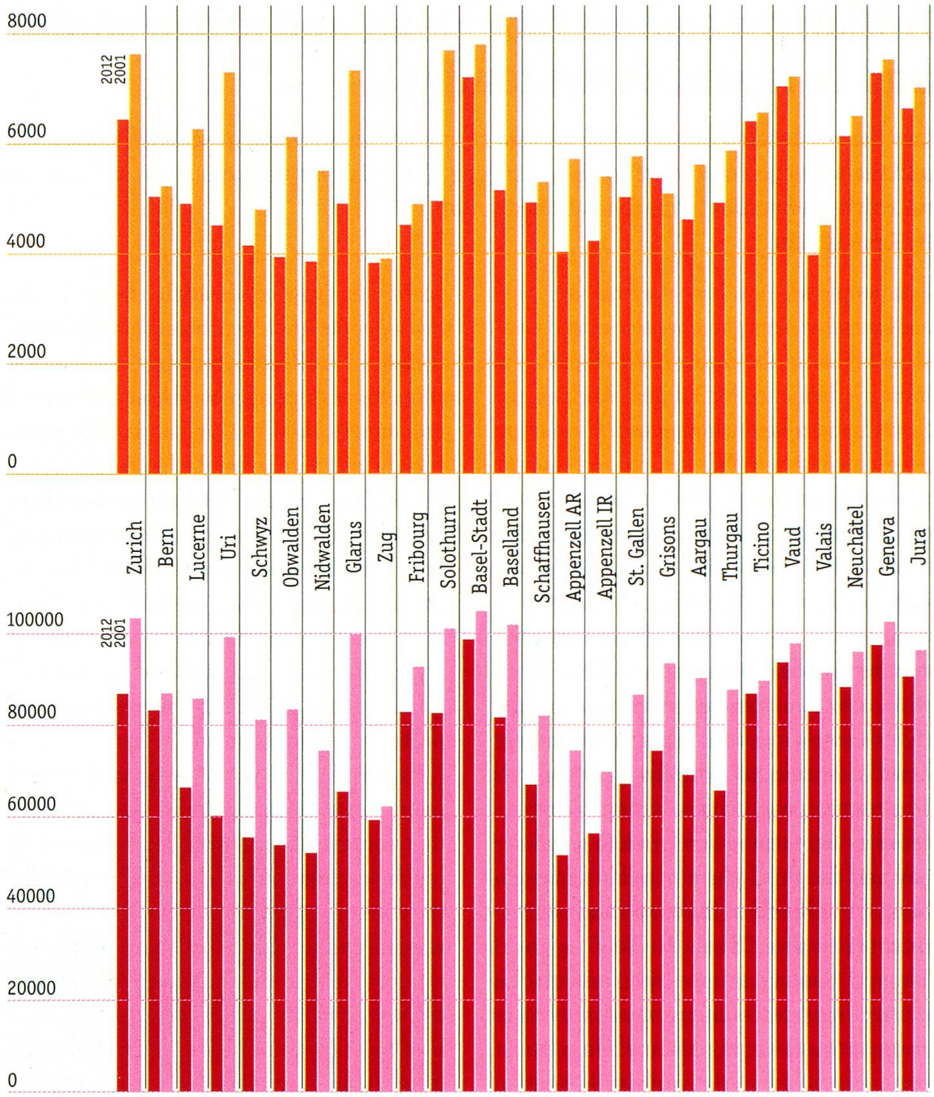
In order to eliminate the unequal tax treatment of domestic and foreign revenues, federal government and the cantons may agree on a general reduction in corporate income tax, at least in those cantons which are home to many such companies and today have above-average corporate income tax rates. This would allow Switzerland to avoid the threat of an exodus of holding companies because their taxes would not have to be increased or would only have to rise slightly.

However, this will result in massive tax losses – at least in the short term. The four

Charts: herzogdesign

Public limited company,
capital and reserves CHF 100,000
net profit CHF 30,000

Public limited company,
capital and reserves CHF 2,000,000
net profit CHF 400,000



large cantons of Basel, Geneva, Vaud and Zurich alone, where a particularly high number of holding companies are domiciled, are anticipating a fall in tax receipts of over two billion Swiss francs. Federal government and the cantons have therefore set up a working group to coordinate the next steps and to discuss sharing the burden. Proponents of tax competition see it as a necessary reform to make the country even more attractive as a business location. By contrast, critics are calling it a "race to the bottom" – a competition for the lowest corporate taxes, the cost of which will ultimately be borne by the middle classes.

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FLAT-RATE TAXATION: ABOLISHING TAX PRIVILEGES FOR WEALTHY FOREIGNERS

Tax competition does not just occur within Switzerland, but internationally as well. Flat-rate taxation, also known as lump-sum taxation, is a key factor in attracting wealthy foreigners. Foreigners who do not have any gainful employment in Switzerland can be taxed based on their living costs. The French rock star Johnny Halliday, Formula 1 boss Bernie Ecclestone and seven-time Formula 1 world champion Michael Schumacher are famous examples. The 5,000 or so people paying flat-rate tax in Switzerland contributed around 700 million Swiss francs to the tax authorities in 2010.

The number of flat-rate taxpayers has increased constantly in recent years, but so too has criticism of this special regime. Flat-rate taxation has been abolished by Parliament or the people in five cantons (AR, BL, BS, SH, ZH). Abolition initiatives have been defeated in four cantons (BE, GL, SG, TG) but, at the same time, taxes were increased for flat-rate taxpayers. The Federal Council and Parliament have also responded to the growing criticism. The taxable income of flat-rate taxpayers is now to be at least seven times their accommodation costs, whereas previously it was five times. A minimum taxable income of 400,000 Swiss francs will apply to direct federal tax. The cantons must also set a lower limit.

Opponents of flat-rate taxation say these measures do not go far enough. They want to abolish what they consider unfair privileges throughout Switzerland, and presented a popular initiative in October.