Working Party of Senior Budget Officials

BUDGETING IN SWITZERLAND

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PREFACE

1. This review of the Swiss budgeting system was carried out as part of the ongoing country review programme of the OECD Working Party of Senior Budget Officials (SBO). The objective of the review programme is to provide a comprehensive overview of the budget process in the country under examination, to evaluate national experiences in light of international best practices and to provide specific policy recommendations, and to offer other member countries an opportunity to comment on specific budgeting issues in the country under examination ("peer review"). This report will serve as a basis for the examination of the Swiss budgeting system at the forthcoming meeting of the SBO.

2. This report is divided into five sections. The first section presents an overview of the fiscal situation in Switzerland. The second section focuses on the budget formulation process. The third section discusses the role of the legislature. The fourth section reviews various aspects of accounting and auditing. The fifth and final section is devoted to Switzerland’s system of fiscal relations across levels of government.

3. A mission consisting of Mr. Michael RUFFNER and Mr. Dirk-Jan KRAAN visited Bern in February to carry out the review. During its visit the mission met with Mr. Peter SAURER, Deputy Director of the Federal Finance Administration Finance and with other senior officials of the Ministry of Finance and several line ministries. The mission also met with Mr. Bruno ZUPPIGER, President of the Financial Delegation of the Parliament, and Mr. Christian AYER, Head of the Budget Secretariat of the Parliament, Mr. Kurt GRÜTER, Director of the Swiss Federal Audit Office, and with Mr. Pascal GENTINETTA, Economic Director of Economie suisse, the Swiss association of employers.

4. The mission would like to express its gratitude and appreciation for the warm and cordial reception by the Swiss authorities and the frank and useful discussions with Swiss officials. In particular, the mission would like to express its thanks to Mr. Peter SAURER, Deputy Director of the Federal Finance Administration, for the generous time he spent with the mission during its stay in Berne.

5. Finally the mission would like to thank Mr. Alain GEIER, Economist, Federal Finance Administration, for organizing the mission’s visit and his unsparing help and assistance throughout this review.

6. The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organizations or individuals consulted for this review.
CHAPTER 1

INTRODUCTION

The central government sector

7. Switzerland came into existence as a national state in the first half of the nineteenth century as a consequence of a process of political integration of twenty-five 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).

8. The strongly federalist nature of the Swiss state is reflected in the relatively small size of its central government sector. Expenditures of 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 percentage of GDP amount to 39.1% of GDP 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.

9. 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.
The fiscal balance

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

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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 European System of Accounts (ESA 95)
11. 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 point. Moreover, this differential has gradually widened, reaching 1 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

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Switzerland</td>
<td>3.8%</td>
<td>-0.8%</td>
<td>0.0%</td>
<td>-0.2%</td>
<td>1.1%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>1.9%</td>
<td>2.8%</td>
<td>1.3%</td>
<td>3.6%</td>
<td>1.0%</td>
<td>0.3%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Euro area</td>
<td>3.7%</td>
<td>2.7%</td>
<td>1.5%</td>
<td>-0.8%</td>
<td>2.4%</td>
<td>2.3%</td>
<td>1.5%</td>
<td>2.4%</td>
<td>2.9%</td>
<td>2.8%</td>
<td>3.5%</td>
<td>1.6%</td>
<td>0.9%</td>
<td>0.1%</td>
</tr>
<tr>
<td>OECD Total</td>
<td>3.1%</td>
<td>1.4%</td>
<td>2.1%</td>
<td>1.3%</td>
<td>3.1%</td>
<td>2.4%</td>
<td>3.1%</td>
<td>3.4%</td>
<td>2.5%</td>
<td>3.1%</td>
<td>3.7%</td>
<td>1.1%</td>
<td>1.4%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

Note: US$ constant prices and constant exchange rates

Source: OECD Statistics Department.
Level of taxation

12. 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, USA, Korea, Ireland, Japan and Mexico). 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\(^2\), 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).

13. In line with the strong growth of expenditures as a percentage of GDP since the early 1990s, tax revenue 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 Turkey, Korea, Greece, Iceland and Portugal, where tax levels were previously low). The average increase was 2 percentage point of GDP in the OECD area over the whole period.

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\(^2\) The highest in Europe apart from Norway that has substantial revenues from oil exploitation.

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Figure 3. Central and General Government Tax revenues as percentage of GDP

Source: OECD Revenues Statistics Database.
Financial liabilities

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

**Figure 4. Gross General Government financial liabilities as percentage of GDP**

CHAPTER 2

BUDGET FORMULATION

Key characteristics of the Swiss budgeting system

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

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

Political environment

16. 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.

17. Direct democracy is the most conspicuous aspect of the Swiss political process. These take 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 organized, 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. 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 that only 25% of

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3 Each canton has one vote, except some small cantons which hold a half vote. In total there are 23 cantonal votes.
eligible citizens vote on a regular basis. The apparent paradox between the high value placed on popular rights and the low turn out at actual votes, may be explained by the fact that participation is now seen more as an individual right that places constraints on the behavior 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. This requirement serves as a formidable obstacle to budgetary expansion.

18. 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 decentralized 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 can not easily be infringed upon.

19. The tradition / system of consensus (concordance) can be seen as an extension of the principle of minority protection that characterizes 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 percent. Consensus (concordance) is based on proportional representation of all groups, without exclusion of minorities. This applies not only to Parliament but also the Federal Council (the federal cabinet), in which all the major parties participate. The Federal Administration consists of only seven ministries and a number of agencies with some degree of autonomy. Accordingly, the Federal Council consists of only seven ministers. 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.

The Debt Containment Rule

20. 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 stabilizers to function

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

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4 The VAT 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 the members of the federal council.
21. 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 account of. 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 stabilize 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.

22. 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. There is an underlying hypothesis of a unitary GDP elasticity of revenues.

23. 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 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 realized within three years.

24. The debt containment rule aims at budget balance over the economic cycle and will thus stabilize 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.

25. 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 the legislature, 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

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6 However, since 2002 the federal loans to the unemployment insurance system are managed outside the federal budget so that the automatic stabilization effect of the unemployment compensation system is not impeded.
financed by previously adopted tax proposals and that tax reductions can only be proposed if expenditure reductions are proposed simultaneously.

26. The debt containment rule aims at macro-economic stabilization by allowing deficits during macro-economic 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 can not entirely be avoided. In general, there are two approaches: statistical methods based on past realizations including, sometimes, forecasts for the medium term and output gap methods based on forecasts derived from macro-economic 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 realizations through a so-called Hodrick-Prescott filter. The method has been revised during the budget preparation of 2004 mainly because the calculation method of the cyclical factor was reexamined in view of its weak reaction upon the considerable downwards adjustment of the GDP forecasts in 2003.

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

28. 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 macro-economic 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 per cent of GDP) was for the largest part (2.5 percentage point) 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 compensated for by fiscal policy. This might put considerable pressure on the budget process, as has indeed been the case during the last three years. 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.

7 Until the revision of the method for the budget year 2004 the trendline was constructed not only from past realizations but also forecasts for the budget year and the three subsequent years.

8 The adjustments were proposed by the Group of Economic Advisers of the FFA 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. This overlooked, however, that nominal forecasts are generally revised in tandem with revision of the realization estimate (because the estimated growth percentage is not changed at 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 year). The end of period problem was therefore mitigated by the adjustment of the filter itself (Bruchez 2003).

9 This matter of fact is reflected by recent research to break down the deficit in three components: structural, cyclical and irregular non-cyclical (Bodmer, Geier 2003). 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.
Figure 5.

Prediction errors of nominal GDP and total revenues* in the budget since 1985
percentage points differences between real and estimated values

Source: Federal Administration of Switzerland and OECD Analytical Database.

Another generally acknowledged problem of the debt containment rule is that it has been 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 years had to be adjusted downwards. Full compensation was widely perceived to be technically hardly possible within the budgeting process, as well as pro-cyclical and therefore undesirable. For this reason the Swiss authorities have decided to temporize the reduction of the structural deficit and to allow an overshoot of the structural deficit of CHF 3 billion in 2004 (0.75 per cent GDP), CHF 2 billion in 2005 (0.5 percent of GDP) and CHF 1 billion in 2006 (0.25 per cent GDP). Simultaneously, an ambitious consolidation plan was presented in the budget for 2004.

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 consists 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 characterizes the Swiss federal budget as a transfer budget.
Table 2 Expenditures of the Swiss federation according to economic character in percentage of total federal expenditure (2002)

<table>
<thead>
<tr>
<th>Consumptive expenditures, of which</th>
<th>18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>9</td>
</tr>
<tr>
<td>Goods and services other than defense</td>
<td>6</td>
</tr>
<tr>
<td>Defense</td>
<td>3</td>
</tr>
<tr>
<td>Direct Investment</td>
<td>1</td>
</tr>
<tr>
<td>Interest</td>
<td>8</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Transfers, of which</th>
<th>60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue sharing with sub-national government</td>
<td>11</td>
</tr>
<tr>
<td>Indemnities to sub-national government</td>
<td>0.1</td>
</tr>
<tr>
<td>Contributions to social insurance funds</td>
<td>25</td>
</tr>
<tr>
<td>Agricultural subsidies</td>
<td>7</td>
</tr>
<tr>
<td>Public transport subsidies</td>
<td>4</td>
</tr>
<tr>
<td>Subsidies for vocational training and fundamental research</td>
<td>7</td>
</tr>
<tr>
<td>Development aid</td>
<td>2</td>
</tr>
<tr>
<td>Road maintenance subsidies</td>
<td>2</td>
</tr>
<tr>
<td>Other subsidies</td>
<td>2</td>
</tr>
<tr>
<td>Capital transfers</td>
<td>13</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>

31. Transfers are generally based on entitlement law and contracts, which diminishes the flexibility of the budget in the short term.

32. Apart from the debt containment rule, the Swiss constitution also contains an expenditure containment rule. This rule prescribes that transfers as well as authorizations to incur obligations resulting in new expenditures of more than 20 million Swiss francs [approximately 13 million Euro], or new recurrent expenditure of more than 2 million Swiss francs annually, require special authorization 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 chapter 5).

33. 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.

Annual budget process

34. 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 generic to be approved by Parliament and defined by the constitution and the LFC.

35. The budget consists of proposals for budget authorizations at the account level with explanations. The budget authorizations can be distinguished in annual credits (cash authorizations) and commitment credits (authorizations 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 authorized by Parliament. Parliament discusses them and takes note.

36. 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.

<table>
<thead>
<tr>
<th>Budget Formulation Timetable</th>
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<tr>
<td><strong>January-February</strong></td>
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<tr>
<td><strong>February</strong></td>
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<td><strong>March-April</strong></td>
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<tr>
<td><strong>May</strong></td>
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<td><strong>May-June</strong></td>
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<td><strong>June</strong></td>
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<td><strong>July-August</strong></td>
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<td><strong>August</strong></td>
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<tr>
<td><strong>September</strong></td>
</tr>
<tr>
<td><strong>End of September – Beginning of October</strong></td>
</tr>
</tbody>
</table>

**Fiscal Year = Calendar Year**
37. 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 macro-economic situation and the requirement of the debt containment rule.

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

39. Tax revenues are estimated by the Federal Finance Administration, 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 macro-economic 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, stamp duty (on emission and transactions of bonds, equities and issuance of insurances), a withholding tax, 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 and dividends) due to erratic movements in the financial markets. See figure 5 above.

40. Following their approval by the Federal Council, the targets and guidelines are sent to the ministries and their associated agencies, some one hundred in total, at the beginning of March. The targets are also submitted to the Finance Committees of the legislature to be discussed at their Spring meetings.

41. During March and April, the various ministries 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 Federal Finance Administration, properly justified in accordance with the guidelines.

42. 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 ministries (see box)

43. Before the summer break, 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 hundreds millions of Swiss francs.

44. 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 ministries, or it can propose cuts across the board. The first strategy usually raises the most resistance. If ministries 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.

45. 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.

46. 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 accrual basis), 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.

47. 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.

48. 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.

49. The Swiss budgeting system is quite input based. Performance measures and evaluations are generally not used in the budget process and are used only in a limited way in program management. It is typically the line ministry that generates performance measures and performs evaluations.

<table>
<thead>
<tr>
<th><strong>Budget formulation in line ministries</strong></th>
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<tbody>
<tr>
<td>Line ministries have financial divisions that are responsible for budget formulation and execution. Each ministry has several agencies that usually have their own financial division. Ministries are sometimes also involved in the financial affairs of independent, autonomous institutions in the policy area of the ministry.</td>
</tr>
<tr>
<td>The ministerial budgets are prepared in two stages, corresponding to the time table of the federal budget process. In March, the ministries prepare their budget requests. For that purpose the finance division sends out guidelines to the agencies of the ministry and the relevant independent, autonomous institutions in accordance with the guidelines of the AFF. They have roughly 5 weeks to prepare their budgets. The ministerial requests are usually prepared by a financial committee or a board in which the directors of the various agencies and the head of the ministry’s financial division participate and which is chaired by the Secretary-General of the ministry. In May and June, the requests are discussed with officials of the FFA. In the second stage, from June to August the ministerial budgets have to be adjusted to the decisions of the Federal Council. This process is usually strongly coordinated by the central financial division in each ministry in order to make sure that the decisions of the Federal Council are adhered to and that the priorities of the minister are respected.</td>
</tr>
<tr>
<td>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 authorizations, but Parliament may allow certain shifts without supplementary authorization. Various ministries have indicated that major new policy initiatives have often more chance of success when they are proposed by way of supplementary authorization 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 authorizations.</td>
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</table>

50. 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 macro-economic performance, endogenous growth of major expenditure programs 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 particular devices, in particular the central imposition of consolidation packages inside or outside the regular budget process and the use of cash ceilings.

51. 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 3 billion Swiss francs in 2006 (increasing from 0.8 billion in 2004, to 2.1 billion in 2005, and 3.0 billion in 2006). Similarly, the Federal Council proposed an additional savings package in 2004 amounting to 2 billion Swiss francs 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 in 2008).

52. In December 2002, Parliament renewed a law that permits a certain percentage of allocated funds in the ordinary budget not be spent (blocked).

53. 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 250 million Swiss francs. 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.

Financial planning

54. 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 the 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.

55. 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 binds the Federal Council.

56. 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.

57. 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. This facilitates the implementation of such measures and enhances 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 above-mentioned consolidation packages of 2003 and 2004 have been implemented in this way.

58. 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 paragraph 28 above) have yet to prove their effectiveness in reducing short term volatility of expenditures and thus increase stability in the future.

59. The question arises whether a better incorporation in the 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 UK, Sweden and the Netherlands towards medium-term financial management may be relevant. These countries too, aim at a zero balance over the economic cycle (in the UK, 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\(^\text{10}\). This policy has roughly the same stabilization effects as the Swiss debt containment rule, which can be characterized as acyclical rather than anticyclical\(^\text{11}\). However, the main differences with the Swiss debt containment rule are: (a) 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 (b) that 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 in the expenditure estimates and a better basis for policy making in the line ministries. 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

\(^{10}\) The main difference between the Dutch approach on the one hand and the Swedish and UK 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 UK and Swedish approach the expenditure ceilings are extended on a rolling basis (in the UK 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 UK the social security sector (the so called Annually Managed Expenditures or AME) is exempted from the multi-annual expenditure ceiling and allowed to fluctuate. This strengthens the stabilization effect and makes the fiscal rule anti-cyclical rather than acyclical.
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\textsuperscript{12}.

Conclusions

60. 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 has been due to consistent and intensive efforts on the part of the Swiss authorities. These included the introduction of the debt containment rule, a strict budgetary policy and large consolidation programs in 2003 and 2004.

61. 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.

62. The debt containment rule is until now 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 increase stability in the future. The Swiss authorities might consider further adjustments of the rule so that it becomes better integrated in the medium term financial planning process.

63. The Swiss budget is largely a transfer budget. Moreover, it is characterized by a relatively high share of earmarked revenues. So far, the expenditure containment rule that aims to restrict 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 the 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.

\textsuperscript{12} One might pose the question whether using trend GDP and structural revenue predictions instead of realizations 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 per definition requires predictions or trend extrapolations because it is forward looking. The question thus hinges on how retrospectively observed deviations between predictions and realizations are taken into account. In the UK, Swedish and Dutch approach such deviations have to lead to 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 equalization account mechanism.
CHAPTER 3

THE ROLE OF PARLIAMENT

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

65. According to the Federal constitution, all expenditures must be approved by both chambers of the Swiss Parliament. In general, Members 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.

The Swiss Parliament

The Parliament consists of two equal Chambers: The National Council which provides proportional representation and the Council of States which represents the Cantons equally (although 6 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.

The Parliament meets four times a year for a period of three weeks, i.e. for twelve 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 Financial Committee made up of sub-committees – to deal with issues of each ministry. In addition, there is a joint committee, the Financial Delegation, made up of representatives from both Chambers which sits year round and has limited ability to act on behalf of Parliament.

There are currently 13 parties represented in the National Council and 5 parties with over 10 members. There are 4 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.

The Swiss Parliamentary Budget Process

66. 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 an 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 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 the parliament. There is an ongoing debate whether to strengthen the role of Parliament in the context of these guidelines.

67. 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 Council is bound by law to send the budget two months prior to the winter session. This is a new legal requirement but in effect it has always been practice.

68. The Finance Committees first have plenary sessions on the budget as a whole, then the examination is broken down to sub-committees. The National Council has seven – one for each ministry - and the State Council four to take account of the smaller size of this chamber and thus the more limited resource. 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.

69. 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 subcommittee then report back on recommendations and the cuts in spending required to achieve the reduction goal.

70. 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 from questioning the Minister. When examination of the budget moves to the subcommittees, it is generally the Secretary-General of the department and directors of the various agencies who come to explain and defend the budget. The subcommittee examination generally lasts a full day for each ministry. 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 subcommittees, are set in the spring by the administrative offices of the two chambers. The financial delegation by contrast is free to set its own schedule as necessity dictates.

### Parliamentary Budget Timetable

<table>
<thead>
<tr>
<th>Month</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>February</td>
<td>Federal Council decides budget guidelines and targets. The Finance Committees receive them for information.</td>
</tr>
<tr>
<td>August</td>
<td>Federal Council informs the Finance Committees on their decisions regarding the Budget and Financial plan.</td>
</tr>
<tr>
<td>September/October</td>
<td>Budget transmitted to Parliament</td>
</tr>
<tr>
<td>October/November</td>
<td>Finance Committees and their subcommittee examine budget proposal</td>
</tr>
<tr>
<td>December</td>
<td>Full Chamber action on budget</td>
</tr>
<tr>
<td>Mid December</td>
<td>Final vote on budget</td>
</tr>
</tbody>
</table>

22
71. 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, though, this has not happened.

72. However, prior to development of the budget, the parliament can pass a “motion.” A motion is a parliamentary instrument that broadly directs the Federal Council on development on 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 by 3 million Swiss francs 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.

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

74. 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 affecting 800 million Swiss francs in spending. Of these 30 amendments, most come in areas that are annually contested: foreign development assistance, agriculture 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 of 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.

75. 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 practically difficult as well, further limiting the room for parliamentary action.

76. However, since all major parties are represented in the Federal Council – and the Federal Council acts by majority vote, it is more likely that budget proposed by the government already reflects the priorities of a majority of parliamentarians.\(^\text{13}\)

\(^{13}\) 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.
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 whole parliament for decision. There is also the possibility for Parliament to approve “additional credits” which are granted for new program spending in the middle of the year. These bills are debated and amended like any normal bill.

Parliamentary System of Oversight

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 rejected the final accounts until changes were finally made to the accounting treatment of pension liabilities.

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 committee is done in subcommittees 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.
The Financial Delegation

80. Since the 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 chair 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 for its part can ask the full Committee to take up tasks as well.

81. The 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. There is a vote scheduled in Parliament to limit such emergency spending at 250 million Swiss francs.

82. 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.

Secretariat

83. The Finance Committees and the Finance Delegation share a permanent secretariat. Administratively, the secretariat is attached to Parliament. The head of the secretariat is, like the head of the audit office, 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, there about 5 professional analysts supported by 3-4 assistants that comprise the secretariat.

Conclusion

84. 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 their success in changing or increasing detailed spending items, the parliament in Switzerland 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.

85. Many OECD countries have gone 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 or even to vote on the totals in the Spring. These efforts deserve a full hearing.
CHAPTER 4

ACCOUNTING AND AUDITING

Accounting

86. 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.

87. 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.

88. Up until recently, the accounting procedures were highly decentralised and each ministry had its 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.

89. 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 cash basis, and for procedural reasons – the Debt Containment Rule links expenditure to revenues.

90. Other deviations from IPSAS were made for practical reasons emanating from work done by a steering committee. For example, defence 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.

Auditing

91. 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 Scandinavian system although in recent years in countries like Sweden and Finland, 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 SFAO’s budget with no oversight by the 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 the Parliament and the summary to the minister concerned by the audit findings. The audit of the annual accounts is a special report that is sent directly to the Parliament’s Finance committees.

92. The SFAO operates as a traditional audit office and it produces about 200 reports per year. Its has incorporated most of the INTOSAI Lima declaration guidelines into its operating program. Of the annual work load about half of the plan is derived from its legal audit mission of state or semi-state organisations and the other half of the year’s plan comes from the audit priorities based on risk analyses. There is a risk assessment process by which those programs considered high risk are audited annually and lower risk programs are in general audited once every five years.

93. There are approximately 100 staff working for the SFAO. About 80 percent are analysts while the remaining 20 percent 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 reelection and may only be removed for cases of material breach of duties. The director in turn is responsible for the appointment of the audit staff.

94. The annual audit program is determined autonomously and submitted simultaneously to the Federal Council and the Parliament Financial Delegation. They do not approve it, but only take note of them. The official program 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 has the ability to be assisted in its work by private firms or contracted out altogether.

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

96. 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, then followed up with a written report. The office then responds in a written statement and the audit report and response is sent to the Financial Delegation of the 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.

97. 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; discreional where the correction is strongly urged; and recommendation where the finding is a suggestion. The audited office must indicate who on their staff is responsible for implementing the audit report conclusions. The audit reports and recommendations are summarized and published in an annual report.

98. In 1994, the SFAO extended the audit function to include effectiveness and efficiency audits. Annually, the audit office conducts between 6 and 8 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% of the work on financial audits (in the wide sense) which includes 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 programs 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 administration activities and leadership. The SFAO contributes to this requirement with its implementation of effectiveness and performance audits.

99. The SFAO shall monitor and conduct audits on the use which is made by the cantons of Federal funding (subsidies, loans, advances) allotted to them, 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 who 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.

**Internal control**

100. 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 fulfillment of their control duties. The SFAO approves their rules and regulations, supervises the effectiveness of controls and guarantees the coordination 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 programs do run internal audits. Where they exist, these are most often set up at the request of the SFAO. A few ministries, like Defence, have inspectorates although they are not specifically for financial matters. For example, they make management and programme recommendations.
CHAPTER 5

FINANCIAL RELATIONS BETWEEN LEVELS OF GOVERNMENT

101. The cantons and municipalities have their own tax and non-tax revenues, amounting to around 105 billion Swiss francs (including shares in the federal taxes by virtue of the prevailing tax sharing systems, mainly 30% of income tax revenue and 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 10 billion Swiss francs in federal transfers. There are some 50 transfers of this kind. More than 30 of them have an equalization aim next to 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 equalized by the indicator of financial capacity. However, equalizing formulas differ between the various subsidies and cantonal shares of federal revenues.

102. 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 have been approved by Parliament in October 2003 and have been ratified by referendum in 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.

103. The present system is considered as non-transparent because equalization takes place in more than 30 transfer laws and because transfers are coming sometimes from different federal ministries or offices. Furthermore, the existing transfers 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 the 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 subsidized. The new system, called Reform of Financial equalization and Redistribution of tasks between the Confederation and the cantons aims to solve or mitigate these problems through two levers: (1) a new division of tasks between federal and cantonal governments, and (2) a new equalization system.

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.
104. The new division of tasks aims at three goals: (1) disentanglement of tasks and financing arrangements, (2) more effective cooperation when tasks have to be shared, and (3) more effective horizontal cooperation 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 in the areas of social services, education, traffic and environment have been identified 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 cooperation 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 programs. These programs will specify targets for service-levels that will be checked by the Federal government. For the third goal, Federal legislation will encourage cooperation. Presently, cantonal cooperation is voluntary. In the future, cantons will have to pay for services delivered by neighboring 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 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.

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

106. The objective of the equalization of tax capacity is that the cantons with the lowest tax capacity will receive additional means so that their tax capacity after equalization will be at least 85% of the average tax capacity per canton. This aim will be attained by an equalization transfer that will be composed of a horizontal and a vertical component. The constitution determines that the horizontal component has to be determined in such a way that it amounts at least to two-thirds but at most to four-fifth of the vertical component. It appeared from model calculations for 2001/2002 that under these conditions a horizontal equalization transfer of around 1.1 billion Swiss francs from the cantons with high tax capacity accompanied by a vertical equalization transfer from the Federation of around 1.6 billion Swiss francs 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 are increased by the relative growth of the tax capacity of the transferring cantons and the vertical transfers are increased by the growth of the tax capacity of all cantons.

107. The tax equalization 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 a 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 depletion rate times the tax base of the canton. This is the tax revenue the canton would receive if it would deplete its tax at the average rate. This measure can be compared to actual tax revenue. It shows how much money the canton looses or wins by staying behind or exceeding the average depletion rate of its tax base. The index of tax capacity is the standardized tax capacity with average = 100.

108. In order to arrive at the desired aim that the tax capacity of the canton with the lowest tax capacity after equalization is above 85% of the average tax capacity, it turned out to be necessary to make
the transfer to the receiving cantons slightly\textsuperscript{15} progressive in regard to the tax capacity index of these cantons (for instance, a canton with the index 80 before equalization getting more than twice that a canton with the index 90 receives before equalization). 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 an index 120 before equalization paying exactly twice as much as a canton with the index 110 before equalization). Figure 6 shows the effects of the tax equalisation system on the tax capacity before and after equalization for the year 2001/2002.

\textbf{Figure 6 -- The Effects of the proposal for Tax Capacity Equalization}
\textit{(cantons on horizontal axis in order of tax capacity)}

\textsuperscript{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 equalization. If this condition would not be imposed, cantons would have no incentive anymore to increase their tax base by attracting firms and family households.
109. 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 equalization mechanism for service capacity next to the one for tax capacity exists. It consists of two parts: a geographical-topographical and a socio-demographical equalization mechanism. Geographical-topographical equalization 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 equalization compensates for high costs caused by the population structure (social services related to poverty, old age and immigration) and high costs caused by population and employment density (security services, traffic).

110. Service capacity equalization 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 equalization of tax capacity. Service capacity equalization 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 equalization of service costs but via inter-cantonal cooperation (see above).

111. Service capacity equalization proceeds by the calculation of three indicators, one for the geographical-topographical equalization and two for the socio-demographical equalization. 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 higher altitude than 880 meter) and two for population density (share of population living in settlements of less than 200 inhabitants and inhabitants per hectare). The four partial indicators are standardized 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 2001/2002, the equalisation transfer will be received by 18 out of the 25 cantons.

112. 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 7 cantons will receive the equalization transfer.

113. 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 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 standardized 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 5 cantons will receive the equalization transfer.

114. In contrast to the tax capacity equalization transfers, the service capacity equalisation transfers are financed exclusively by the Federation (there is no horizontal component). The size of the service capacity transfers are 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 increased to compensate for inflation.
115. From model calculations for the year 2001/2002 it appears that if the reforms would have been introduced that year on the basis of budget neutrality (in comparison to the present system), the Federal equalization transfers would consist of 72.5% for the tax capacity transfer (the vertical component), 13.7% for the geographical-topographical service capacity transfer, for 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 equalization 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 be reduced from 30 to 17 percent.

116. In order to avoid that certain cantons see their Federal transfers diminished or growing 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 equalization 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 2001/2002 data). On the basis of the 2001/2002 data, the hardship transfer would apply to 7 cantons and amount to around 244 million Swiss francs. The total effects of the reforms for 2001/2002 are shown in table 3.
Table 6. The new financial equalisation system: charges, payments and equalisation effects
Charges (+) and payments (-) in 1 000 CHF

<table>
<thead>
<tr>
<th>Resource equalization</th>
<th>Cost compensation</th>
<th>Resource indicator</th>
<th>Cohesion fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Charges to cantons with above average potential of resources (horizontally)</td>
<td>Payments to cantons with below average potential of resources (horizontally and vertically)</td>
<td>Social services (poverty, highly aged population and immigrants)</td>
</tr>
<tr>
<td>Zurich</td>
<td>578,211</td>
<td>-</td>
<td>-25,596</td>
</tr>
<tr>
<td>Berne</td>
<td>-</td>
<td>-749,119</td>
<td>-</td>
</tr>
<tr>
<td>Lucerne</td>
<td>-</td>
<td>-225,482</td>
<td>-</td>
</tr>
<tr>
<td>Uri</td>
<td>-</td>
<td>-35,308</td>
<td>-</td>
</tr>
<tr>
<td>Schwyz</td>
<td>21,176</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Obwald</td>
<td>-</td>
<td>-33,696</td>
<td>-</td>
</tr>
<tr>
<td>Nidwald</td>
<td>14,009</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Glaris</td>
<td>-</td>
<td>-13,007</td>
<td>-</td>
</tr>
<tr>
<td>Zoug</td>
<td>148,239</td>
<td>-</td>
<td>-75</td>
</tr>
<tr>
<td>Vaud</td>
<td>148,239</td>
<td>-</td>
<td>-285,885</td>
</tr>
<tr>
<td>Soleure</td>
<td>-</td>
<td>-112,708</td>
<td>-</td>
</tr>
<tr>
<td>Bâle-Ville</td>
<td>99,781</td>
<td>-</td>
<td>-25,094</td>
</tr>
<tr>
<td>Bâle-Campagne</td>
<td>60,532</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Schaffhouse</td>
<td>-</td>
<td>-11,593</td>
<td>-558</td>
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<tr>
<td>Appenzell Rhônes-Extérieures</td>
<td>-</td>
<td>-11,743</td>
<td>-</td>
</tr>
<tr>
<td>Appenzell Rhônes-Intérieures</td>
<td>-</td>
<td>-7,027</td>
<td>-6,468</td>
</tr>
<tr>
<td>St-Gall</td>
<td>-</td>
<td>-187,892</td>
<td>-</td>
</tr>
<tr>
<td>Grisons</td>
<td>-</td>
<td>-6,793</td>
<td>-</td>
</tr>
<tr>
<td>Argovie</td>
<td>-</td>
<td>-30,817</td>
<td>-</td>
</tr>
<tr>
<td>Thurgovie</td>
<td>-</td>
<td>-162,293</td>
<td>-</td>
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<tr>
<td>Tessin</td>
<td>-</td>
<td>-66,202</td>
<td>-17,797</td>
</tr>
<tr>
<td>Vaud</td>
<td>-</td>
<td>-91,311</td>
<td>-57,626</td>
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<tr>
<td>Genève</td>
<td>167,785</td>
<td>-</td>
<td>-63,056</td>
</tr>
<tr>
<td>Jura</td>
<td>-</td>
<td>-111,092</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>1,089,732</td>
<td>-2,646,492</td>
<td>-196,832</td>
</tr>
</tbody>
</table>

Source: Swiss Financial Federal Administration
117. 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 coordinated by the responsible Federal ministry. The design of the system is in accordance with modern principles of fiscal federalism. Equalization, financing and compensation of spill-overs are henceforth separated and independently manageable.

118. The equalization 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 equalization system fulfills a financing as well as an equalization 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 called for. Compensation of spill-overs will take place through inter-cantonal treaties and not involve Federal budgetary means.

119. Economists have often emphasized that equalization of tax capacity is largely a matter of allocative efficiency. Indeed without such equalization, 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. This efficiency enhancing effect of tax capacity equalization 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 tax payers. In Switzerland, the share of public goods in cantonal budgets seems quite high (infrastructure, law enforcement, prison systems, public transport).

120. On the other hand, service capacity equalization 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 can not be carried out at the minimal costs.

121. Although in the case of Switzerland it is entirely clear that the solidarity motive behind service capacity equalization 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 equalization while providing information to the public. This could in particular contribute to a relative moderate development of the cost equalization transfers in the future, or even a gradual reduction of these transfers.

Conclusions

122. Switzerland has presently a system of fiscal equalization 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.

123. The design of the reforms is in accordance with modern principles of fiscal federalism. Equalization, financing and compensation of spill-overs are henceforth separated and independently manageable.

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16 Buchanan 1950; Boadway, Flatters 1982. There is a small difference between the equalization of fiscal residuums as proposed by Buchanan and the equalization 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.
124. The equalization 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 equalization of service capacity ensures that cantons with exceptional costs because of geographical-topographical or socio-demographical circumstances are compensated.

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