ISSN 1608-7143
OECD JOURNAL ON BUDGETING
Volume 5 – No. 1

Budgeting in Switzerland

by
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The Swiss budgeting system is characterised by three special features: the political environment; the debt containment rule; and the nature of the federal budget as a transfer budget. Prominent features of the political environment are direct democracy, consensus and federalism. The debt containment rule requires a balanced cyclically adjusted general government budget (zero deficit). The nature of the federal budget as a transfer budget implies among other things that around a quarter of total federal expenditure is spent by the federal government, the rest being transferred – mainly to sub-national government and social security funds. Various elements of the Swiss budgeting system are described: the development of the central government sector and the fiscal balance; the development of taxation and financial liabilities; the budget formulation timetable in the federal government and in Parliament; financial planning, accounting, auditing, and internal control; and financial relations between levels of government, including the tax equalisation system.

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1. Introduction

1.1. The central government sector

Switzerland came into existence as a national State in the first half of the 19th century as a consequence of a process of political integration of 25 regional communities known as "cantons". This process culminated in the establishment of the first federal constitution in 1848. This constitution was based on a compromise between a liberal Protestant majority, mostly living in a small number of populous cantons, and a Catholic conservative minority, mostly living in a large number of thinly populated cantons. The rights of the minority were protected through constitutional provisions that guarantee the competences of the cantons and limit the responsibilities of the Federation and through cantonal representation in the federal political system, particularly in the Council of States (the upper chamber of Parliament).

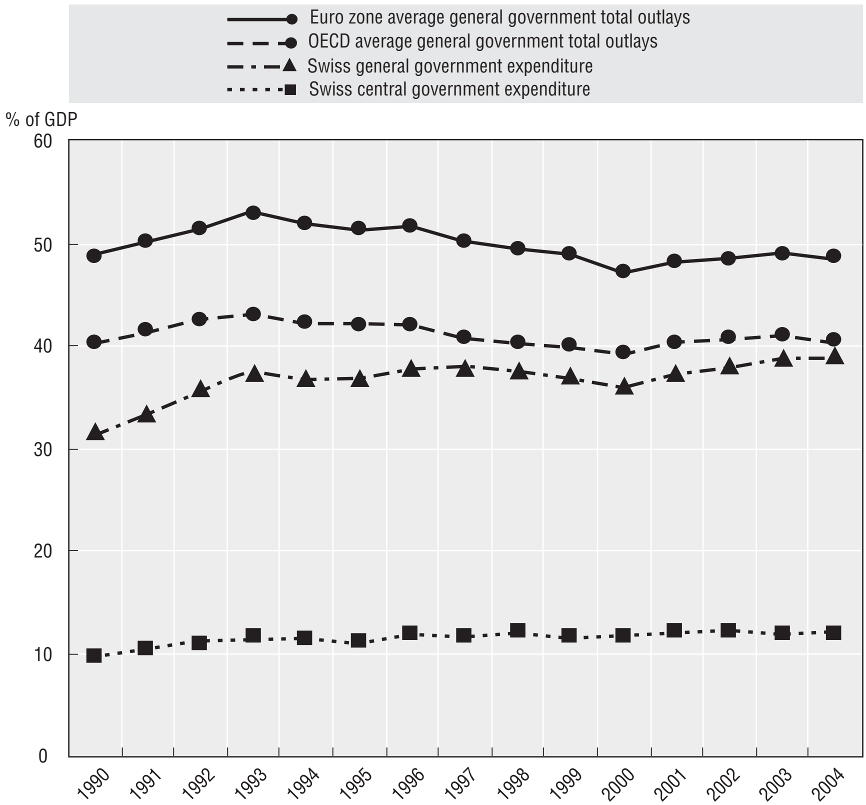
The strongly federalist nature of the Swiss State is reflected in the relatively small size of its central government sector. Expenditures of the central government as a percentage of GDP amount to 11.9% only. This value is among the lowest in the OECD area. On the other hand, expenditures of the general government as a percentage of GDP amount to 39.1% in 2004, which is close to the OECD average (Figure 1). However, this percentage does not take into account all expenditures for the compulsory national health care scheme. When these expenditures – which in most other OECD countries are covered by public social insurance – are added to the ratio of general government outlays as a percentage of GDP, the ratio is some three percentage points higher.

The evolution of this ratio – expenditure of general government as a percentage of GDP – since 1990 has been atypical. Whereas many OECD countries reduced their expenditure ratios in this period, Switzerland experienced an increase of 7 percentage points in the period 1990-2002, which is the highest increase in the OECD area. On average, this ratio remained stable in the OECD area in this period.

1.2. The fiscal balance

As far as the fiscal balance is concerned, Switzerland compares favourably with other OECD countries since 1990, in particular with European countries (Figure 2). Until 1999, the actual deficit of general government was

Figure 1. **Central and general government expenditure as percentage of GDP**

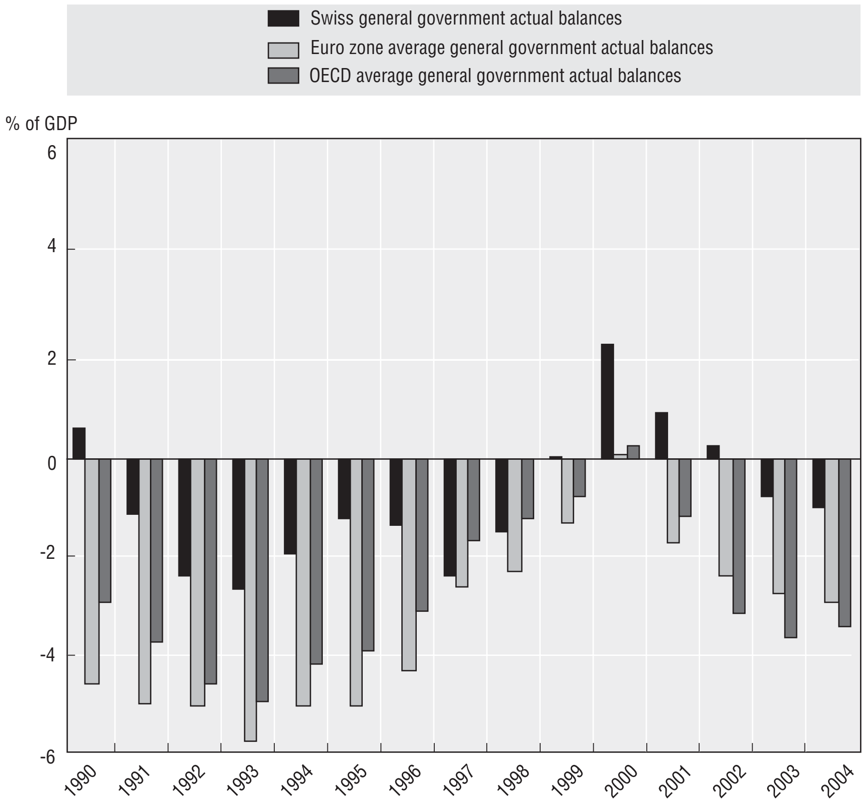


Sources: OECD Economic Outlook 74; Swiss Federal Finance Administration FS 01.02.2005.

consistently lower than that of countries in the euro area. In 2000 and 2001, there was a surplus in Switzerland, whereas the euro area showed a smaller average surplus in 2000 and, on average, a deficit in 2001. Although Switzerland has moved into deficits since then, its deficits have been lower than on average in the euro area.[1] Up to 1998, the general government deficits were for a large part due to deficits at the cantonal level. From 1999 to 2003, the cantons were in surplus. The public social security funds have shown a surplus over the entire period until 2002.

The firm control of the nominal deficit in Switzerland is all the more remarkable because real economic growth has trailed behind other OECD and European countries since the early 1980s. Between 1980 and 2002, the annual growth differential vis-à-vis the euro area averaged 0.75 percentage

Figure 2. **General government actual fiscal balances as percentage of GDP**



Source: OECD Analytical Database.

point. Moreover, this differential has gradually widened, reaching one percentage point on average in the 1990s. It has been noted, however, that the traditional measure of GDP does not take into account the considerable improvement in the terms of trade that has taken place in this period in favour of the Swiss economy (37% over the period 1980-2002). Due to the high quality of Swiss products and the strong appreciation of the Swiss franc, Switzerland is able to import ever more foreign goods and services in exchange for its exports. This effect is not fully reflected in the traditional (national accounts) concept of GDP. However, even if the improvement in the terms of trade is taken into account, the performance of the Swiss economy remains relatively weak in comparison to other OECD countries, especially in the 1990s (OECD, 2004).

Table 1. **Real growth of gross domestic product (annual growth rates)**
USD constant prices and constant exchange rates

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Switzerland	3.8%	–0.8%	0.0%	–0.2%	1.1%	0.4%	0.5%	1.9%	2.8%	1.3%	3.6%	1.0%	0.3%	–0.4%
Euro area	3.7%	2.7%	1.5%	–0.8%	2.4%	2.3%	1.5%	2.4%	2.9%	2.8%	3.5%	1.6%	0.9%	0.6%
OECD total	3.1%	1.4%	2.1%	1.3%	3.1%	2.4%	3.1%	3.4%	2.5%	3.1%	3.7%	1.1%	1.4%	2.2%

Source: OECD Statistics Department.

1.3. *Level of taxation*

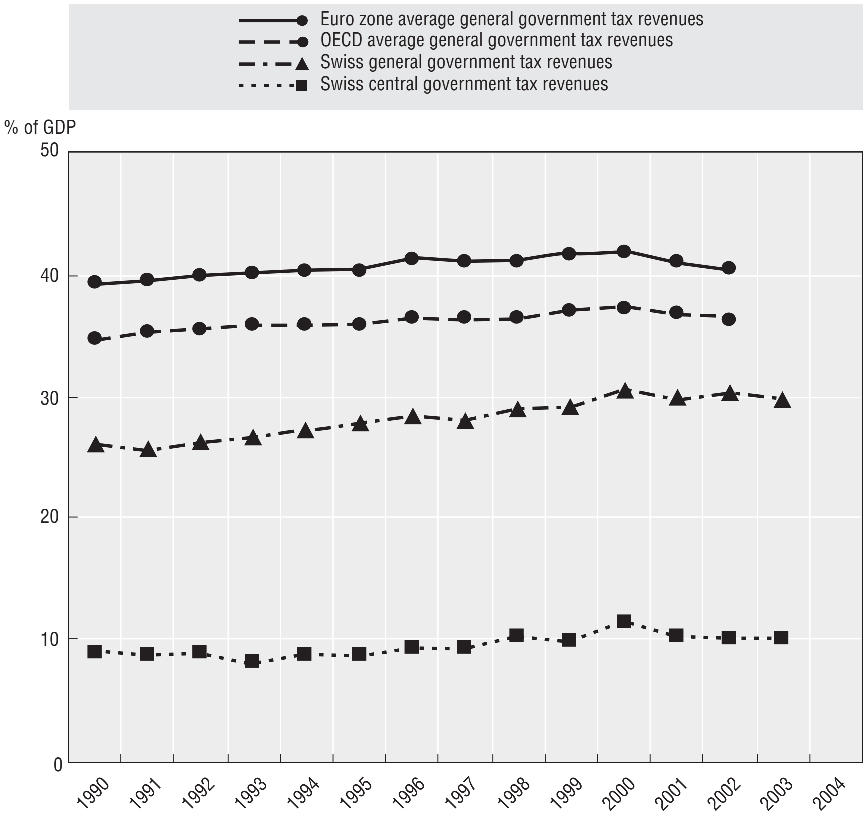
Tax revenue as a percentage of GDP in Switzerland was 29.6 in 2003, which is among the lowest in OECD countries (only above Austria, Ireland, Japan, Korea, Mexico and the United States). However, this was previously not the case and appeared only after a statistical revision in the calculation of total tax revenue in 2002 whereby a number of receipts were reclassified as not being tax revenue in order to meet a definition closer in line with international practice. Consequently, the size of non-tax revenues in Switzerland is among the highest in the OECD area[2] and many of those are fees which cannot be classified as tax revenue because they are paid in exchange for a concrete performance but in reality cannot be easily avoided – for instance various kinds of environmental fees. Furthermore, as noted before, premiums to private companies which manage the compulsory health insurance scheme are not reflected in the fiscal rate. If these obligatory insurance premiums are included, total tax revenue as a percentage of GDP amounts to 35.6% in 2003, which is close to the OECD average (Figure 3).

In line with the strong growth of expenditures as a percentage of GDP since the early 1990s, tax revenues have also grown substantially. Switzerland increased its tax level as a percentage of GDP in the period 1990-2002 by 5 percentage points. This is one of the highest increases in the OECD area (lower only than Greece, Iceland, Korea, Portugal and Turkey, where tax levels were previously low). The average increase was 2 percentage points of GDP in the OECD area over the whole period.

1.4. *Financial liabilities*

Although expenditures and revenues have moved more or less in line and deficits have generally been under control, general government gross financial liabilities have increased considerably in relation to GDP in the period since 1990 (Figure 4). This has partially been due to the improvement of accounting procedures aimed at a clearer separation of public enterprises, pension funds and general government, and partially due to the slow growth of the Swiss economy over these years. Whereas gross financial liabilities of Switzerland were among the lowest in the OECD area in the early 1990s (but partially as a

Figure 3. **Central and general government tax revenues as percentage of GDP**



Source: OECD Revenues Statistics Database.

consequence of inappropriate accounting procedures), Switzerland is now close to the median position (but still considerably below the OECD average, which is strongly affected by the very high debt rates of a few large countries).

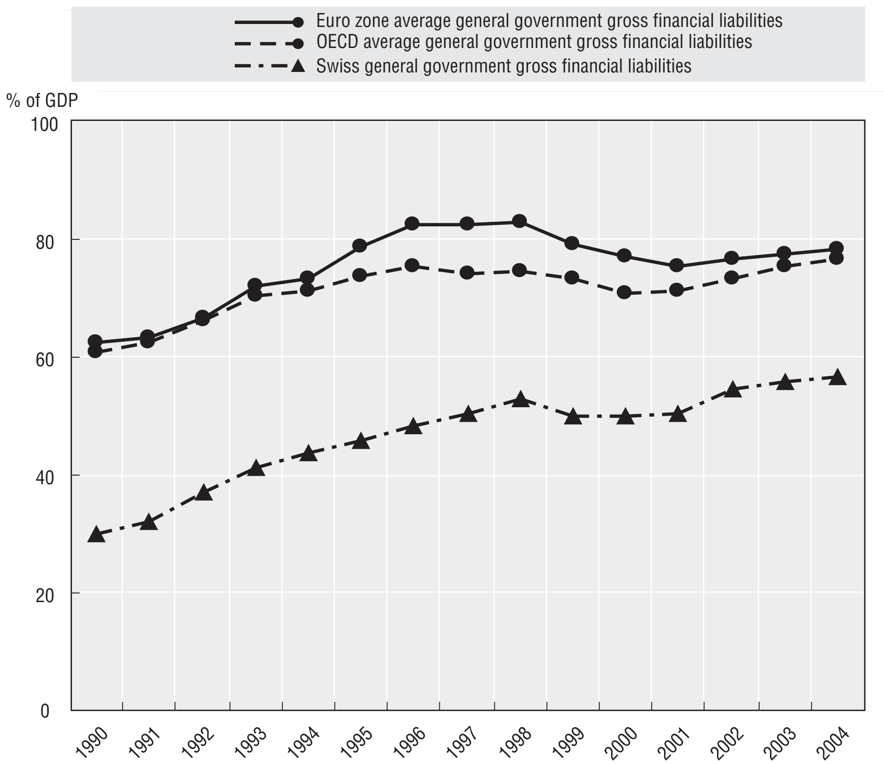
2. Budget formulation

2.1. Key characteristics of the Swiss budgeting system

The Swiss budgeting system is characterised by three special features that differentiate it from most other OECD countries:

- the political environment, characterised by direct democracy (referendums), federalism and a tradition/system of achieving consensus;

Figure 4. **General government gross financial liabilities as percentage of GDP**



Sources: OECD Economic Outlook 74; Swiss Federal Finance Administration FS 01.02.2005.

- the debt containment rule, which is a constitutional provision mandating a balanced budget over a business cycle (structural balance);
- the nature of the Swiss federal budget as a transfer budget.

Each of these features is briefly discussed below.

2.1.1. *Political environment*

The Swiss political system has several distinct features. These include direct democracy, federalism, and a tradition/system of achieving consensus (*concordance*). Direct democracy means that Swiss citizens can decide by popular vote on matters of public policy and institutional arrangement. Federalism means that the Swiss constitution guarantees a high degree of autonomy to the cantons (and the municipalities). Consensus (*concordance*) means the participation of all important political groupings in the public decision making process and the resolution of conflict through negotiation and compromise.

Direct democracy is the most conspicuous aspect of the Swiss political process. This takes several forms. For example, all proposed changes to the constitution are subject to mandatory referendum. Citizens may also seek a referendum on an amendment that they want to make to the constitution. For such an initiative to be organised, the signatures of 100 000 voters must be collected within 18 months. Citizens can also seek a referendum to in effect veto parliamentary decisions, *i.e.* enacted laws. In this case, a popular ballot is held if 50 000 citizens so request. The signatures must be collected within 100 days of publication of the relevant parliamentary decision. For referendums on constitutional change, a double majority is needed for adoption: first, a popular majority by which is meant a majority of the valid votes cast throughout the country; second, a majority of the cantons, *i.e.* a majority of cantons in which the voters adopted the proposal.[3] Referendums on parliamentary decisions require only a popular majority. The Swiss take great pride in these rights and, according to surveys, popular rights are the most valued political institutions. At the same time they place high demands on the citizens. On average about 40% of the voters actually go to the ballot box and only 25% of eligible citizens vote on a regular basis. The apparent paradox between the high value placed on popular rights and the low turnout at actual votes may be explained by the fact that participation is now seen more as an individual right that places constraints on the behaviour of other parts of the political system, such as Parliaments, than as a civic duty. With respect to the budget process, it is important to note that the federal constitution defines the maximum rates of the two most important taxes which implies that these rates can only be increased by referendum.[4] This requirement serves as a formidable obstacle to budgetary expansion.

The Swiss State came into existence in 1848 by a voluntary act of association of independent cantons. From the beginning, the cantons have seen to it that their autonomy was guaranteed in the constitution. Many areas of public policy that in other countries belong to the domain of central government are attributed to the cantons in Switzerland. Each canton has its own educational system, its own system of social services (apart from some federal social security laws) and its own system of judicial courts. Although the development of the welfare State in the period after the Second World War has shifted the balance somewhat to the federal level, in particular as far as public expenditures are concerned, Switzerland still is the most decentralised country in the OECD area. Since the competences of the cantons are guaranteed in the constitution and since constitutional change not only requires a majority of the popular vote but also a majority of the cantonal votes, the autonomy of the cantons cannot easily be infringed upon.

The tradition/system of consensus (*concordance*) can be seen as an extension of the principle of minority protection that characterises the Swiss constitution. There are a number of important social and socio-economic differences in Switzerland. This is best exemplified by the fact that Switzerland has four official languages – German, French, Italian and Romansh. The German-speaking part of Switzerland is the largest comprising three-quarters of the population, followed by the French-speaking part with less than 20%. Consensus (*concordance*) is based on proportional representation of all groups, without exclusion of minorities. This applies not only to Parliament but also to the Federal Council (the federal cabinet), in which all the major parties participate. The federal administration consists of only seven departments (ministries) and a number of agencies with some degree of autonomy. Accordingly, the Federal Council consists of only seven ministers.[5] Switzerland is not the only OECD country with a strong tradition of consensus, but the Swiss system is more entrenched in the constitutional structure. Indeed, direct democracy and federalism strongly support this system because lack of consensus may easily trigger popular votes or cantonal vetoes. The budget process is strongly affected by the system of consensus. In general, it fosters continuity and gradual adjustment and hampers fundamental reform or far-reaching reallocation or retrenchment.

2.1.2. The debt containment rule

The debt containment rule is a fiscal rule. It has a double objective:

- to ensure a balanced budget in structural terms;
- to permit the automatic stabilisers to function.

Regarding the first objective, it implies that the debt in absolute terms remains unchanged over a business cycle. To let automatic stabilisers function implies deficits in periods of recessions and surpluses in economic upturns. The debt containment rule applies to the federal budget only.

The debt containment rule is inscribed in the Swiss constitution. It was adopted by Parliament in June 2001 and ratified by referendum in December 2001. It went into effect with the budget for 2003. This rule operationalises a long-standing provision of the Swiss constitution which prescribes that the Confederation has to balance its expenditures and revenues in the long term and in particular to pay off debt which was not covered by assets. In doing so, the overall situation of the economy had to be taken into account. This provision had not prevented the accumulation of considerable debts in the past decades, as indicated above. The debt containment rule was preceded by a transitory rule which stipulated a maximum deficit for the year 2001. There was a need for a new fiscal rule that would be less susceptible to asymmetric policies in bad and good times (more expenditures in bad times to stabilise the economy; more expenditures in good times as well because the resources are available). The Swiss answer to this challenge is the debt containment rule.

The debt containment rule puts a ceiling on the maximum admissible expenditures. According to the rule, the expenditures are a function of expected revenues and the economic situation. It prescribes that total federal expenditures must equal expected revenues multiplied by expected trend GDP divided by expected actual GDP, plus an adjustment factor that takes account of past deviations of budget outturns from the norm laid down by the rule. The rule implies that if trend GDP exceeds actual GDP, expenditures can be somewhat higher than expected revenues, whereas the reverse applies when expected trend GDP remains behind expected actual GDP.[6] There is an underlying hypothesis of a unitary GDP elasticity of revenues.

The maximum expenditures are calculated twice: first, when the budget is established; second, when the final accounts for the fiscal year are presented. In case of overspending, the amounts have to be carried forward on a separate account and eventually be compensated for with cuts in spending in the future. Differences between the budget and the final accounts can happen in the case of forecasting errors in revenue estimates or in the trend GDP. If the total deviations exceed 6% of total expenditures, the necessary adjustments have to take place. The adjustments have to be realised within three years.

The debt containment rule aims at budget balance over the economic cycle and will thus stabilise the nominal public debt. The Swiss authorities consider this aim as both ambitious and realistic. It is deemed ambitious in view of the fact that public debt has continuously increased in the last decades at a rapid rate, both in nominal terms and as a share of GDP. It is also ambitious in view of the fact that some economists consider an increasing nominal public debt that remains constant as a share of GDP as sustainable. The rule is deemed realistic because it does not prescribe the reduction of the public debt in absolute terms.

The debt containment rule aims not only to correct the asymmetry of expenditure policy in good times and bad times, but also to correct the institutional asymmetry of decision making for expenditures and taxation as embedded in the Swiss constitution. The latter asymmetry is due to the fact that the expenditure increases are decided by Parliament whereas tax increases, in so far as they require adjustment of the maximum rates, have to be decided by constitutional amendment and are thus subject to a compulsory referendum. The rule assures that new expenditures can only be proposed if they are financed by previously adopted tax proposals and that tax reductions can only be proposed if expenditure reductions are proposed simultaneously.

The debt containment rule aims at macroeconomic stabilisation by allowing deficits during macroeconomic downturns and requiring surpluses during upswings. As with all structural deficit rules, this requires the calculation of a cyclical factor, in the Swiss case specified as expected trend GDP divided by expected actual GDP. It is well known that the calculation of trend GDP is a fairly complex exercise in which arbitrary elements cannot entirely be avoided. In general, there are two approaches: statistical methods based on past realisations including, sometimes, forecasts for the medium term; and output gap methods based on forecasts derived from macroeconomic production functions. The EU and the OECD use output gap methods. Switzerland uses a statistical method which entails the construction of a smooth trend line on the basis of past realisations through a Hodrick-Prescott filter.[7] The method was revised during the budget preparation of 2004 mainly because the calculation method of the cyclical factor was re-examined in view of its weak reaction upon the considerable downwards adjustment of the GDP forecasts in 2003.[8]

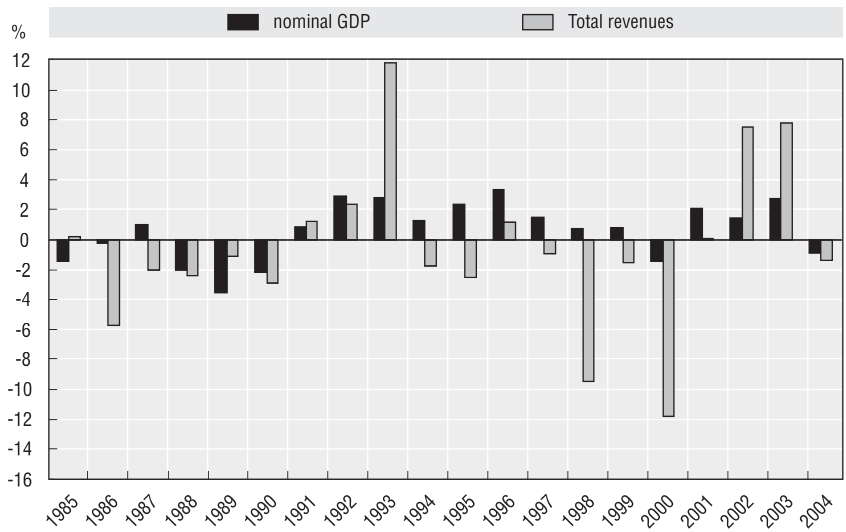
The OECD has noted in previous reports that the effectiveness of the debt containment rule is limited by the relatively small size of the federal budget compared to general government expenditure, in combination with the lack of coordination of fiscal policy with the cantons (OECD, 2002 and 2004).

Perhaps the largest challenge to the rule, however, noted both in previous OECD reports and by the Swiss authorities themselves, is the lack of correspondence between the macroeconomic cycle and the financial assets cycle (OECD, 2004). Indeed, according to official estimates, the considerable deterioration of the budget balance that occurred between 2000 and 2003 (4.5% of GDP) was for the largest part (2.5 percentage points) not due to the slow economic recovery, but rather to revenue shortfalls originating in the bursting of the bubble in the financial markets (inducing a sharp decline in proceeds from the withholding tax and stamp duty). Figure 5 shows the prediction errors in nominal GDP and total revenues since 1985. In view of the structure of the debt containment rule, revenue volatility induced by the financial markets leads to volatility of the structural deficit, which in principle has to be compensated by fiscal policy. This might put considerable pressure on the budget process, as has indeed been the case during the last three years.[9] This problem is avoided at the moment by using trend forecasts for the withholding tax. Short-term fluctuations that are not linked to the economic cycle are thus not represented in the forecast of these revenue components.

Another generally acknowledged problem of the debt containment rule is that it was implemented at a moment (budget year 2003) when, retrospectively, the structural deficit appeared to deviate from zero. Since the rule requires compensation of structural deficits, a considerable consolidation effort was necessary from 2004 onward, when revenue estimates for previous

Figure 5. **Prediction errors of nominal GDP and total revenues**[1] **in the budget since 1985**

Percentage point differences between real and estimated values



1. Less actions Swisscom sales (98.02) and licences UMTS (01).

Sources: Federal Administration of Switzerland and OECD Analytical Database.

years had to be adjusted downwards. Full compensation was widely perceived to be hardly possible technically within the budgeting process, as well as pro-cyclical and therefore undesirable. For this reason the Swiss authorities have decided to temporise the reduction of the structural deficit and to allow an overshoot of the structural deficit of CHF 3 billion in 2004 (0.75% of GDP), CHF 2 billion in 2005 (0.5% of GDP) and CHF 1 billion in 2006 (0.25% of GDP). Simultaneously, an ambitious consolidation plan was presented in the budget for 2004.

2.1.3. The character of the federal budget as a transfer budget

Hardly one-third of the total expenditures of the Federation is used for the tasks of the Federation. More than two-thirds consist of transfers to sub-national government (cantons and municipalities), the social security funds (old age and war victim pensions, disability insurance) and other semi-autonomous public institutions. This characterises the Swiss federal budget as a transfer budget. Transfers are generally based on entitlement law and contracts, which diminishes the flexibility of the budget in the short term.

Table 2. **Expenditures of the Swiss Federation according to economic character**

(in percentage of total federal expenditure, 2002)

Consumptive expenditures, *of which:*		18
	Personnel	9
	Goods and services other than defense	6
	Defense	3
Direct investment		1
Interest		8
Current transfers, *of which*:		60
	Revenue sharing with sub-national government	11.0
	Indemnities to sub-national government	0.1
	Contributions to social insurance funds	25.0
	Agricultural subsidies	7.0
	Public transport subsidies	4.0
	Subsidies for vocational training and fundamental research	7.0
	Development aid	2.0
	Road maintenance subsidies	2.0
	Other subsidies	2.0
Capital transfers		13
Total		100

Source: Swiss Federal Finance Administration.

Apart from the debt containment rule, the Swiss constitution also contains an expenditure containment rule. This rule prescribes that transfers as well as authorisations to incur obligations resulting in new expenditures of more than CHF 20 million (approximately EUR 13 million), or new recurrent expenditure of more than CHF 2 million annually, require special authorisation of Parliament by qualified majority of all members in each chamber. The expenditure containment rule is explained by the large share of transfers in the Swiss budget, but it has not proved to be a very effective barrier. Perhaps other approaches, such as further integration in the revenue sharing system for sub-national governments, would be more effective (see Section 5).

Another characteristic of the Swiss federal budget which is related to its transfer character is the relatively large share of earmarked revenues (roughly a quarter of the budget). Important earmarked revenues include the revenue-sharing parts of the income tax, the obligatory contributions from the revenues of the value-added tax, and the tax on mineral oils to the Railway Fund and road infrastructure. This restricts the flexibility of the budget process and may hamper allocative efficiency.

2.2. Annual budget process

This section outlines the major events in the annual budget formulation process in Switzerland. This process is subject to an organic budget law and its executive decree. These regulations prescribe, among other things, the accounts structure of the budget, the mode of application of the debt containment rule and the procedures for the ordinary and supplementary budget proposals, and the establishment of multi-annual estimates. The budget in Switzerland is not enacted as a (set of) formal laws as in many other OECD countries, but is a proposal *sui generis* to be approved by Parliament and defined by the constitution and the organic budget law.

The budget consists of proposals for budget authorisations at the account level with explanations. The budget authorisations can be distinguished in annual credits (cash authorisations) and commitment credits (authorisations to incur obligations). The budget is submitted to Parliament with an explanatory report. The budget is accompanied by an updated multi-year financial plan, a report on the financial plan, and multi-year estimates at the account level. The financial plan and the multi-year estimates are not authorised by Parliament; Parliament discusses them and takes note.

Central responsibility for budgetary affairs lies with the Federal Finance Administration (FFA), an agency of the Federal Department of Finance. The FFA has a total staff of around 240.

The executive budget process starts in January with the development of budgetary targets and guidelines for the preparation of the budget. These targets and guidelines are based on a provisional assessment of the macroeconomic situation and the requirement of the debt containment rule.

Within the administration, the macroeconomic forecasts are made by a Committee of Economic Experts in which participate experts from the State Secretariat for Economic Affairs, the Federal Statistical Office and the Central Bank as well as experts from the Federal Finance Administration (FFA).

Tax revenues are estimated by the FFA, the Federal Tax Administration and the Federal Customs Administration. Two approaches are used in the process of revenue forecasting. A top-down approach starts from the updated macroeconomic assessment and assumes a unitary GDP elasticity. A bottom-up approach starts from developments in the tax base of the separate tax laws. The most important federal taxes are the value-added tax, the income tax (with distinct regimes for private households and legal corporations), a tax on mineral oil, a stamp duty (on emission and transactions of bonds, equities and issuance of insurances), a withholding tax, a tobacco tax and customs duties. In the recent past, revenue estimates have sometimes been considerably off the mark, mainly for the stamp duty and the withholding tax (interest income

Box 1. **Budget formulation timetable**

Fiscal year = calendar year

January-February: Guidelines and expenditure targets are developed by the Federal Finance Administration.

February: Federal Council decides on guidelines and targets.

March-April: Budget proposals are prepared by line departments.

May: Line departments submit proposals to the FFA.

May-June: Departmental proposals are examined by the FFA and discussed with line departments.

June: Federal Council decides about the totals and required expenditure reductions in the light of updated macroeconomic assumptions and new revenue forecasts.

July-August: Line departments adjust budget proposals.

August: Federal Council takes final decisions regarding expenditures and revenues.

September: The FFA elaborates the budget (financial account and results account) and the financial plan.

End of September – beginning of October: Federal Council finalises the budget message and the report on the financial plan and submits the budget and the financial plan to Parliament.

and dividends) due to erratic movements in the financial markets (see Figure 5).

Following their approval by the Federal Council, the targets and guidelines are sent to the departments and their associated agencies, some one hundred in total, at the beginning of March. The targets are also submitted to the Finance Committees of Parliament to be discussed at their spring meetings (March-May).

During March and April, the various departments and agencies establish their budgetary requests in accordance with the ceilings established in the guidelines. They are also requested to provide estimates for the non-tax revenues accruing in their respective areas. In the beginning of May, the requests have to be submitted to the FFA, properly justified in accordance with the guidelines.

The requests submitted by the agencies do not always respect the ceilings contained in the guidelines. Furthermore, additional savings are often required to attain the budgetary targets. These subjects are discussed between the agencies and the FFA in the course of May and June. In this stage, the outlines of the budget are also discussed in meetings with the secretaries-general of the line departments (see Box 1).

Before the summer break end June, the Federal Council is informed about the progress with developing the budget and makes decisions about outstanding issues that have not been resolved at the administrative level. The room for manoeuvre at this stage is usually restricted, as 80% of expenditures is inflexible in the short run for legal reasons and contractual obligations. Even for the remaining 20% (mainly investments and material expenses) the margin of flexibility is usually small and amounts to a few hundred million Swiss francs.

When additional savings are necessary, the FFA follows by and large three strategies. It can try to identify itself the measures that are least painful to citizens and politicians; it can leave the decision of where to save to the departments; or it can propose cuts across the board. The first strategy usually raises the most resistance. If departments are to propose the cuts themselves, they tend to propose cuts that have a high probability of being reversed by Parliament. Cuts across the board have proved to be an effective and efficient instrument, if the necessary savings do not exceed a certain threshold amount.

In July and August, the agencies adjust their requests in accordance with the decisions of the Federal Council. At the end of August, the Federal Council receives an updated budget and financial plan. The Federal Council *de facto* decides on the budget, *i.e.* revenues and expenditures at the level of accounts (line items) in view of the requirements of the debt containment rule.

In September, the FFA prepares the budget proposal that will be submitted to Parliament. This proposal is made up of a report (on both a cash basis and an accrual basis) and budget line items with explanations and financial statistics. The FFA also prepares the financial plan, which contains multi-annual estimates for the three years following the next budget year and a comment regarding further development of expenditures in the various policy areas.

At the end of September or at the beginning of October, the Federal Council approves the budget message and the report on the financial plan and sends them to Parliament. Parliament has expressed its desire to receive the budget earlier. With the introduction of full accrual budgeting and accounting in 2007, Parliament has obliged the Federal Council to submit the budget one month earlier, *i.e.* at the end of August.

The Swiss budgeting system is quite input based. Performance measures and evaluations are generally not used in the budget process and are used

Box 2. **Budget formulation in line departments**

Line departments have financial divisions that are responsible for budget formulation and execution. Each department has several agencies that usually have their own financial division. Departments are sometimes also involved in the financial affairs of independent, autonomous institutions in the policy area of the department.

The departmental budgets are prepared in two stages, corresponding to the timetable of the federal budget process. In March, the departments prepare their budget requests. For that purpose the financial division sends out guidelines to the agencies of the department and the relevant independent, autonomous institutions in accordance with the guidelines of the Federal Finance Administration (FFA). They have roughly five weeks to prepare their budgets. The departmental requests are usually prepared by a financial committee or a board in which the directors of the various agencies and the head of the department's financial division participate and which is chaired by the secretary-general of the department. In May and June, the requests are discussed with officials of the FFA. In the second stage, from June to August, the departmental budgets have to be adjusted to the decisions of the Federal Council. This process is usually strongly co-ordinated by the central financial division in each department in order to make sure that the decisions of the Federal Council are adhered to and that the priorities of the minister are respected.

After the start of the budget year, there are two opportunities for supplementary budget proposals. In principle all shifts of expenditures between accounts require supplementary budget authorisations, but Parliament may allow certain shifts without supplementary authorisation. Various departments have indicated that major new policy initiatives often have more chance of success when they are proposed by way of supplementary authorisation rather than when they are proposed in the regular budget process. This may be due to the fact that during budget execution there is sometimes less fiscal stress than during budget formulation due to windfalls and that, moreover, proposals in particular policy areas may get more attention when they are proposed by way of supplementary authorisations.

only in a limited way in programme management. It is typically the line department that generates performance measures and performs evaluations.

It should be noted that in the last few years the Swiss federal budget formulation process has to a large extent been dominated by the necessity to find savings. This necessity had its roots in sluggish macroeconomic performance, endogenous growth of major expenditure programmes based on entitlement legislation (social security, education, health) and the introduction of the debt containment rule in 2003. In order to meet this challenge, the Swiss authorities have not only relied on the regular budget formulation process but also on some special devices, in particular the central imposition of consolidation packages inside or outside the regular budget process and the use of cash ceilings.

When in the course of 2002 the revenue estimates decreased rapidly (mainly in reaction to the deterioration of the financial markets), the Federal Council submitted a new budget for 2003 to Parliament although the previously submitted budget for 2003 had already been approved. A few months later, the Federal Council proposed a savings package of CHF 3 billion in 2006 (increasing from 0.8 billion in 2004, to 2.1 billion in 2005, and to 3.0 billion in 2006). Similarly, the Federal Council proposed an additional savings package in 2004 amounting to CHF 2 billion in 2008 (increasing from 0.5 billion in 2004, to 1.0 billion in 2005, to 1.1 billion in 2006, to 1.8 billion in 2007 and to 2.0 billion in 2008).

In December 2002, Parliament renewed a law that permits a certain percentage of allocated funds in the ordinary budget to not be spent (blocked). Certain expenditures are not subject to this law, including interest payments, contributions to the social security and health care funds, the contribution to the Railway Fund, and the transfer of tax proceeds by virtue of tax-sharing systems. Since the introduction of the law, Parliament has each year imposed restrictions of 1% or 2% on all susceptible accounts or on specific groups of accounts. In this way, savings can be achieved of circa CHF 250 million. These cuts can be waived by the Federal Council in case of legal or contractual obligations towards recipients of benefits. The cuts can also be waived due to severe economic recessions but this must be approved by Parliament.

2.3. Financial planning

The chambers of the Swiss Parliament are elected for a period of four years. At the beginning of each legislative period, the Federal Council presents a report to Parliament on the main features of its policy. It looks back at the previous legislative period and provides a complete picture of the new tasks the Federal Council wants to undertake and the goals it wants to achieve. This report is accompanied by a financial plan for the legislative period which establishes targets for the main budgetary aggregates (total federal expenditures and revenues, deficit and debt development) from year to year.

The financial plan is updated from year to year in the annual budget process. Each year new projections are added at the end of the planning period to maintain a quadri-annual perspective (the budget year plus three subsequent years). The financial plan is the Federal Council's instrument to gain insight into the mid-term perspective. Parliament takes notice and its endorsement or rejection is not legally binding according to current legislation (ParlG).

During the annual budget formulation process, the planning numbers of the financial plan are the point of departure. However, in view of the requirements of the debt containment rule or in view of unexpected developments or new policy initiatives, the budgetary targets and multi-annual estimates may already be changed at the beginning of the budget formulation process (*i.e.* in the guidelines sent out in March). In the course of the budget process further changes are likely.

In spite of this annual process of updating, the quadri-annual perspective is maintained from year to year. This implies that the agencies have to provide multi-annual estimates from year to year and that these estimates have to satisfy the macro-budgetary planning numbers for the next four years as established by the updated financial plan and the financial perspectives. This multi-annual approach to the budget formulation process makes it possible to decide on consolidation measures or new policy initiatives well in advance. With respect to consolidation efforts this makes it possible to phase in the required measures gradually, facilitating the implementation of such measures and enhancing their political acceptability. It should also be noted in this context that saving measures are always stated in relation to the previous multi-annual estimate. Consequently a saving measure does not necessarily imply a nominal decrease compared to the prevailing budget estimate; it may rather imply a less rapid growth than foreseen in previous multi-annual estimates. The consolidation packages of 2003 and 2004 were implemented in this way.

Although the financial plans and perspectives provide a certain degree of stability to the budget process, the annual revisions required by the debt containment rule may have an opposite effect. In an earlier OECD report, it was noted that the implementation of the debt containment rule was marked by errors in predicting the structural budget balance required for implementing the rule and that the inaccuracy of the structural balance estimates raises doubts about using this type of indicator as a guide for federal policy. Also, it has been noted that the rule leads to year-by-year fiscal management in view of the instability of estimates and the frequent revision of estimates once made. In this connection, a better incorporation of the rule in medium-term financial management has been recommended (OECD, 2004). The changes in the revenue forecasting process that accompany the current implementation of the debt containment rule (see above) have yet to prove their effectiveness in reducing short-term volatility of expenditures and thus increasing stability in the future.

The question arises whether a better incorporation in medium-term financial management is possible while maintaining the rule as it is presently worded in the constitution and the organic budget law. In this respect, the approaches of the Netherlands, Sweden and the United Kingdom towards medium-term financial management may be relevant. These countries too aim for a zero balance over the economic cycle (in the United Kingdom, only current expenditure) or a gradual reduction of the structural deficit, but they avoid the annual adjustment of fiscal policy in the light of the most recent estimates of trend GDP or structural tax revenues. They rather determine a medium-term expenditure path on the basis of the expected medium-term GDP development which maintains the structural budget balance at zero, or gradually reduces the structural budget balance to zero, and then stick to that expenditure path for a number of years.[10] This policy has roughly the same stabilisation effects as the Swiss debt containment rule.[11] However, the main differences with the Swiss debt containment rule are that: trend GDP estimates for the budget year and the next few years (let alone for the previous years) are not changed from year to year; and all non-structural revenue fluctuations are seen as cyclical (and not just those that are induced by cyclical GDP fluctuations). The advantage of this approach is mainly that it brings multi-annual tranquility to the expenditure estimates and a better basis for policy making in the line departments. An emergency brake remains necessary if the medium-term GDP estimates appear too optimistic. Such a brake could take the form of an upper bound for the allowable fluctuation of the nominal deficit. The risk that the emergency brake has to be applied could be reduced by the use of conservative estimation of medium-term GDP development or the use of a prudence margin between the trend GDP estimates used for the determination of the medium-term expenditure path and the official estimates. Such an approach would on first sight not be incompatible with the debt containment rule as worded in the Swiss constitution although it might require some adjustments in the organic budget law.[12]

2.4. Conclusion

The general government nominal deficit in Switzerland is firmly under control. This is all the more remarkable in view of the comparatively low growth of the Swiss economy in the last two decades. This achievement is due to consistent and intensive efforts on the part of the Swiss authorities including the introduction of the debt containment rule, a strict budgetary policy and large consolidation programmes in 2003 and 2004.

At this point, general government liabilities in Switzerland are not a reason for concern, given that the relatively rapid growth is due, for a substantial part, to better accounting procedures, although a bias towards budget deficits has also emerged during the last decade.

The debt containment rule is respected by the major players in the Swiss budget process and has contributed to the control of the federal deficit. However, the rule also has some problematic effects, the most important of which is that it tends to disturb the financial planning process through frequent adjustments of budgetary targets. This problem is avoided at the moment by using trend forecasts for the withholding tax. Short-term fluctuations that are not linked to the economic cycle are thus not represented in the forecast of these revenue components. This change in the revenue forecasting process has yet to prove its effectiveness in reducing short-term volatility of expenditures and thus increasing stability in the future. The Swiss authorities might consider further adjustments of the rule so that it becomes better integrated into the medium-term financial planning process.

The Swiss federal budget is largely a transfer budget. Moreover, it is characterised by a relatively high share of earmarked revenues. So far, the limitation of the growth of transfer expenditures has not been very effective. The Swiss authorities might consider other ways to restrict the growth of subsidies, for instance the further integration of transfers in the system of revenue sharing with sub-national governments (cantons and municipalities). In order to increase the flexibility of the budget, the Swiss authorities might also consider possibilities for reducing the use of earmarked revenue.

3. The role of Parliament

The Swiss Parliament is, relative to other OECD countries, a powerful body regarding its potential effect on the budget process. This means that Parliament has full and unlimited amendment rights over the State budget as introduced, and has used this power in the past.

According to the federal constitution, all expenditures must be approved by both chambers of the Swiss Parliament. In general, Members of Parliament have full rights to amendments. Parliament's only constraint is the debt containment rule, which puts a cap on overall expenditure. Yet Parliament is free to make changes within this limit among the different policy areas.

3.1. The Swiss parliamentary budget process

Parliamentary involvement in the budget process starts in March when the Finance Committees are notified of the Federal Council's decision on major directions for the upcoming budget. At present this is an informational release, as it does not require action by Parliament. It is only the Finance Committees that receive the guidelines for the budget. At this point, the Finance Committee can discuss the guidelines, send letters of request to the Federal Council or use the instrument of a motion for a change in the

Box 3. **The Swiss Parliament**

Parliament consists of two equal chambers: the National Council which provides proportional representation, and the Council of States which represents the cantons equally (although six former cantons which are now divided receive one vote each instead of the usual two). There are 200 members of the National Council and 46 members of the Council of States.

Parliament meets four times a year for a period of there weeks, *i.e.* for 12 weeks during the course of a year. Members of Parliament are not "professional" politicians, but rather assume their parliamentary duties in addition to their regular occupations.

The budget is dealt with in December. As a rule, committees meet outside of the four parliamentary sessions. Each chamber has a Finance Committee made up of sub-committees to deal with issues of each department. In addition, there is a joint committee – the Financial Delegation – made up of representatives from both chambers, which sits all year and has limited ability to act on behalf of Parliament.

There are currently 13 parties represented in the National Council and five parties with over ten members. There are four parties represented in the Council of States. A unique feature of the Swiss system is that there is no singular executive authority. There is a seven-person Federal Council of equals drawn from the major parties. This means that coalitions must come together to pass a budget.

guidelines. However, according to the constitution, the budget draft is the exclusive domain of the Federal Council whereas the budget bill that is voted in December is the exclusive right of Parliament. There is an ongoing debate on whether to strengthen the role of Parliament in the context of these guidelines.

The Finance Committees have a first round of discussions once the Federal Council has made its last decisions. The real engagement, however, starts in October when the Federal Council submits its budget and financial plan to Parliament. The Federal Council is bound by law to send the budget two months prior to the winter (December) session. This is a new legal requirement but in effect it has always been practice.

The Finance Committees first have plenary sessions on the budget as a whole, and then the examination is broken down to sub-committees. The National Council has seven sub-committees – one for each department – and the State Council four to take account of the smaller size of this chamber and thus the more limited resources. The Finance Committees are by mandate the sole bodies to review the budget. Sectoral committees play no formal role in the examination and approval process. Sectoral committees may send letters on an *ad hoc* basis with views and estimates for the process, but these are not sought and not required.

The full Finance Committees can give the sub-committees instructions on their work. For example, if the full Committee decides to reduce spending, it is the sub-committee which is tasked with achieving the reductions. The sub-committee then reports back on recommendations and the cuts in spending required to achieve the reduction goal.

Ministers (who are members of the Federal Council, the collective executive body) appear before the plenary Committee to discuss their budgets in the presence of the finance minister. There are no restrictions on Parliament for questioning the minister. When examination of the budget moves to the sub-committees, it is generally the secretary-general of the department and directors of the various agencies who come to explain and defend the budget. The sub-committee examination generally lasts a full day for each department. The schedule is well known in advance to all participants in the budget process. The sessions of all parliamentary committees, including the Finance Committee and its sub-committees, are set in the spring (March-May) by the administrative offices of the two chambers. The Financial Delegation by contrast is free to set its own schedule as necessity dictates.

In December, after the work of the Finance Committees, the budget bill is sent to the full chambers for decision. What follows is a timed process. The budget bill is sent back and forth between the two chambers three times. Finally, if there are still differences between the two chambers, the budget is sent to a "reconciliation committee" comprising members from both chambers. If the two chambers cannot agree on a particular figure of a budgetary item, the lower figure counts. Thus, the procedure is set up to ensure a budget by the end of the year. In principle, though, in the case of extreme differences, Parliament has the option of sending the budget back to the Federal Council for revision. In practice, this has not happened.

However, prior to development of the budget, Parliament can pass a "motion": a parliamentary instrument that broadly directs the Federal Council on development of government policy. In the area of budget policy, Parliament in recent years has promoted strong fiscal discipline. For example, a recent motion charged the Federal Council with developing an annual budget and a three-year financial plan so that supplemental requests will not exceed CHF 3 million for the 2004 budget. Motions like this set out expectations and political limits prior to the formal work on the details of the budget by Parliament.

Box 4. **Parliamentary budget timetable**

February: Federal Council decides budget guidelines and targets. The Finance Committees receive them for information.

August: Federal Council informs the Finance Committees of its decisions regarding the budget and the financial plan.

September/October: Budget transmitted to Parliament.

October/November: Finance Committees and their sub-committees examine the budget proposal.

December parliamentary session: Chambers take action on budget.

Mid December: Final vote on budget.

In plenary parliamentary sessions, individual MPs in both the Council of States and the National Council represent themselves and their constituents. Moreover, political party discipline is not strong by international standards. Individual rights and weak party discipline enhance the potential influence of Parliament in the budget process.

While parliamentarians have full rights to amend the budget, the reality is that not much is changed by the end of the process. Despite the large number of amendments that are submitted, one estimate is that there are perhaps 30 amendments per year passed by Parliament. Of these 30 amendments, most come in areas that are annually contested: foreign development assistance, agricultural policy, railroads, road infrastructure, defense and the like. This inability to substantially change the budget and reallocate spending is largely due to a number of factors including: the collective process of the Federal Council, general agreement on the role of the State in society, the debt containment rule (whereby being fiscally irresponsible is not politically feasible) and the fact that up to 80% of spending is entitlement spending or effectively outside the control of Parliament in the short run. On average, deviations between the budget proposal and the budget bill approved by Parliament amount to plus or minus CHF 250 million.

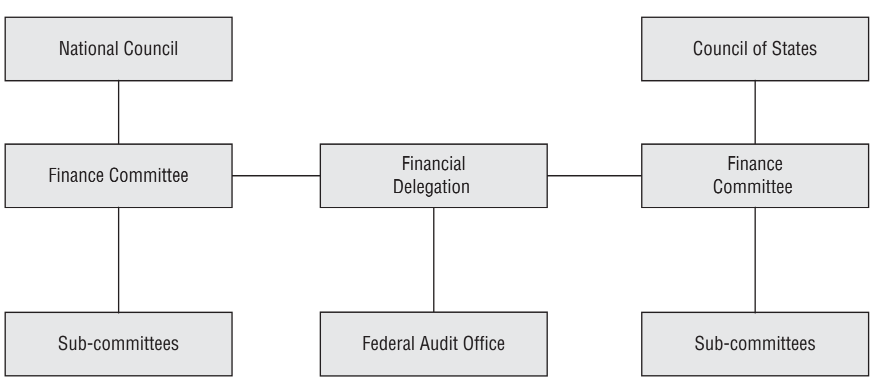
Parliament only approves the annual budget. There is no formal vote on the multi-year estimates known as the financial plan. There is the possibility of a motion, as was mentioned earlier, directing the Federal Council to take certain actions – either with respect to aggregate spending or specific budget functions. By and large, the debate on the budget is limited to single items of spending, and amendments to the budget are limited to minor items. There are no legal sanctions should Parliament not respect the fiscal rule enshrined in the constitution. There is no recourse for court action if Parliament approves a budget over the spending limits decided by the Federal Council. There is an informal political limit on parliamentary budgetary action that limits the appetite for overspending. Practically, this means that any proposals for increased spending must be met with a proposed cut elsewhere. Moreover, proposed cuts in other functional areas are also difficult practically, further limiting the room for parliamentary action.

However, since all major parties are represented in the Federal Council, and the Federal Council acts by majority vote, it is more likely that the budget proposed by the government already reflects the priorities of a majority of parliamentarians.[13]

In general, there are two supplementary budget bills presented by the Federal Council each year. In principle, departments must try to compensate additional spending within their own budgets. If this is not possible, the supplemental request is decided by the Federal Council. After Federal Council approval, it is sent to the Finance Committee for review, which then passes it to the full Parliament for decision. There is also the possibility for Parliament to approve "additional credits" which are granted for new programme spending in the middle of the year. These bills are debated and amended like any normal bill.

Parliament also approves the financial accounts of government. In most countries this is a routine event with little discussion of the documents; after all, the spending has already occurred and there is no spending that can be called back. This is more or less true for Switzerland, except that it is a signalling device and the financial accounts receive a real hearing in Parliament. The most important example is the rejection of the accounts of the Federal Pension Fund in the 1990s. With the support of the Federal Audit Office, Parliament did not approve the final accounts of the Confederation's pension insurance (EVK) until changes were finally made to the accounting treatment of pension liabilities in 1997.

Figure 6. **Parliamentary system of oversight**



3.2. The Finance Committees

The Finance Committees have three main functions: oversight of the budget process (including the long-term fiscal situation,) examination of the budget and supplemental spending, and reviews of the financial accounts of the State. It is the responsibility of the Finance Committees to put forth the annual budget law and any supplemental appropriation bills to the full Parliament. On the details of the budget, the work of the Committees is done in sub-committees following a *rapporteur* approach. The *rapporteur* writes the majority opinion of the sub-committee on the budget proposal. Individual members or groups of members may support different proposals or advice. These accompany the *rapporteur's* report.

3.3. The Financial Delegation

Because Parliament sits part time, there is a special Financial Delegation made up of members of the Council of States and the National Council. The Delegation meets through the year according to necessity, but at least once every two months. There are three members from each Finance Committee with the presidency of the Delegation changing every year. The Delegation is given special responsibilities to oversee and examine the totality of financial administration of the Confederation. This responsibility includes both the budget as well as execution and accounting of federal funds. The work plan of the Delegation is unlimited and is up to the decision of the Delegation. The Finance Committees can charge the Delegation with particular tasks related to the budget, or the Delegation can ask the full Committees to take up tasks as well.

The Financial Delegation is given special responsibility on behalf of Parliament to deal with emergency or special budget requests during the year. While there are formal supplemental laws during the year that are considered and debated in the usual method, the Delegation has the right to act on the behalf of Parliament and approve emergency appropriations with no ceiling on amounts granted. A vote is scheduled in Parliament to limit such emergency spending to CHF 250 million.

In addition, individual Members of Parliament must ask the Financial Delegation to request certain investigations or audits by the Federal Audit Office. It is the Financial Delegation that requests, receives and uses the audit reports. Approximately 10% of the work performed by the National Audit Office is based on requests from the Financial Delegation.

3.4. Secretariat

The Finance Committees and the Financial Delegation share a permanent secretariat. Administratively, the secretariat is attached to Parliament. Like the head of the Federal Audit Office, the head of the secretariat is named by the Federal Council and ratified by Parliament. The secretary is then subordinated to the presidents of the Finance Committees and Financial Delegation. The secretary is afforded the same rights to documentation and information from the government as the Federal Audit Office. At present in each chamber of Parliament there about five professional analysts supported by three to four assistants that comprise the secretariat.

3.5. Conclusion

Switzerland's parliamentary budget process is performing very well. In many respects, this performance is due to a strong political consensus. While in many countries Parliament measures its success in changing or increasing detailed spending items, the Swiss Parliament has seen its effect in restraining spending and calling for further reductions in personnel and expenditures. The parliamentary procedures have been developed over a long period and work well in their context.

Many OECD countries have moved to a two-stage budget process. In Switzerland for now the financial plan and the preliminary aggregates are given to Parliament for information purposes only. There are efforts underway to make the review more formal. These efforts deserve a full hearing.

4. Accounting and auditing

4.1. Accounting

Accounting in Switzerland is regulated by public laws and regulations. Because of the sovereignty of the cantons, federal laws do not apply and the cantons are free to develop their own rules and accounting systems. Even though each canton is different, it is fair to say that in general the cantons follow more private sector practices and operate more technically sophisticated systems than the federal level. The introduction of accruals in the federal budget and federal financial reporting will be adopted in law in June 2005. Adoption of accruals at the federal level was aided by the use of accruals at the sub-national level. While in many countries the adoption of accruals has been hampered or blocked by ministries or Parliaments, it is seen as a natural extension of current practice in Switzerland.

Traditionally, the federal budget and financial statements have been on a cash basis. Political decision making has thus been on cash expenditures. The debt containment rule applies to a cash perspective as well.

Up until recently, the accounting procedures were highly decentralised and each department had is own system and procedures, albeit generally on a cash basis. The Federal Council decided to adopt a standard accounting system that will be ready by the end of 2005, and a new federal budget and accounting system approved in 2001 will be ready by 2007.

The new system is designed to be closely aligned with the framework of international public sector accounting standards (IPSAS). There are some important deviations from IPSAS because of constitutional reasons – the constitution foresees a balanced budget on a cash basis – and for procedural reasons – the debt containment rule links expenditure to revenues.

Other deviations from IPSAS were made for practical reasons emanating from work done by a steering committee. For example, defense investments will not be capitalised according to long-standing political reasons and immediately written down to zero. A second example of a difference is that the balance sheet will distinguish between financial and administrative assets according to a Swiss solution that is shared between the central and local levels. Administrative assets are defined as assets that are designated to fulfil publicly fixed functions. Financial assets are assets that can be sold without legal or public obligation. Despite the decision to deviate from many of the IPSAS rules, each deviation will be described in the footnotes to the financial reports.

4.2. Auditing

The Swiss Federal Audit Office (SFAO) is the supreme financial supervisory organ of the Swiss Confederation. In its auditing activity it is bound only by the federal constitution and the law. It is not an independent parliamentary body like is the case in most OECD countries, but for administrative purposes the SFAO is assigned to the Federal Department of Finance. This is a model similar to the Scandinavian system although in recent years in countries like Finland and Sweden the audit offices have been made offices of Parliament. This integration into the administration, though, is only technical and the office is functionally independent of the Federal Council and executive branch. Parliament directly decides the budget of the SFAO with no oversight by the Federal Department of Finance. All reports are sent directly to the concerned office. The office's responses, as well as the original report, are then sent to the Financial Delegation of Parliament, and the summary is sent to the minister concerned by the audit findings. The audit of the annual accounts is a special report that is sent directly to the Finance Committees of Parliament.

The SFAO operates as a traditional audit office and produces about 200 reports per year. It has incorporated most of the INTOSAI "Lima Declaration" guidelines (INTOSAI, 1977) into its operating programme. Of the annual workload, about half of the plan is derived from its legal audit mission of State or semi-State organisations and the other half comes from the audit priorities based on risk analyses. There is a risk assessment process by which those programmes considered high risk are audited annually and lower risk programmes are in general audited once every five years.

There are approximately 100 staff persons working for the SFAO. About 80% are analysts while the remaining 20% consist of administrative staff. Most analysts have backgrounds in auditing and accounting. The head of the SFAO is nominated by the Federal Council and approved by Parliament. The term of the director is six years with the possibility of unrestricted re-election; removal can only be for cases of material breach of duties. The director in turn is responsible for the appointment of the audit staff.

The annual audit programme is determined autonomously and submitted simultaneously to the Federal Council and the Parliament Financial Delegation. They do not approve it, but only take note. The official programme is annual; however, the SFAO also creates an internal four-year plan. In addition to the plan, there is flexibility to do unplanned audits during the year. The unplanned audits can be generated by both the Federal Council and Parliament. The SFAO can be assisted in its work by private firms or by contracting out altogether.

The SFAO is responsible for all federal spending including Swiss companies that are majority owned by the Confederation (like Swiss Federal Railways and Swisscom). In practice, the majority owned private companies are audited by private firms and the SFAO only does special audits.

After a report is finished, the findings (supported facts) and opinions (recommendations) are presented first to the concerned office. The findings are first presented orally, and then followed up with a written report. The office then responds in a written statement, and the audit report and response are sent to the Financial Delegation of Parliament (which is charged with general oversight of spending through the year). A summary of the report is also given to the head of the department concerned by the audit findings.

Normally, the audited office accepts the findings of the SFAO and makes the necessary changes. The SFAO can issue a binding directive in the case of regularity or legality problems. There are three levels of findings: binding, where the office must comply because of legality or regularity issues; discretional, where the correction is strongly urged; and recommendation, where the finding is a suggestion. The audited office must indicate who on its staff is responsible for implementing the audit report conclusions. The audit reports and recommendations are summarised and published in an annual report.

In 1994, the SFAO extended the audit function to include effectiveness and efficiency audits. Annually, the audit office conducts between six and eight efficiency evaluations which represent about 10% of the workload. The audit office has two main tasks where about 40% of the work is on accounting audits (more internal control checks) and 40% is on financial audits (in the wide sense) which include all the legality, regularity and performance audits. The final 10% of the workload is taken up in assistance work for the Swiss Parliament. According to the new Article 170 of the federal constitution, it is required that the federal programmes also have to be audited with respect to performance. In application of a special law and decree, the Federal Council and the offices are held to examine the federal tasks in a periodic and systematic way on their necessity and their correspondence with the principles of administrative activities and leadership. The SFAO contributes to this requirement with its implementation of effectiveness and performance audits.

The SFAO shall monitor and conduct audits on how the cantons use the federal funding allotted to them (subsidies, loans, advances), provided such control is foreseen by a federal law or decree. In all other cases the SFAO may only examine the use of federal funds with the consent of the cantonal government concerned. As a rule of conduct the SFAO will work together with the cantonal auditing services to which it may delegate certain auditing assignments. The strategy of the SFAO also mentions leadership in auditing questions and permanent audit formation. The cantonal auditing services and the internal audit units can participate in the SFAO formations. Because of the independence of cantons, the federal government has no role in dictating processes and procedures. But the SFAO does initiate an annual meeting and different working groups and can make recommendations on practices.

4.3. Internal control

The internal audit units (inspectorates) of the federal administration, including those of the Federal Court and the enterprises and institutions of the government, shall be responsible for the control of the financial management in their domain. They shall be directly assigned to the managing director, although being autonomous and independent in the fulfilment of their control duties. The SFAO approves their rules and regulations, supervises the effectiveness of controls, and guarantees the co-ordination of the financial inspectorates. The SFAO is also responsible for the training and further education of the personnel of the financial inspectorates within the general federal administration. There are no general requirements for an internal audit; however larger programmes do run internal audits. Where they exist, these are most often set up at the request of the SFAO. A few departments, like defense, have inspectorates although they are not specifically for financial matters. For example, they make management and programme recommendations.

5. Financial relations between levels of government

The cantons and municipalities have their own tax and non-tax revenues, amounting to around CHF 105 billion (including shares in the federal taxes by virtue of the prevailing tax-sharing systems, mainly 30% of income tax revenue, 10% of the dividend and interest withholding tax and 12% of the tax on mineral oils). Cantons also receive a share in the profit of the Swiss Central Bank. In addition, they receive around CHF 10 billion in federal transfers.[14] There are some 50 transfers of this kind. More than 30 of them have an equalisation aim as well as the financing aim. These subsidies are in principle composed of a base rate and a rate that aims to compensate for differences in financial capacity. The financial capacity is assessed by means of an indicator which is based on various factors, one of which is inversely related to the actual fiscal sacrifice per inhabitant, relative to the federal average (so that a canton that already has a relatively high level of taxation per inhabitant is supposed to have low fiscal capacity) and another of which is the share of arable area (low in mountainous cantons). The cantonal and municipal shares in the federal taxes are also equalised by the indicator of financial capacity. However, equalising formulas differ between the various subsidies and cantonal shares of federal revenues.

Since the present system is considered as non-transparent, ineffective and inefficient, an entirely new system of financing and equalisation has been developed over the past several years. This project requires the amendment of 27 constitutional provisions. The constitutional amendments were approved by Parliament in October 2003 and ratified by referendum on 28 November 2004. The required changes in dozens of transfer laws will be discussed in Parliament in 2005 and 2006. In 2007, the equalisation parameters of the new system will be determined. In each of these phases, optional referenda may be held. In 2008, the new system is expected to be launched.

The present system is considered as non-transparent because equalisation takes place in more than 30 transfer laws and because transfers sometimes come from different federal departments or offices. Furthermore, the existing transfer laws often stem from a diffuse division of tasks between the Federation and the cantons. The present system is considered as ineffective because the differences in financial capacity between the cantons are equalised to a lesser degree than desired by the government and Parliament. The present system is considered as inefficient because it contains incentives for the financially weaker cantons to increase taxation and to concentrate expenditures on tasks that are relatively more subsidised. The new system, called Reform of Financial Equalisation and Redistribution of Tasks between the Confederation and the Cantons, aims to solve or mitigate these problems through two levers: a new division of tasks between federal and cantonal governments, and a new equalisation system.

The new division of tasks aims at three goals: disentanglement of tasks and financing arrangements; more effective co-operation when tasks have to be shared; and more effective horizontal co-operation between the cantons. For the first goal, seven tasks have been identified that will be concentrated at the federal level, and a large number of tasks have been identified in the areas of social services, education, traffic and environment that will be concentrated at the cantonal level. For the second goal, 17 tasks have been identified where exclusive attribution to a single level of government is not desirable and where co-operation between federal and cantonal government remains necessary. In these areas, subsidies will be based on normative costs or budgets (not on costs of separate means of production) and multi-annual programmes. These programmes will specify targets for service levels that will be checked by the federal government. For the third goal, federal legislation will encourage co-operation. Presently, cantonal co-operation is voluntary. In the future, cantons will have to pay for services delivered by neighbouring cantons in exchange for rights of participation. The specific arrangements have to be laid down in separate treaties between the cantons concerned or in a general inter-cantonal treaty. At the request of a qualified majority of cantons concerned, Parliament will be able to impose inter-cantonal treaties on all cantons and to oblige individual cantons to accede to inter-cantonal treaties adopted by other cantons.

The new equalisation system will be separated from the current transfer laws and be managed as an independent transfer system. It is based on two principles: equalisation of revenue capacity and equalisation of service costs.

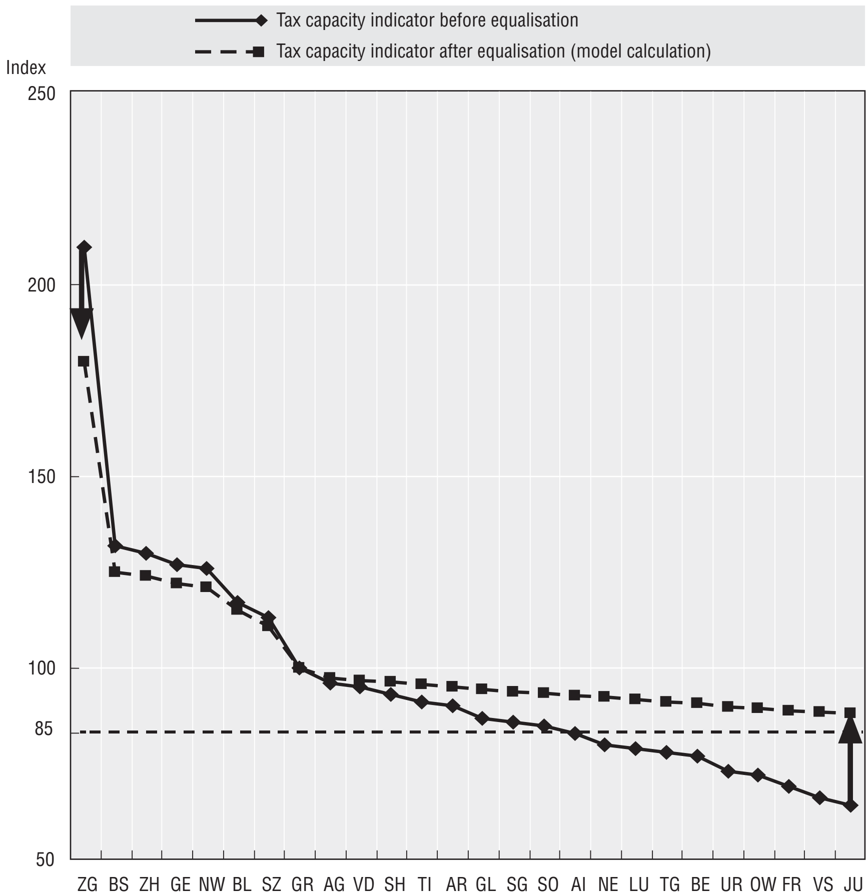
The objective of the equalisation of tax capacity is that the cantons with the lowest tax capacity will receive additional means so that their tax capacity after equalisation will be at least 85% of the average tax capacity per canton. This aim will be attained by an equalisation transfer that will be composed of a horizontal and a vertical component. The constitution states that the horizontal component has to be determined in such a way that it amounts to at least two-thirds but at most four-fifths of the vertical component. It appeared from model calculations for 2001/02 that under these conditions a horizontal equalisation transfer of around CHF 1.1 billion from the cantons with high tax capacity accompanied by a vertical equalisation transfer from the Federation of around CHF 1.6 billion would be required. The actual amounts of the vertical and horizontal components will have to be determined every four years by the Swiss Parliament in compliance with the proportional 2/3 to 4/5 band. In the next three years, the horizontal transfers will be increased by the relative growth of the tax capacity of the transferring cantons and the vertical transfers will be increased by the growth of the tax capacity of all cantons.

The tax equalisation system is based on a tax capacity index. This index is based on the tax base of the cantons, not on actual tax revenue. The tax base is computed from the taxable incomes and wealth of family households and the taxable profits of firms in the canton. In order to arrive at an index that is comparable with actual tax revenue, it is necessary to define a measure of average depletion of the tax base, namely: the sum of the tax revenues of all cantons and municipalities divided by the sum of all tax bases of the cantons. This measure for 2002 is 31.5%. Tax capacity of an individual canton is subsequently defined as the average tax depletion rate times the tax base of the canton. This is the tax revenue the canton would receive if it would deplete its tax base at the average rate. This measure can be compared to actual tax revenue. It shows how much money the canton loses or wins by staying behind or exceeding the average depletion rate of its tax base. The index of tax capacity is the standardised tax capacity with an average of 100.

In order to arrive at the desired aim that the tax capacity of the canton with the lowest tax capacity after equalisation is above 85% of the average tax capacity, it became necessary to make the transfer to the receiving cantons slightly[15] progressive in regard to the tax capacity index of these cantons (for instance, a canton with index 80 before equalisation getting more than twice what a canton with index 90 receives before equalisation). On the other hand, the transfers from the sending cantons are strictly proportional in regard to the tax capacity of these cantons (for instance, a canton with index 120 before equalisation paying exactly twice as much as a canton with index 110 before equalisation). Figure 7 shows the effects of the tax equalisation system on the tax capacity before and after equalisation for the year 2001/02.

The mountainous cantons and the cantons that comprise cities are confronted with relatively high service costs which they cannot avoid. In order to compensate for these costs, an equalisation mechanism for service capacity exists in addition to the one for tax capacity. The mechanism consists of two parts: a geographical-topographical and a socio-demographical equalisation mechanism. Geographical-topographical equalisation compensates for altitude (leading for instance to high costs for infrastructure), steepness (leading for instance to high costs for forest management) and low population density (leading for instance to high costs for infrastructure, education, and health services). Socio-demographical equalisation compensates for high costs caused by the population structure (social services related to poverty, old age and immigration) and for high costs caused by population and employment density (security services, traffic).

Figure 7. **The effects of the proposal for tax capacity equalisation (cantons on horizontal axis in order of tax capacity)**



Source: Information brochure for referendum proposal of 28 November 2004, Federal Department of Finance.

Service capacity equalisation is independent from factual costs: it compensates for the costs of potential services, regardless of whether these services are actually provided. In this respect it is fully comparable to the equalisation of tax capacity. Service capacity equalisation compensates only for the additional costs of a basic package of cantonal and municipal services, not for those services that cantons and municipalities choose to offer in addition to the basic package (for instance swimming pools or cultural services). Spillovers between cantons (for instance in higher education, law enforcement, the prison system, cultural services) are in principle not compensated via the equalisation of service costs but via inter-cantonal co-operation (see above).

Service capacity equalisation proceeds by the calculation of three indicators, one for the geographical-topographical equalisation and two for the socio-demographical equalisation. The first indicator is composed of four partial indicators, one for steepness (median of the altitudes of arable surfaces), one for altitude (share of population living at a higher altitude than 880 meters) and two for population density (share of population living in settlements of less than 200 inhabitants, and number of inhabitants per hectare). The four partial indicators are standardised and integrated with weights 33.3%, 33.3%, 16.7% and 16.7% in the geographical-topographical indicator. On the basis of model calculations for 2001/02, this equalisation transfer will be received by 18 out of the 25 cantons.

The second indicator measures the high costs of social services. It is composed of three partial indicators, one for poverty (consisting itself of sub-indicators for long-term unemployment, drug dependence and single parents), one for the share of elderly population (>80) and one for the share of immigrants. The three partial indicators are again standardised and integrated with weights 40%, 23% and 36% respectively in the social services indicator. The transfer is received only by cantons with above-average costs. Since the costs of social services are concentrated in a few cantons, only seven cantons will receive this equalisation transfer.

The third indicator measures the high costs of police, law enforcement and traffic in cantons comprising large cities. It is composed of three partial indicators, one for the number of inhabitants, one for building density (number of inhabitants and jobs in relation to productive surface) and one for employment density (number of jobs in relation to population). Again the partial indicators are standardised and integrated with weights 25%, 37% and 28% respectively in the city indicator. This transfer too, is received only by cantons with above-average costs. Since the costs of large cities are even more concentrated than the costs of social services, only five cantons will receive this equalisation transfer.

In contrast to the tax capacity equalisation transfers, the service capacity equalisation transfers are financed exclusively by the Federation (there is no horizontal component). The size of the service capacity transfers is decided every four years by the Swiss Parliament. The size of each of the three transfers has to be decided separately. In the next three years, each of the three transfers is to be increased to compensate for inflation.

From model calculations for the year 2001/02, it appears that if the reforms had been introduced that year on the basis of budget neutrality (in comparison to the present system), the federal equalisation transfers would have consisted of 72.5% for the tax capacity transfer (the vertical component), 13.7% for the geographical-topographical service capacity transfer, 9.2% for the social services component of the socio-demographical service capacity transfer, and 4.6% for the large city component of the socio-demographical service capacity transfer. The shares of the vertical and horizontal components in the tax capacity equalisation transfer would have been 59% (vertical) and 41% (horizontal). In order to achieve budget neutrality, the cantonal share of federal income taxes would have to have been reduced from 30% to 17%.

In order to avoid having certain cantons see their federal transfers diminish or grow less rapidly than intended as a consequence of the reforms, it will be necessary to introduce a temporary hardship transfer. The transfer is determined on the basis of an intended target of net benefits from the introduction of the reforms per canton. The intended target is dependent on the tax capacity index (a canton with a lower tax capacity before equalisation is supposed to benefit more). Cantons for which the target is not reached receive the hardship transfer. The transfer will be frozen for eight years and subsequently be reduced by 5% per year. Parliament can decide every four years to abolish the hardship transfer in the light of information about its effectiveness. The transfer will be paid from a cohesion fund which is financed two-thirds by the Federation and one-third by the cantons. For the federal part, the condition of budget neutrality does not apply (it will amount to a net cost of the introduction of the reforms). The distribution of the cantonal part will be based on population and thus be roughly equal per inhabitant (around 11 Swiss francs on the basis of 2001/02 data). On the basis of the 2001/02 data, the hardship transfer would apply to seven cantons and amount to around CHF 244 million. The total effects of the reforms for 2001/02 are shown in Table 3.

The reform of the transfer system is an impressive project. It is very large and complex and still seems to be well integrated and strongly co-ordinated by the responsible federal department. The design of the system is in accordance with modern principles of fiscal federalism. Equalisation, financing and compensation of spillovers are henceforth separated and independently manageable.

The equalisation system is based on tax capacity and service capacity and does not contain improper incentives to increase or decrease cantonal taxation or to increase or decrease cantonal service levels. The equalisation system fulfills a financing function as well as an equalisation function. Financing covers a basic package of cantonal services, often prescribed in federal legislation. Financing through special transfers will henceforth be limited to cases where collaboration of the Federation and the cantons is required. Compensation of spillovers will take place through inter-cantonal treaties and not involve federal budgetary means.

Table 3. **The new financial equalisation system: charges, payments and equalisation effects**

Charges (+) and payments (-) in thousands of Swiss francs

	Resource equalisation		Cost compensation				Resource indicator		Cohesion fund	
	Charges to cantons with above average potential of resources (horizontally)	Payments to cantons with below average potential of resources (horizontally and vertically)	Social services (poverty, highly aged population and immigrants)	Large city services (population, building density, employment density)	Geographic-topographic cost compensation	Total	Before resource equalisation	After resource equalisation	Charges of cantons	Payments to cantons
Zurich	578 211	–	–25 596	–50 537	–	502 078	132.7	125.2	13 551	–
Berne	–	–749 119	–	–1 879	–15 860	–766 858	78.7	91.0	10 641	–102 592
Lucerne	–	–225 482	–	–	–6 146	–231 628	81.3	91.5	3 845	–
Uri	–	–35 308	–	–	–9 666	–44 974	74.7	90.3	387	–
Schwyz	21 176	–	–	–	–3 626	17 550	111.8	109.1	1 419	–
Obwald	–	–33 696	–	–	–4 070	–37 766	73.6	90.2	358	–16 879
Nidwald	14 009	–	–	–	–855	13 153	126.4	120.4	409	–
Glaris	–	–13 007	–	–	–4 288	–17 294	88.6	93.8	429	–
Zoug	148 239	–	–	–	–75	148 164	207.2	182.7	1 087	–
Fibourg	–	–285 885	–	–	–12 506	–298 391	70.6	89.9	2 634	–
Soleure	–	–112 708	–	–	–	–112 708	85.2	92.5	2 708	–
Bâle-Ville	99 781	–	–25 094	–18 330	–	56 357	134.2	126.4	2 155	–
Bâle-Campagne	60 532	–	–	–	–	60 532	116.3	112.5	2 862	–
Schaffhouse	–	–11 593	–558	–	–	–12 151	93.2	95.6	819	–
Appenzell Rhodes-Extérieures	–	–11 743	–	–	–15 747	–27 490	91.4	94.8	598	–9 344
Appenzell Rhodes-Intérieures	–	–7 027	–	–	–6 468	–13 496	84.9	92.5	163	–
St-Gall	–	–187 892	–	–	–2 034	–189 926	86.3	92.9	4 994	–
Grisons	–	–6 793	–	–	–111 045	–117 838	97.8	98.3	2 101	–
Argovie	–	–30 817	–	–	–	–30 817	96.6	97.5	6 013	–24 347

Table 3. **The new financial equalisation system: charges, payments and equalisation effects**

Charges (+) and payments (-) in thousands of Swiss francs *(Cont.)*

	Resource equalisation		Cost compensation				Resource indicator		Cohesion fund	
	Charges to cantons with above average potential of resources (horizontally)	Payments to cantons with below average potential of resources (horizontally and vertically)	Social services (poverty, highly aged population and immigrants)	Large city services (population, building density, employment density)	Geographic-topographic cost compensation	Total	Before resource equalisation	After resource equalisation	Charges of cantons	Payments to cantons
Thurgovie	–	–162 293	–	–	–3 598	–165 892	80.0	91.2	2 539	–
Tessin	–	–66 202	–17 797	–	–11 455	–95 454	91.5	94.9	3 404	–2 206
Vaud	–	–91 311	–57 626	–3 521	–	–152 457	93.6	95.9	6 990	–
Valais	–	–402 282	–	–	–65 374	–467 656	66.6	89.7	3 041	–39 756
Neuchâtel	–	–102 243	–7 106	–	–19 179	–128 528	82.2	91.7	1 861	–45 752
Genève	167 785	–	–63 056	–24 149	–	80 580	128.6	122.1	4 527	–
Jura	–	–111 092	–	–	–3 253	–114 345	64.2	89.6	754	–
Total	1 089 732	–2 646 492	–196 832	–98 416	–295 248	–2 147 255	100.0	100.0	80 292	–240 875

Source: Swiss Federal Finance Administration.

Economists have often emphasised that equalisation of tax capacity is largely a matter of allocative efficiency. Indeed, without such equalisation, the tax prices that households and firms pay for goods and services provided by sub-national governments would be dependent on the presence of other households and firms, particularly rich ones, in the area of the sub-national government. That would lead to price differences and spiraling effects of migration movements and additional price differences (Buchanan, 1950; Boadway and Flatters, 1982).[16] This efficiency enhancing effect of tax capacity equalisation is stronger to the extent that the share of public goods in the budgets of sub-national government is larger (as opposed to private goods). This is the case because the tax price of private goods in more populous governments decreases only because of economies of scale, whereas the tax price of public goods in more populous governments also decreases because of the fact that costs do not increase but are shared by more taxpayers. In Switzerland, the share of public goods in cantonal budgets seems quite high (infrastructure, law enforcement, prison systems, public transport).

On the other hand, service capacity equalisation is a matter of solidarity between cantons. It also tends to harm allocative efficiency because it contains an incentive to steer productive activities towards regions where they cannot be carried out at minimal costs.

Although in the case of Switzerland it is entirely clear that the solidarity motive behind service capacity equalisation cannot be discarded and in a certain sense is a basic part of the constitutional set up of the Swiss Federation, it could nevertheless be sensible for the Swiss authorities to put more emphasis on the different allocative effects of the two types of equalisation while providing information to the public. This could in particular contribute to a relatively moderate development of the cost equalisation transfers in the future, or even a gradual reduction of these transfers.

5.1. *Conclusion*

Switzerland presently has a system of fiscal equalisation that is not transparent, not very effective and inefficient (wrong incentives). Therefore, it has undertaken an integral overhaul of the system. The introduction of the new system is an impressive project.

The design of the reforms is in accordance with modern principles of fiscal federalism. Equalisation, financing and compensation of spillovers are henceforth separated and independently manageable.

The equalisation system is based on tax capacity and service capacity and does not contain improper incentives to increase or decrease cantonal taxation or to increase or decrease cantonal service levels. Equalisation of tax capacity ensures that the tax capacity of each canton is at least 85% of the average cantonal tax capacity, and equalisation of service capacity ensures that cantons with exceptional costs because of geographical-topographical or socio-demographical circumstances are compensated.

In public information about the reforms, the Swiss authorities could emphasise somewhat more the distinct effects on allocative efficiency of equalisation of tax capacity on the one hand and of equalisation of service capacity on the other hand.

Notes

1. Switzerland is not part of the euro area, nor a member of the EU, but in calculating its deficit it excludes exceptional factors in the same manner as required by the rules of the European System of Accounts (ESA 95; see Eurostat, 1996).
2. The highest in Europe apart from Norway that has substantial revenues from oil exploitation.
3. Each canton has one vote, except some small cantons which hold a half vote. In total there are 23 cantonal votes.
4. The value-added tax and the federal income tax are also limited in time. To keep these taxes in place they have to be approved periodically in referendums as well.
5. Presently the Federal Council consists of two Social Democrats, two Free Democrats, one Christian Democrat, and two Swiss People Party representatives. The Federal Council is elected every four years. The presidency of the Federal Council changes every year among its members.
6. However, since 2002 the federal loans to the unemployment insurance system are managed outside the federal budget so that the automatic stabilisation effect of the unemployment compensation system is not impeded.
7. Until the revision of the method for the budget year 2004, the trendline was constructed not only from past realisations but also from forecasts for the budget year and the three subsequent years.
8. The adjustments were proposed by the Group of Economic Advisers of the Federal Finance Administration and entailed among other things the removal of the GDP forecasts from the data from which the trendline is estimated and the adjustment of the Hodrick-Prescott filter to make it less sensitive to short-term fluctuations. The forecasts were introduced to begin with because the Hodrick-Prescott filter makes the trendline relatively sensitive to end-of-period estimates and thereby reduces the size of the cyclical factor. By using forecasts, the budget year would be further removed from the end-of-period estimate. However, this overlooked the fact that nominal forecasts are generally revised in tandem with revision of the realisation estimate (because the estimated growth percentage is not changed on the occasion of the revision), so that the problem is enlarged rather than reduced. Moreover the Group of Economic Advisers concluded that GDP forecasts are generally not very accurate (usually held at 2% in the last 20 years). The end-of-period problem was therefore mitigated by the adjustment of the filter itself (Bruchez, 2003a).
9. This fact is reflected by recent research to break down the deficit into three components: structural, cyclical and irregular non-cyclical (Bodmer and Geier, 2004). However, it is questionable whether policy reform on the basis of this

proposal could be made compatible with the constitutional formulation of the debt containment rule. Apart from that, it would complicate the rule and add to the subjective elements in its interpretation.

10. The main difference between the Dutch approach on the one hand and the British and Swedish approach on the other hand is that, in the Netherlands, the expenditure path is established at the beginning of a cabinet period and then remains fixed, whereas in the British and Swedish approach the expenditure ceilings are extended on a rolling basis (in the United Kingdom the planning cycle is biannual so that two new years are added at the end of the planning period every two years; in Sweden the planning cycle is annual so that one year is added at the end of the planning period every year).

11. However, in the United Kingdom the social security sector (the annually managed expenditures or AME) is exempted from the multi-annual expenditure ceiling and allowed to fluctuate. This strengthens the stabilisation effect and makes the fiscal rule anticyclical rather than acyclical. In Switzerland the unemployment insurance is exempted from the fiscal rule to the same effect.

12. One might pose the question of whether using trend GDP and structural revenue predictions instead of realisations is in accordance with the wording of the debt containment rule in the Swiss constitution. A relevant consideration in this respect may be that the budget by definition requires predictions or extrapolations because it is forward looking. The question thus hinges on how retrospectively observed deviations between predictions and realisations are taken into account. In the British, Dutch and Swedish approaches, such deviations have to lead to revisions of the GDP trend or structural revenues and adjustments of the expenditure path at the end of the planning period or in the next planning period, rather than in the next three years as required by the Swiss equalisation account mechanism.

13. Federal Council members are typically drawn from Parliament but they must resign their seat upon election to the Council. However, there is no requirement that Council members be parliamentarians.

14. In the Swiss budgetary terminology it is customary to make a distinction between subsidies that have the character of financial aid and those that have the character of indemnity. The first are given as an incitation for activities that cantons and municipalities have undertaken on their own initiative. The latter are given as a compensation for costs incurred by virtue of tasks prescribed by federal law.

15. The payment schedule cannot be made strongly progressive because that would violate the condition that the order of the cantonal tax capacities must not be changed before and after equalisation. If this condition is not imposed, cantons would no longer have an incentive to increase their tax base by attracting firms and family households.

16. There is a small difference between the equalisation of fiscal residuums as proposed by Buchanan and the equalisation of tax capacity as treated by Musgrave (1961) in that the former aims at equity at the individual level rather than at the sub-national level. In practice, both approaches are roughly identical.

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