



Economic Survey of Switzerland, 2007

How can the current economic upswing be turned into a lasting pickup in growth?

Which considerations should guide monetary policy?

How should public finances be managed in the medium- and long-term?

How can the tax system be improved so as to reinforce entrepreneurial activity and labour supply?

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Summary

A vigorous economic expansion has allowed Switzerland to emerge from a decade of weak economic growth. However, some of the factors fuelling the current upswing are likely to prove temporary, as manufacturing has benefited from currency depreciation and financial intermediation from a rebound in global and domestic capital market activity, which could be coming to an end. The recent large inflow of immigrants has the potential to make a longer lasting positive contribution to aggregate supply. But, held back by weak competition in sectors not exposed to international trade, the productivity level is still moderate, and prices are high in comparison with other high income countries, lowering living standards.

The government has taken a number of steps to remove barriers to product market competition. Some have just come into force or still await parliamentary approval. Nonetheless, the pace of reform remains slower than in other OECD countries, entailing the risk that relative living standards may slip further in the medium term. While the government has stepped up efforts to control overall outlays, the trend rise in mandatory social spending is unbroken, limiting the extent to which public finances could serve to increase potential growth. The labour market has been fully opened to the residents of most EU countries and will remain attractive to other migrants, so the authorities will have to continue to try to make the most of immigrants' potential contribution to domestic prosperity. Therefore, to turn the recent cyclical upswing into a lasting improvement in growth outcomes, the policy challenges are as follows:

- **Public finances should focus on medium- and long-term sustainability so as to support potential growth.** The general government has moved into a surplus position. However, welfare reform efforts need to halt the trend increase in mandatory social spending and preserve high labour-force participation. To this end, incentives for disability beneficiaries to return to work need to be improved. Mixed hospital funding responsibilities are problematic. Pension system

This Policy Brief presents the assessment and recommendations of the 2007 OECD Economic Survey of Switzerland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

design must confront demographic change. Tax reform could help to stimulate economic activity by lowering compliance costs and reducing distortions.

- **Competition in product markets should be strengthened to raise productivity and lower prices.** Measures taken to eliminate barriers to competition in product-market regulation need to be followed up if their benefits in terms of improved performance are to be reaped. Conditions are not yet in place to guarantee that new entrants in the network industries do not suffer discrimination by incumbents. Enforcement of general and sector-specific competition legislation would be improved by providing regulators with more resources and powers and by ensuring their independence. In agriculture, remaining production-related support and barriers to structural change in land law need to be removed.
- **Immigrants' labour-market performance and human-capital acquisition should be nurtured.** While most immigrants are well integrated in the labour market, discrepancies in outcomes between immigrants and natives are marked, and migrants' children under-perform in education. The acceptance of immigrants' foreign credentials needs to be facilitated. Stronger incentives for foreigners to acquire local language skills would be helpful. Access of immigrant families to early childhood education and childcare needs to be widened, and non-selective lower secondary schooling should be developed. Such reforms would lower the impact of socio-economic background on all children's education outcomes. ■

How can the current economic upswing be turned into a lasting pickup in growth?

Switzerland has enjoyed a vigorous economic recovery since 2004. Growth has exceeded euro area outcomes for three consecutive years, after having lagged behind throughout the preceding decade. However, some of the factors fuelling the current upswing are likely to prove temporary. The significant contribution of the financial sector to the expansion has benefited from cyclical strength in global financial markets, which could be coming to an end, and manufacturing from a depreciating exchange rate and above-potential growth in important trading partners, especially Germany. On the other hand, immigration flows have increased, and they have the potential to make a longer-lasting positive contribution to aggregate supply.

The level of economy-wide labour productivity is lower than in many other high-income OECD countries and has fallen further behind since the late 1990s, held back by weaker outcomes in sectors that are sheltered from international competition. In 2004, the government launched a “growth package”, including a series of measures aimed at boosting productivity. However, many of these measures are either not yet legislated or have only just taken effect. It intends to propose a further package of measures to parliament to strengthen potential growth in the next four years. While the general government balance has swung into surplus, spending on social entitlements is continuing to grow strongly. This may compromise the capacity of fiscal policy to support turning what is a substantial cyclical expansion into a lasting acceleration of potential output. The fundamental policy challenges are therefore as follows:

- *Improving the long-term sustainability of public finances and reducing tax distortions.* Budgetary rules across all levels of government, as well as control of tax rates through the exercise of direct democracy and tax competition among sub-national levels of government, have helped exercise overall spending restraint. However, better control of social entitlement outlays would avoid disincentives for labour supply and free up resources for measures more conducive to growth. Tax reforms could provide stronger support to labour-force participation and entrepreneurship.
- *Raising the contribution of productivity improvements to potential economic growth.* Switzerland continues to lag behind in a number of regulatory policy areas in which reforms favouring competition in product markets have had a marked impact on productivity performance across OECD countries. Implementation of the government’s earlier “growth package” needs to be completed rapidly and followed up by further measures, outlined below.
- *Removing remaining hurdles for immigrants and their offspring to realise their full potential in the labour market.* Although immigration has become rich in skills in recent years, and integration efforts have been substantial, gaps between immigrants and the native population in labour-market performance as well as in educational outcomes are in some respects more significant than in other OECD countries. Scope remains to enhance the contribution of immigrants and their offspring to national prosperity.

Reforming the regulation of product markets and containing social spending were also identified as policy priorities in the OECD’s 2007 *Going for Growth* publication.

2006 marked the fourth year of the expansion, with real GDP growth reaching 3.2%, exceeding the potential rate by more than one percentage point. While significant inflationary pressures have not emerged, the output

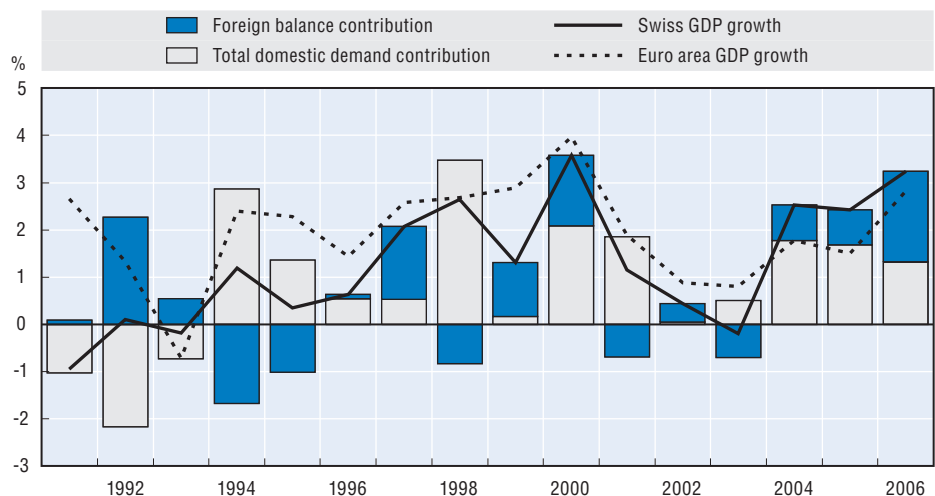
gap is likely to be closed. Spending has been led by external demand. More recently, consumption has also accelerated. Financial sector value-added has been especially buoyant, boosted by rising stock-market indices and unusually strong increases in stock-market turnover, while low interest rates have supported lending activity. Employment gains have been sizeable, as increasing immigration has contributed to a significant expansion of labour supply, although the unemployment rate has also fallen to 2.6%. The rise in immigration partly reflects the agreement between Switzerland and the European Union on the free mobility of workers concluded in 1999. Coming into force in June 2002, it took full effect in June 2007, although transitional quotas continue to apply to Central and Eastern European EU member countries.

While economic growth is projected to decelerate somewhat, it is expected to remain above its potential rate, given the favourable conjuncture foreseen in European trading-partner economies. At the same time inflation may edge up, in line with increasing demand pressures. Those pressures would be heightened if the Swiss franc continues its downward trend. In any case, there seems little reason to expect any significant decline in the long-standing but also surging current-account surplus, which has reached more than 15% of GDP. That surplus is attributable mainly to the huge balance on investment income, itself in large part a result of the important role of multinational enterprises in Switzerland, even if that role is exaggerated by international methodological conventions. In a more fundamental sense the rising surplus can be linked with a very high national saving rate – caused to some extent by the mandatory pension system – juxtaposed with a relatively low domestic investment rate, in part the consequence of already high capital intensity and modest total factor productivity growth. The continued weakness of the franc, despite the high and rising surplus, may be partly due to the “carry trade”, which may reverse at some point. ■

Which considerations should guide monetary policy?

In view of the surge in economic growth and the deterioration in the inflation outlook the Swiss National Bank (SNB) has withdrawn monetary policy stimulus, raising the target range for the 3 month Swiss Franc interbank interest rate by a cumulative 2 percentage points in the last two years, positioning

Figure 1.
ECONOMIC GROWTH IN SWITZERLAND AND THE EURO AREA
Per cent



Source: OECD, Economic Outlook 82 database (forthcoming).

it between 2.25 and 3.25%. At the same time, the SNB provided temporary additional short-term credit to banks in the aftermath of the turbulence in global financial markets in mid-August 2007, which had led to a significant increase in demand for liquidity. Further interest rate increases may be necessary should the expansion of output remain strong. The continued depreciation of the Swiss franc in 2006 and the first half of this year has contributed to more marked increases in import prices. Pass-through of such pressures to headline inflation may strengthen now that output slack has largely been eliminated in Switzerland as well as in Europe, and headline CPI inflation has risen slightly this year, to 0.7% in September. However, expanding labour supply has kept wage inflation low and some progress in opening up sheltered product markets to competition could in principle damp domestic price rises, offsetting rising import costs. Moreover, the impact of the global financial market turbulence on economic activity in Switzerland is as yet uncertain. Overall, these conditions warrant a slow paced and flexible approach to further tightening, in particular to allow the expansion of aggregate supply to be absorbed, even with the current robust activity. ■

How should public finances be managed in the medium- and long-term?

The general government's budget balance has improved from a deficit of around 1 per cent of GDP in 2004 to an estimated surplus of about 1.2% in 2006, with a similarly-sized outcome expected for 2007, appropriately achieving consolidation at a time of high growth. The improvement reflects, in part, tighter spending control following the 2003 introduction of the "debt brake" rule, which requires the estimated cyclically adjusted federal budget to be balanced. Moreover, the recovery has impacted strongly on government revenues, reflecting the buoyancy of volatile profit and capital-income tax receipts, which yielded considerably more income than expected, in part reflecting booming financial-sector activity. However, spending on social programmes has continued to increase rapidly, notably in health care, disability insurance and social assistance, notwithstanding favourable labour-market developments.

Since the federal debt-brake rule is binding for the annual budgets of the Confederation, there is a risk that control will be largely exercised through cuts on items that can be influenced in the short term, leaving increases in social entitlements, in particular, unchecked. A medium-term budgeting framework consistent with the rule would improve the setting of expenditure priorities. *The operation of the debt brake should be complemented by more medium-term planning of the federal finances.* The federal government is conducting a medium-term review of its spending tasks (*Examination of Tasks Programme, ETP*) in order to identify potential areas of savings. While the ETP would add a desirable degree of medium-term planning to budget management and therefore complement the operation of the debt brake, its implementation has run into delays, and no regular re-evaluations are foreseen. *Efforts should be made to complete the ETP soon. As an input into longer-term budgeting, sustainability reports should be prepared and complemented by scenarios reflecting impacts of possible policy reforms. The setting of medium-term spending priorities should be made a recurrent exercise.*

The trend increase in social entitlement outlays generates the risk that future government spending on public services that contribute to raising potential output is crowded out. In some services – notably early childhood education and competition law enforcement – provision is already low. Moreover, benefit entitlements can lower incentives to work. Hence, measures to raise cost effectiveness are required:

- While the quality of medical services, health-insurance coverage and health status are excellent, some OECD countries achieve similar outcomes at lower cost. Hospital spending is particularly high. Ambulatory care is funded by health insurers, but recurrent hospital funding is characterised by shared financing by cantons and health insurers, fostering incentives to shift patients to the hospital sector. Therefore, *the mixed hospital funding responsibilities should be abandoned, assigning the entire role of collective coverage of health provision costs to the insurance companies but avoiding adverse redistributive effects of such a move through appropriate flanking measures*. Scope also exists to improve cost-saving incentives that can result from competition among providers and insurers. In particular, *the current system of transfers among insurers needs to be reformed so that they compete by raising cost-effectiveness rather than by “cream-skimming” of low-risk insurees. Once an effective system of risk equalisation is in place, insurers should be allowed greater contractual freedom, which, combined with better information on provider performance and minimum quality standards, would encourage value-based competition. Reducing the geographic fragmentation of service provision would also enhance the benefits of selective contracting*.
- The number of recipients of disability pensions has continued to rise, reflecting a decline in the outflow rate to very low levels. Replacement rates are relatively high, and benefits are withdrawn quickly as recipients take up work. *Introducing mandatory testing in the initial period of benefit receipt and phasing benefits out more slowly as labour income rises could help raise exit rates*.
- The pay-as-you go first-pillar pension system is, on current policies, expected to register a deficit already in 2015, reflecting demographic factors including gains in life expectancy. To put the system on a sustainable footing *a package of changes in taxes, benefits and years of contribution, including indexation of the statutory retirement age to changes in life expectancy, is required*.

Increasing life expectancy has also been contributing to rising outlays in the compulsory, funded, second-pillar occupational pension schemes, in which the level of pension benefits is fixed relative to the value of assets accumulated upon retirement by a conversion rate set in federal legislation. A further cut in this rate is necessary to ensure that pension benefits will be fully covered by accumulated assets. The federal government's most recent proposal to reduce this rate is still being debated in parliament. It would be better if technical adjustments to the conversion rate that are necessary to ensure sustainability were not subject to political decisions. To this end, *determination of the conversion rate should be left to the occupational pension funds, subject to the regulatory requirement of actuarially appropriate calculation*.

A reform of the assignment of spending responsibilities will come into force in 2008, reducing the degree of shared funding responsibilities across levels of government, such as in disability benefit spending, and improving mechanisms for co-operation across cantons in the provision of services. These measures are welcome, as they are likely to facilitate the setting of expenditure priorities and make spending more conducive to economic activity. However, scope remains for further improvements.

Cost effectiveness of outlays on job placement services, including active labour market measures, is hampered by split funding and spending responsibilities, which may contribute to the relatively long duration of unemployment spells. The federal government finances cantonal active labour market policies on the basis of fixed lump-sum payments per registered job-seeker. This set-up may dull incentives for the cantons to move the unemployed rapidly into jobs,

especially as unemployment benefits are also federally financed. However, there remain two kinds of incentives for the cantons to place their unemployed. First, regional placement offices are annually benchmarked with respect to their performance. The publication of these results creates political pressure on low performing cantons. Second, unemployed persons whose spells exceed the maximum benefit entitlement period become eligible for cantonal or communal social assistance. Nevertheless, incentives for the cantons to place the unemployed rapidly and durably should be further strengthened. Furthermore, participants in some activation policies can thereby re-qualify for unemployment benefit receipt. *Such possibilities should be reduced. Also, performance-related elements in the disbursement of federal funds should be strengthened.* ■

How can the tax system be improved so as to reinforce entrepreneurial activity and labour supply?

Even though corporate taxation is low in international comparison, heavy taxation of dividends generates incentives for tax evasion through constituting complicated corporate structures and might distort financing decisions of firms that cannot raise equity on international capital markets. The tax-induced incentives to retain earnings are further increased by the absence of a capital gains tax. The government intends to lower dividend taxation but plans to limit tax relief to owners of stakes exceeding 10% to limit revenue losses. This limit could create incentives for some companies not to raise equity capital from new shareholders, so that existing shareholders keep their shares above the 10% threshold. *Reductions in the taxation of dividends should not be subject to ownership limits.* The added cost of extending reduced dividend taxation to portfolio investments could be funded by introducing a moderate capital gains tax. Stamp duties on the issuance of equity stock also raise the cost of firm creation and growth without raising significant revenue. *They should be abolished.*

At the federal level, marginal income tax rates for second earners in married couples are in many cases significantly higher than the rates applying to a single earner in households with a couple, reducing married women's incentives to work. A reform of the taxation of married couples, effective from 2008 onwards, will reduce this differential through the introduction of a supplementary tax allowance for working spouses. A more fundamental review of the taxation of married couples is under way. *Reform of the taxation of couples should reduce the gap in marginal tax rates between main and secondary earners by moving from joint to individual assessment of each spouse's income.* ■

Which barriers to competition need to be removed?

The degree to which product market regulation encourages effective competition is one of the determining factors of productivity performance. Over the last decade there have been efforts to make the regulatory framework in goods and services markets more conducive to competition, but compared to most OECD countries, product market reform is still lagging behind, especially in general competition law and in the regulation of agriculture and the network industries. Reforms in these policy areas could both stimulate trend total factor productivity growth, which has been low relative to other OECD countries, and raise the investment share of GDP (which has weakened in international comparison), thereby lowering the current-account surplus and arguably enhancing future output gains. The measures in the government's 2004 "growth package" will make progress in opening up these markets to competition if fully implemented. However, many will need to be followed up by further steps if they are to bring about the desired gains in productivity. Technical barriers to trade still contribute to high goods prices. *Products marketed in the EU internal*

market should be allowed to enter Switzerland without complying with further Swiss technical requirements.

The reformed competition law, in force since 2005, has allowed the enforcement authority (the Competition Commission, ComCo) to step up action against anti-competitive practices. However, its independence is still compromised by the appointment of representatives of organisations such as the employers' association and trade unions. *Its independence should be ensured by excluding members that represent particular economic interests. Furthermore, its resources should be raised so that its staff level comes into line with its enlarged responsibilities. Finally, action against hard-core cartels is still hampered by the need to prove abuse. The prohibition principle should be applied to all hard-core cartels.*

In the enforcement of rules to ensure competition in network industries, short terms of office for senior staff, combined with the option of reappointment, weaken the perceived independence of regulators, as do, in some instances, lack of enforcement powers and low staffing. *The independence of sector regulators should be strengthened, for example by lengthening the terms of office of senior staff and by removing the possibility of reappointment.* A case in point is the postal services regulator, which does not have the power to fine market participants breaching its decisions and whose decisions require government approval. *All sector regulators should have powers to fine those who contravene its regulatory determinations, and government departments should not be able to intervene in such judgements.*

Performance in the network industries is held back by weak framework conditions, as reflected in productivity outcomes and prices. As part of the measures in the 2004 "growth package", a new regulatory framework for the electricity industry has been legislated and will come into effect in January 2008 – introducing sector-specific *ex ante* regulation of prices and gradually liberalising consumer choice. New entrants have been granted access to the incumbent's local loop in telecommunications. Planned railway reform foresees, *inter alia*, tendering of regional passenger transport services in cases where benchmarking indicates poor performance. While these measures mark significant progress, they should be followed up to ensure the intended competition-enhancing benefits are realised:

- Potential gains from competition in the *electricity industry* are likely to be strongest in generation. Competition in this activity requires ownership separation from transmission network operations, whereas the new legislation foresees only weak vertical separation requirements. *Ownership separation between electricity generation and transmission operations should be introduced.* With the impending liberalisation of consumer choice, the motivation for incumbent integrated generation and transmission operators to extend ownership to local distribution and retailing utilities will grow sharper, generating stronger incentives to discriminate against new entrants in the generation business and undermining those facing retailers to put competitive pressure on generators. *The acquisition of further stakes in electricity distribution networks by vertically integrated incumbents should be prevented.* The weakness of vertical separation constraints conflicts with the limited powers and staffing foreseen for the new regulator and reinforces the need to bolster its enforcement capacity.
- In the *telecommunications industry*, limits to the new access rights to the local loop for new entrants are likely to prolong the dominant market position of the telephony incumbent, notably in broadband services, where lack of competition

has contributed to high prices and low data transmission speeds. *The legal limitations on access of competitors to the local loop should be lifted.* The absence of ex ante regulation has undermined the timeliness of regulatory decisions that should serve to maintain a level playing field among market players and, with respect to interconnection charges, may deter development of competing networks. Therefore, *ex ante price regulation should be introduced.*

- In the *railways industry*, competition is virtually absent in national passenger transport. Making the tendering of regional passenger services compulsory should be considered. Experience from other OECD countries suggests that such tendering requires removing incentives facing vertically integrated operators to discriminate against new entrants in investment decisions, as well as guaranteeing access of competitors to rolling stock. The incumbent operator exercises a high degree of discretion over small-scale investment projects, and access to rolling stock is unregulated. *Equal access to rolling stock should be ensured by obliging the incumbent operator to rent it out under non-discriminatory conditions. Investment decisions should be based on an independent assessment of costs and benefits.*
- In the *postal services*, legislation still keeps letter-delivery services largely closed to competition. The government intends to open this market further. Some current provisions create cost advantages for the incumbent vis-à-vis its competitors. *Regulations disrupting a level playing field for competition between the incumbent and market entrants should be removed.* Competitors are also required, in effect, to offer similar working conditions as the incumbent, including on wages, reducing the scope for cost reductions, such as through the introduction of new technology. *Regulation regarding the fixing of pay and working conditions that is specific to the sector should be abolished.* All services in market segments where La Poste Suisse holds a legally guaranteed monopoly are subject to price regulation by the relevant Ministry. Currently, cost-based *ex post* price regulation is applied, reducing incentives to lower costs. *Price caps should be used to regulate the prices of services for which La Poste Suisse holds a dominant or monopoly position, and price regulation should be entrusted to an independent body.*

Legislation adopted by Parliament in summer 2007 foresees keeping subsidies to the agricultural sector – currently worth about 1.3% of GDP – constant until 2011, with some shifting from price support and export subsidies to less distorting forms of assistance. A limited unilateral reduction of feed grain tariffs is also part of the package, but tariff protection continues to contribute to the high overall price level in Switzerland. Prospects for a lower degree of tariff protection further in the future – for example, as a result of a free trade agreement with the EU, as sought by the government – reinforce the need to remove regulatory hurdles to structural adjustment, notably in land law, so as to avoid having trade liberalisation result in calls for extended subsidy payments. *Impediments to structural change in land law should be removed. The replacement of subsidies linked to production activities by direct income support in Switzerland should be accelerated, since it is less distortive of prices.* While positive environmental externalities remain a justification for some direct payments to farmers, *unconditional income support should be reduced by tying it to incumbent farmers, rather than farming businesses, so as to prevent government payments from biasing inheritance decisions.* ■

How can the positive contribution of immigrants to living standards be raised further?

Drawn by the prospects of comfortable living standards and strong labour demand, immigrants have been attracted to Switzerland over many decades. Immigrants have again boosted labour supply in recent years, turning Switzerland into one of the countries with the highest immigration rates in the OECD. The large inflow has been absorbed well overall, and the contribution of expanding labour supply to per capita GDP growth has been supported by the rising share of skilled immigrants. Sustained inflows may persist as a result of the recent removal of remaining restrictions with regard to worker mobility to and from most EU countries. Regarding immigration from other countries, policy has become more strongly oriented towards the admission of skilled workers. Nonetheless, integrating less-qualified workers from earlier immigration waves and their offspring remains a challenge. A persistent demand for low skilled workers, for example, from countries which joined the EU recently, provides additional justification for such efforts.

Labour-market outcomes among immigrants are less favourable than those among the native-born population, in terms of unemployment rates and wages, holding back the contribution immigrants can make to GDP growth. Some of these differences are more marked than in some other OECD countries that have experienced strong immigration flows. Employment and pay prospects of some immigrants are hampered by difficulties in foreign (especially non-EU) credentials recognition. *Further efforts should be made to improve the system for recognising qualifications and experience obtained abroad.* Discrimination against immigrant job applicants can lower their incentives to acquire human capital. While anti-discrimination legislation is in place, the effectiveness of its enforcement can be improved. *The legal recourse available to victimised foreigners should be facilitated, possibly with the help of associations combating discrimination. Also, employers' attention should be called to the issue of discrimination, in order to improve the integration of foreign workers in the Swiss labour market. In this regard, the public sector should set an example. Finally, the rules on the length of residency required by cantons and communes for naturalisation could be a barrier to geographic mobility and should therefore be harmonised.*

Underperformance of migrants' children in education is relatively pronounced, in part reflecting the negative impact of socio-economic background on performance more generally. *Hence, reforms in the schooling system should aim at lowering the impact of socio-economic background on all children's education outcomes.* Low participation in pre-school education and childcare exacerbates this deleterious impact, as does the early streaming of children into different school tracks, which generally occurs between the ages of 10 and 12. *Access by the foreign population to early childhood education and childcare services should be promoted. They should be made more widely available through better co-ordination of the provision of such services between different levels of government.* The planned lowering of the compulsory entry age into education from six to four years is a welcome step. Measures along these lines would also have significant benefits for native-born children from poor backgrounds and would improve incentives to work among women (another policy priority identified in the 2007 *Going for Growth* publication), who often choose not to work full-time because of a lack of availability of childcare facilities. *Non-selective educational models in the lower secondary cycle should likewise be developed. The standardisation and transparency of educational guidance systems assigning pupils to special classes can be improved.* Immigration inflows have become more diverse over the decades with regard

