



FEDERALISM AND SWISS COMPETITIVENESS

**An overview of the study conducted by Lars P. Feld
and Christoph A. Schaltegger on behalf
of the ch Foundation for Federal Cooperation
and the Association of Swiss Cantonal Banks**

Published by the ch Foundation
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This brochure is based on a study by Lars P. Feld and Christoph A. Schaltegger et al. entitled *Federalism and Swiss Competitiveness; State Structures for a Successful Switzerland in the 21st Century*. It was conducted on behalf of the ch Foundation for Swiss Cooperation and the Association of Swiss Cantonal Banks, and published in September 2017 by NZZ Libro (ISBN 978-3-03810-3). The brochure is available from the publishers in German, French, Italian and English.

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Foreword from the Chairman of the ch Foundation

The ch Foundation for Federal Cooperation will celebrate its 50-year anniversary this year. Founded in 1967 and dedicated to the concept of the federal state, its objective is to promote cooperation between the cantons and with the federal government, and to foster understanding between Switzerland's different linguistic communities and cultures. The ch Foundation thus embodies one of the chief characteristics of Swiss federalism: cooperation between the individual constituent states for the good of the whole. The national fiscal equalisation scheme, under which economically stronger cantons subsidise weaker ones, is a good example of this.

At the same time, however, Swiss federalism is extremely competitive in nature. The great independence enjoyed by the cantons, their far-reaching powers in key areas such as education, health and security, and not least their financial autonomy, makes for lively (fiscal) competition between the 26 micro-states. This competition helps to ensure that public services are more needs-focused and provided at lower cost, even though the structures involved are smaller and more complex than in centralised systems. Both pillars of the Swiss approach to federalism, solidarity and competition, have contributed to the economic success of our country – something for which we now also have scientific proof.

But is federalism in Switzerland equipped to face the challenges of the future? Globalisation and an increase in political alliances at the international level are putting federal structures under pressure. This seems to be reflected in a trend towards harmonisation and centralisation. In other words, functions are increasingly being transferred to the federal government, be it in response to calls for standard regulation nationwide, or in order to fulfil obligations under international law. The principle of subsidiarity states that public services should be provided as closely as possible to the citizens who receive them, and that higher levels of government should take on only those functions for which the lower levels lack the resources. The developments we are seeing are increasingly pushing this principle into the background.

And yet, in today's world more than ever, it would seem all the more important for politics, business and

society to have strong local and regional roots if we are to continue actively to shape the places in which we live and work. Even in a globalised world, the needs of the Swiss Riviera along Lake Geneva or those of Zurich's Bahnhofstrasse shopping mile differ from those of the Freiberge plateau in the Jura, or of the high valley of the Lower Engadine. Thanks to our federal structure, our country enjoys great economic, social and cultural diversity within a very small area. It is this wealth which gives Switzerland its particular appeal and quality of life. At the same time, however, it requires that differences in public service provision are not just accepted, but also considered a plus.

The ch Foundation has therefore joined forces with the Association of Swiss Cantonal Banks to commission Prof. Lars P. Feld and Prof. Christoph A. Schaltegger to examine closely the role that federalism plays in Switzerland's competitiveness and economic success. This brochure summarises the key findings of their study in a straightforward format for a broad readership. The full study is available in bookshops.

Switzerland is unique in the way in which it combines its federal structure with direct democracy. This system is fundamental to our prosperity and to national cohesion, and is part of our identity. It is an asset that must be preserved for the future. That will require a greater understanding of the advantages of federalism, as well as of the challenges that it faces. With that in mind, I wish you a stimulating read.

Cantonal Councillor Pascal Broulis, Chairman of the ch Foundation for Federal Cooperation



Foreword from the Chairman of the ASCB

In Switzerland, we are firm in our belief that federal, or decentralised (as opposed to centralised) structures are a good thing for the economy and our prosperity. However, it still makes sense to examine this belief at the academic level, the question being: are the economies of countries with decentralised systems of government genuinely stronger than those of states with centralised systems?

But why should federalism have any influence at all on the economy? We are familiar with a variety of transmission channels from economic theory. Firstly, within decentralised structures, politicians and public servants are more familiar with the people and local companies they serve, and are thus better able to respond to their needs. As a result, they are more likely to do the right thing, i.e. be more effective. Secondly, decentralised structures imply a better knowledge of regional circumstances and markets, and are thus able to provide public services at lower cost. They are thus more likely to do the right thing better, i.e. they are more efficient. The aggregate effect of this is greater prosperity.

Furthermore, empirical research has found that a degree of decentralisation really does have a significant, positive effect on gross domestic product (GDP) per capita, as well as on GDP growth. One transmission channel is particularly interesting (and relevant) to Switzerland: decentralisation in higher education results in more applied research and more patent applications, and thus to more innovation. This in turn improves competitiveness and prosperity in the regions concerned.

It is worth remembering, however, that the centralisation/decentralisation issue is not a matter of one thing or the other. Instead, each government function has its own optimum degree of decentralisation, and thus an optimum level of government – corresponding to the federal government, the cantons, or the municipalities under the Swiss system.

These findings strengthen the cantonal banks' commitment to upholding Switzerland's decentralised structures and federalist diversity. After all, what holds true for government is largely applicable to business, and thus also to the financial sector. The size of the market for financial services depends on the particular service on offer, for example.

- Global: significant economies of scale mean that there are only a few successful providers of investment banking services. Their market covers the entire world.
- National: capital markets and asset management are primarily structured on a national basis.
- Regional: where savings, mortgages and small business loans are concerned, Swiss clients prefer providers with deep regional roots.

Thus, while investment bankers market their services globally, not a single financial institution offers mortgages world-wide. This difference in ideal market size for individual services also results in differing business models. As largely regional players, cantonal banks tend to take an active leading role in areas of interest at the regional level, such as savings, mortgages, and SME loans. Cantonal banks offer “federal” banking. They are a living expression of a federalist culture, and support the success of the Swiss system:

- “Federal banking” is one of the factors in the cantonal banks' success: they are closer to their clients, are highly familiar with specific local circumstances, and typically have short decision-making paths within their regions. This strengthens both their effectiveness and their efficiency.
- “Federal banking” is a factor in the success of Switzerland's financial system overall: it ensures that everyone has access to basic banking services and reduces systemic risk. This strengthens Switzerland's broader financial system.
- “Federal banking” is a factor in the success of the cantons: much of the value generated by the cantonal banks – in the form of salaries, profits and purchased goods and services – remains within the canton; in addition to the banks' enormous support for the arts in their individual cantons, cantonal coffers are swelled considerably by the banks' distributions (a total of CHF 1.530 billion in 2015). This strengthens the cantons.

It could also be said that the cantons and their cantonal banks have a symbiotic relationship, because each profits from the other. The cantons have an interest in hav-

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ing a strong cantonal bank, and the cantonal banks have an interest in an economically robust canton.

With this in mind, it is only right that the cantonal banks promote “federal banking” as part of Switzerland’s broader federal system. Yet they are also committed to ensuring the strength of the cantons, and to optimising the country’s federal structure in general. That is why the cantonal banks have joined together with the ch Foundation for Federal Cooperation to fund the

Federalism and Swiss competitiveness study. I hope that its findings will further improve federalism in Switzerland, and further strengthen the country’s competitiveness and prosperity.

Prof. Urs Müller, Chairman of the Association of Swiss Cantonal Banks (ASCB)

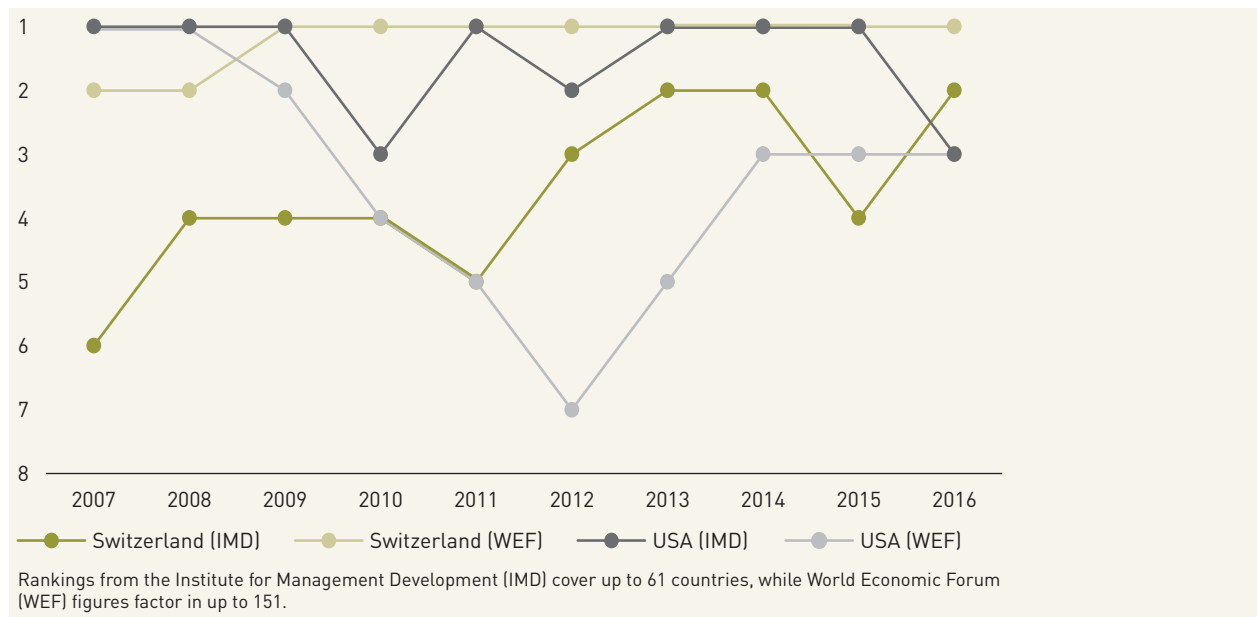


1. Introduction

Federalism has shaped Switzerland ever since the modern federal state was founded in 1848, when the cantons joined together to form the Swiss Confederation and ceded some of their sovereignty to the federal government. Although a number of further functions have been transferred to the federal authorities since then, the cantons still enjoy a high degree of autonomy. In particular, they are largely fiscally independent, with their own tax revenues, and are thus able to decide for themselves how they wish to fulfil their governmental role.

However, federalism repeatedly faces the criticism that its small-scale structures are no longer able to meet the demands of an increasingly outward-looking economy. A look at the major rankings of national competitiveness, such as the WEF's Global Competitiveness Ranking or the IMD's World Competitiveness Scoreboard, nonetheless shows that the top spots are regularly occupied by countries organised along federal lines, such as Switzerland, the USA, Canada and Germany (Figure 1).

Figure 1: International competitiveness rankings 2007–2016



The history of federalism in Switzerland

Federalism has been one of Switzerland's defining structural characteristics since 1848 at the latest, when the modern federal state was founded. The nation's federal origins have a much longer history, however. The territorial boundaries of the Old Confederation, and the Act of Mediation in 1803, laid the foundations for cantonal independence. Although there had been efforts during the time of the Helvetic Republic to institute a centralised governmental structure in the Act of Mediation the French occupying forces declared that federalism had become established over time and was Switzerland's natural political state. Even before the foundation of the modern federal state, this resulted in a pragmatic political system which respected cantonal diversity, and conferred a rather moderating and balancing, and less authoritarian, role on the highest level of government.

Competitiveness

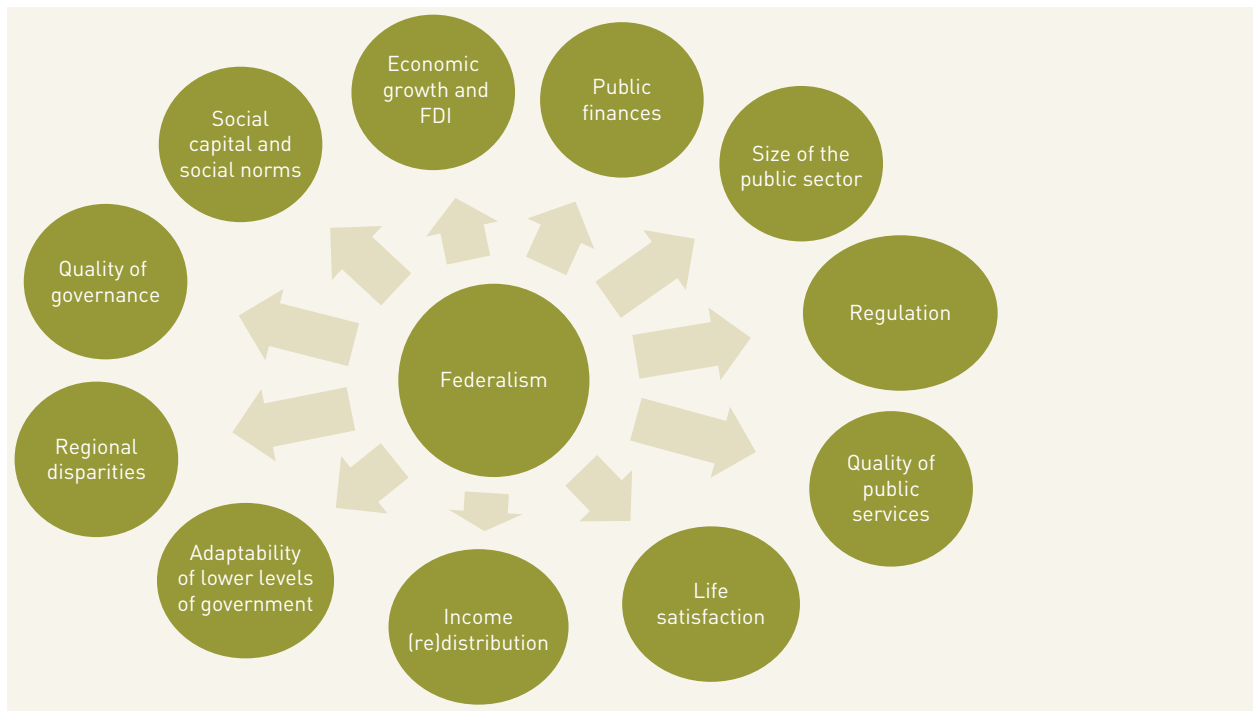
When determining national competitiveness, a fundamental distinction must be drawn between price and non-price factors. *Price competitiveness* focuses on an economy's ability to sell its products on the world market and thus turn comparative price advantages into absolute ones. In addition to corporate productivity, labour costs, exchange rates and other macroeconomic price and cost factors play a major part in this. Defined thus, price competitiveness is generally measured in terms of real exchange rates, which reflects the relative development of price indices, unit labour costs and export prices. Studying these exchange rates over an extended period enables statements to be made about price competitiveness itself, but does not permit any conclusions to be drawn about the underlying reasons.

To achieve this, further analysis that encompasses *non-price competitiveness factors* is required. These cover all public-sector factors within an economy, such as the education system, infrastructure and regulatory environment. These factors can affect corporate productivity through their determining influence on companies' capacity for innovation and on the flexibility of their resource allocation. However, the problem with the concept of non-price competitiveness is that, unlike price competitiveness, it is difficult to measure and to express in individual key indicators.

So, is Switzerland doing so well in these rankings despite, or because of, its federal structure? That was the central question asked in the study entitled *Federalism and Swiss competitiveness*, commissioned by the ch Foundation for Federal Cooperation and the Association of Swiss Cantonal Banks. Lars P. Feld of the University of Freiburg (Germany) and Christoph A. Schaltegger of the University of Lucerne investigate how various elements of federalism affect Switzerland's competitiveness. In this context, "competitiveness" essentially refers to that public-sector of the national framework that falls within the sphere of public-sector influence, and has an impact on the country's companies, and thus a bearing on the country's appeal as a business location. Examples include regulation, and the provision and funding of public services such as the transport infrastructure and education, etc. (Figure 2).

This brochure provides an overview of the main statements and findings of the *Federalism and Swiss competitiveness* study. Reflecting the structure of the study itself, it begins with the current status of economic research into federalism, which has produced a number of findings but still shows gaps and contradictions (Section 2). Section 3 summarises new research findings on a variety of unresolved questions about the influence of federalism on competitiveness which were examined in depth in the Feld and Schaltegger study. These findings are evaluated and conclusions presented in Section 4. In the interest of simplicity this brochure does not cite sources. The references are documented comprehensively in the study itself (see "publication details").

Figure 2: The influence of federalism on various aereas of research



2. Findings of federalism research to date

This Section presents the current status of economic research into federalism. First, Section 2.1 explores the theory. From the economic perspective, there are arguments both *for* and *against* federalism. A large number of empirical studies help to clarify these theoretical contradictions. These are summarised in Section 2.2. Both the theory and empirical studies examine a variety of elements of federalism, such as the number and size of local and regional (subnational) authorities (fragmentation), the decentralisation of public revenues and expenditures, the intensity of fiscal competition, and transfer payments between jurisdictions as an expression of national solidarity (fiscal equalisation). The study by Feld and Schaltegger et al. investigates the effect of each of these individual elements on the country's competitiveness. A number of indicators are used to measure the latter, such as foreign direct investment and economic growth.

2.1 Opportunities and risks of federalism – the theoretical perspective

Economic research into federalism began in the 1970s with the Decentralisation Theorem. In essence, this says that federalism is the best way in which to satisfy regional differences in what the state is required to provide. Wallace E. Oates draws on the theory of public goods and shows that federalism is able to allocate the various public services to the appropriate level of government by applying the principle of subsidiarity. A lower level of government, such as the municipality or canton in the case of Switzerland, is the right choice where there are significant regional differences in the role that the state is expected to fulfil. Examples include the arts, education, local and regional transport companies, economic development, tourism and the police. A higher level of government – such as the canton or federal government – is called upon to fulfil those functions where citizens' preferences are more homogeneous, where the benefits of a public service have a wider reach or cannot be confined to a specific area, where all citizens derive benefits from that service without one person obstructing another's access. Likewise, central government is considered more suitable to provide public goods and services where economies of scale can be

achieved, i.e., the average costs fall as volumes rise (e.g. cantonal hospitals or universities, federal social security schemes, the armed forces, etc.). Federalism is not aimed solely at the perfect allocation of public service provision to the individual levels of government, however. It must also tap in to the tax base required to finance those services in accordance with the principle of fiscal equivalence, i.e., at the same level at which public services are provided. This means that, where public services are concerned, decision-making, provision and financing all fall within the same area of responsibility. Liability, control and risk are all in the same hands.

Efficient, citizen-oriented public service provision under a federal system

In reality, it is not possible to allocate public services perfectly to the different levels of government. This is because the optimum size of local or regional jurisdictions differs depending on the task at hand, specific preferences, the way in which benefits are distributed, and the economies of scale which apply. This is especially true as the range of tasks which must be fulfilled is broad, and the different areas of activity are changing rapidly at all levels of government. That said, where public services are not perfectly allocated, fiscal equivalence can be achieved (to a large degree) by sharing the burden of financing through a fiscal equalisation scheme. By compensating others for external effects or excessive burdens, the costs are distributed more equally across the jurisdictions. Furthermore, much of the inefficiency in service provision and funding can be resolved in direct negotiations between local and regional bodies. Cantons can decide to fulfil public functions together, entering into formal agreements to exploit economies of scale and ensure that free-riders pay their fair share, while still meeting differing requirements. Examples include the cross-subsidisation of arts programmes.

High quality at a good price thanks to competitive federalism

Under a federal system, if a country's constituent states are granted sufficient autonomy in terms of material powers, and the capacity to raise their own revenues

and decide how to spend them, there will naturally be a competitive relationship between them. The closer the structure of the federal state reflects the principles of the decentralisation theorem – subsidiarity and fiscal equivalence – the more efficiently this competition can develop. It has a specific effect on the behaviour of political decision-makers, and creates incentives to consider what voters actually want. This is because the electorate is able to punish those in power at the next elections, or to move to a different canton or municipality if they are not satisfied with the package of taxes and services on offer. These two sanction options are particularly well-used in states that are organised according to federal principles. The greater proximity between citizens and political decision-makers permits more effective control over politics, while people are also able to compare the services offered by their own canton or commune with those of neighbouring cantons or municipalities. This ability to “shop around” in a federal system influences politics without people actually having to vote politicians out of office or move to a different area.

Finally, these mechanisms reveal what citizens actually want, while at the same time creating incentives to provide services that closely reflect those preferences in a way that is both transparent and cost-effective. Federalism should therefore result in a more streamlined public sector and responsible fiscal policy – providing cantons and municipalities are liable for their own actions. Specifically, they must regard budgetary restrictions as binding, and cannot expect the federal government or any other canton or municipality to give any explicit or implicit deficit guarantee.

The federal “laboratory” can encourage political innovation

A further advantage of federalism is the greater ability of a decentralised political system to innovate and reform. As in a laboratory, individual cantons or municipalities can develop and test new problem-solving approaches. If a solution works, over time it can be adopted by other municipalities, cantons or the federal government. At the same time, any mistakes generally remain limited to the local authority concerned. In this way, federalism limits the risk attached to policy experiments. This laboratory function can be understood as a process of discovery in which innovation is born out of trial and error. One example here is the “debt brake”, which was introduced

for the first time in the canton of St. Gallen in 1929. Today, a majority of cantons and the federal government have adopted a debt brake or similar budget rule.

Disadvantages and challenges of federalism

There can be a variety of disadvantages to federalism and the decentralised provision of public services. The theory points out that states organised according to federal principles can incur significant costs owing to the additional government layers, the increased need for coordination, and the greater complexity of domestic financial relationships. Furthermore, it can be attractive for individual local authorities to pass off some of their financial burdens to higher or lower levels of government by means of joint financing arrangements. Distributing these burdens across as many parties as possible not only violates the principle of “liability, control and risk in the same hands”, but also reduces transparency. In addition, it increases the risk of political interdependency, which stifles innovation and makes reform impossible owing to the pressure from interest groups. Indeed, there is a general risk that public services are provided not according to citizens’ preferences, but according to the demands of influential special interest groups adept at exploiting politicians’ proximity to the people to impose their own particular wishes.

Furthermore, cantonal or municipal politicians might be tempted to circumvent the fiscal competition they dislike by entering into cartel-like arrangements with other cantons or municipalities, for example by agreeing a standard rate of tax. Conversely, there is also the risk that, in their attempts to attract mobile taxpayers, cantons or municipalities try to undercut each other, thereby embarking on a ruinous race to the bottom. This phenomenon can ultimately lead to shortages in service provision to the population, or to budget deficits.

In addition to the competitive elements of federalism there are also elements of solidarity, such as the subsidisation of poorer local authorities by richer ones under the fiscal equalisation scheme. However, false incentives are created if financial equalisation is too generous, or if there is an implicit or explicit guarantee that the next higher level of government or other cantons and municipalities will cover any deficit. These can lead to a lack of fiscal discipline – and thus to excessive expenditure – within individual local authorities.

2.2 Findings of empirical research into federalism

Determining what effect federalism actually has on Swiss competitiveness requires an empirical examination of the theoretical arguments, some of which contradict each other. The current status of empirical research indicates that federalism can generally be assumed to have a positive influence on various indicators of competitiveness. For example, according to most empirical studies, federal structures are conducive to healthy public finances, although the strength of this effect differs from country to country. Consistent with this, there is no indication that federalism results in an increase in public spending or revenues. Furthermore, federalism appears to offer protection against public deficits. A large number of studies show that competitive federalism inhibits debt.

Compared with the international research, the findings for Switzerland are even clearer where public finances are concerned. Here, too, there is no evidence that federalism increases government debt or gets in the way of budgetary consolidation. Rather, studies have found that Swiss federalism reduces levels of public debt and acts as a brake on government revenues and spending, especially on social welfare and administration. Transfer payments between the federal government and the cantons (such as those under the fiscal equalisation scheme) appear to increase revenue and spending, however.

Creeping centralisation is nonetheless a problem in Switzerland, as it is increasingly undermining the subsidiarity principle and frequently violates the principle of fiscal equivalence. This process has become even more marked in recent years, as new multi-level financing arrangements have become established in many areas of policy. Popular initiatives, such as that on second homes, are another factor exerting a certain pressure towards centralisation. Greater federal government influence on the way in which the cantons fulfil their functions can also be observed. Similar centralisation trends are emerging in the relationship between the cantons and the municipalities.

Federalism and economic growth

The current status of research into the correlation between federalism and economic growth does not lead to any clear conclusion. For example, the effects of decentralised structures on foreign direct investment, an

important determinant of economic development, seems to differ depending on which countries are examined. Multinational and individual studies on the relationship between federalism and GDP have identified elements that both encourage and hamper economic growth.

Federalism and the size of public sector

Empirical research pays considerable attention to the relationship between federalism and the size of the public sector which is generally measured as the ratio between public revenues or spending, and GDP. These studies tend to find that federal structures limit this share, although the relationship is not always clear. By contrast, tax autonomy at the subnational level very clearly restricts the size of the public sector. The findings for Switzerland lead to the conclusion that federalism reduces the government's share of the economy as a whole. A number of studies have also found that tax competition holds cantonal revenues and spending down. Furthermore, there is evidence that fiscal policy decisions at cantonal level depend on fiscal policy in the surrounding cantons.

Federalism and the quality of public services

It may also be assumed that federalism has a positive effect on the quality of public services, although the findings are clearer for education than they are in the health sector. This positive effect is confirmed where studies use popular preference as a criterion of efficient service provision. Despite a limited number of empirical studies, the boost that federalism gives to quality of life – an important soft location factor – should also be emphasised.

Federalism and inequality

Various studies have examined the influence of federalism on income distribution (at the individual level) or on regional disparities, both of which can also be regarded as factors in the operating framework of a national economy. The extent to which federal systems affect income distribution nonetheless remains unclear. The studies that have been conducted to date have considered widely differing elements of federalism, making any general conclusion impossible. The specific picture for Switzerland is also incomplete.

Empirical findings about the relationship between federalism and regional disparities are clearer, although they show that the effect depends on a country's stage of economic development: the more developed an economy, the greater the likelihood of regional equalisation under a decentralised system of government.

Federalism as a buffer against economic shocks

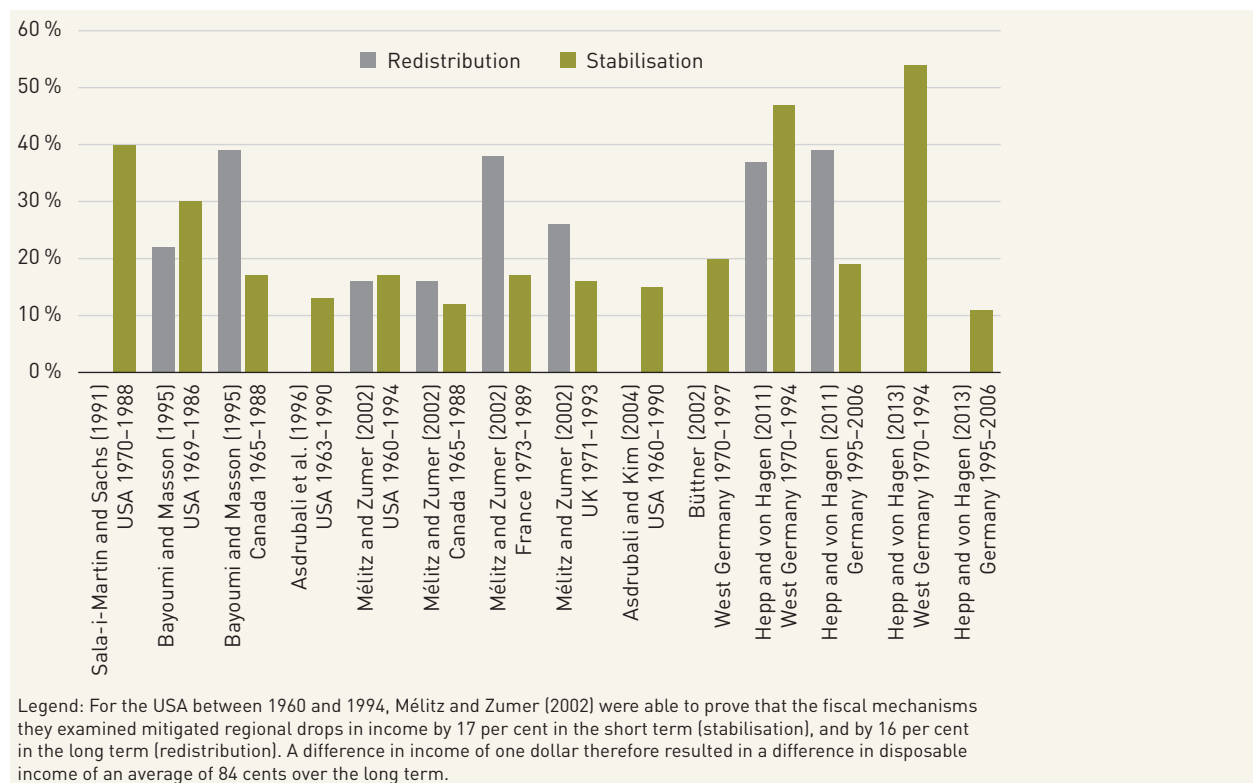
Past studies have also shown that federalism offers the country's constituent states a sort of buffer against economic volatility. For example, if economic output in one canton collapses, fiscal equalisation systems or other fiscal mechanisms such as the social security system can have an (indirect) stabilising effect on the cantonal budget. The constituent states are thus able to share the risk of economic shocks between them (Figure 3). The importance of fiscal instruments as a buffer

against such shocks has nonetheless declined in recent years. Nowadays, factor markets, such as those for labour and capital, have assumed most of this redistribution and stabilisation function.

Federalism encourages adherence to social norms

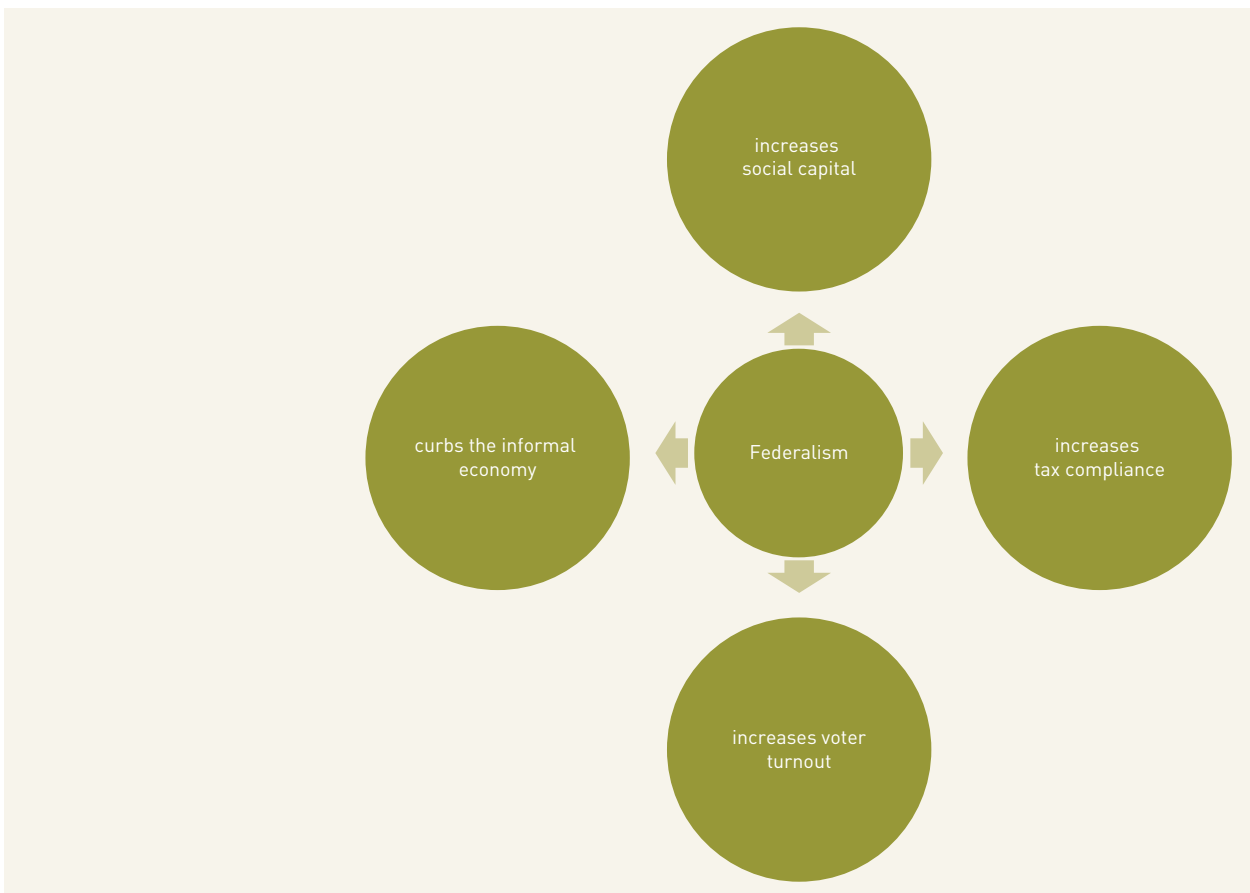
Federalism has been found to have a positive effect on quality of governance, specifically where corruption is concerned. In democratic states, in particular, federal structures tend to limit corruption because of the high degree of transparency they offer. Federalism has also been shown to increase social capital¹ and adherence to social norms (Figure 4). Most studies prove that federalism is a good thing for tax compliance, and that it also curbs the informal economy. Switzerland is no exception in this regard.

Figure 3: Overview of empirical findings on the buffer function of federalism



1 Taking the system-oriented definition, social capital is understood as the sum of factors which promote coexistence and thus social development. Sociologist Robert Putnam described social capital as trust, reciprocity and community life (voluntary association). It is generated by citizens' willingness to cooperate with each other, and requires a basis of trust (social trust) on which mutual support can grow.

Figure 4: Federalism, social capital and social norms



3. Research contributions

As the overview of federalism research to date shows, it can be assumed that there is a fundamentally positive relationship between federalism and certain indicators of national competitiveness, although not all of them have been examined thoroughly. The Feld and Schaltegger study addresses these gaps and delivers new scientific findings on six key competitiveness indicators. The study is based on a broad concept of competitiveness. It looks into the effects of federalism on public-sector activity in three areas: allocation (efficient governance), distribution (income redistribution) and stabilisation (economic growth and protection against growth shocks). A brief summary of these research contributions is given below.

3.1 Federalism and foreign investment

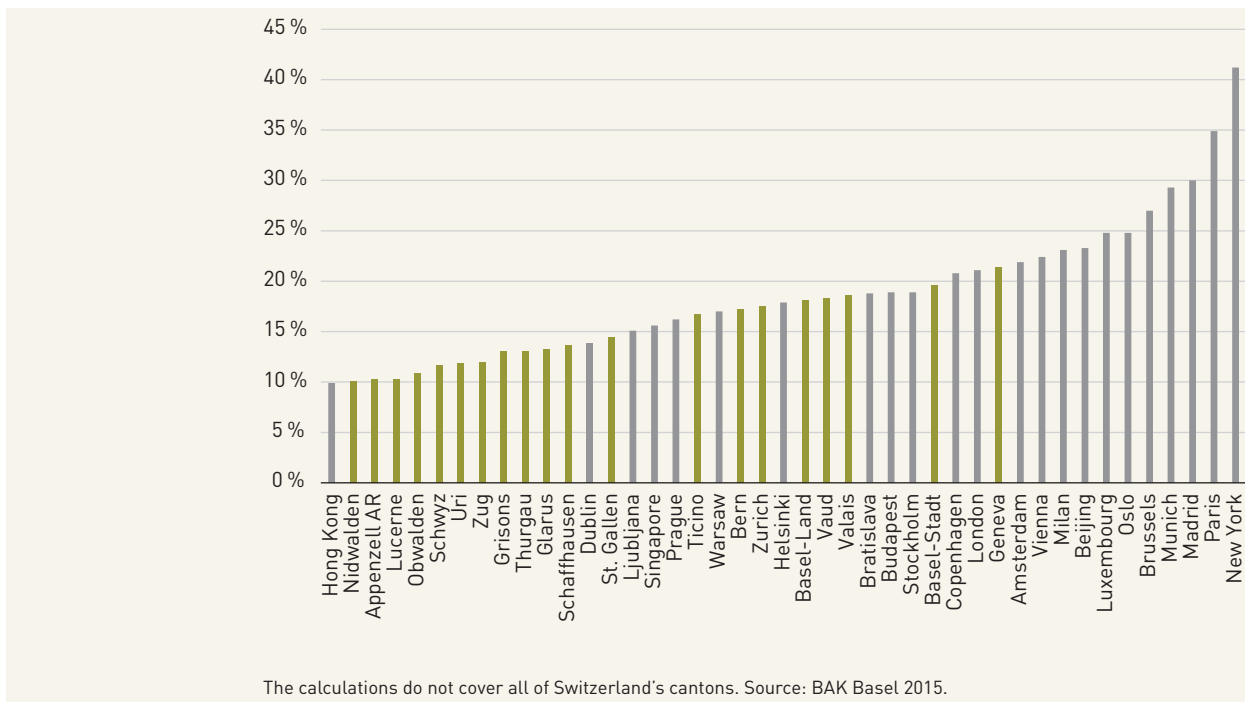
The first research contribution analyses data for 187 countries to determine how a federal system affects foreign direct investment (FDI), measured in terms of the number of cross-border company acquisitions. The influence of federalism differs depending on the recipient country's stage of development. While federalism is detrimental to a country's FDI appeal in non-OECD states, no fundamental correlation could be proven for states within the OECD. Federalism thus does not harm the investment appeal of highly developed countries such as Switzerland.

From a theoretical perspective, competition for foreign investors should force the cantons and municipalities to adopt attractive regional economic policies. Indirectly, competition supports efficient governance and sound public budgets, and should thus increase a country's competitiveness. Foreign direct investment increases the capital stock of the recipient economy and lends it important technological impetus. At the same time, however, it can also be argued that the greater complexity of multiple-level, federal systems present barriers to investors and thus make it difficult to promote a country or region as a business location.

Based on a large data set covering 187 countries for the 1997–2014 period, the international analysis shows that the effect of federalism – measured by the number of levels of government – on foreign direct

investment depends on the stage of development of the recipient country. It indicates that federalism impacts negatively on foreign investment appeal only in non-OECD states. By contrast, the number of levels of government within members of the OECD does not influence investment appeal. In addition, the investment climate in these OECD countries is much more attractive if corporation tax is higher in the country of origin than it is in the recipient country. These findings are of particular interest to Switzerland for two reasons: firstly, one of the explanations often given for the decline in FDI in Switzerland is that such investment is lower in federal states than in those with centralised systems of government because the former are more complex. This argument does not stand up to empirical examination. Secondly, the findings underscore the importance of taxation in attracting FDI. In Switzerland, taxes are kept low by fiscal competition at the subnational level. In fact, of the 29 jurisdictions around the world that tax corporate earnings at an effective average rate of under 20 per cent, 19 are Swiss cantons (Figure 5).

Figure 5: Effective average tax rate on profits by company location in % 2015



3.2 Federalism and economic growth

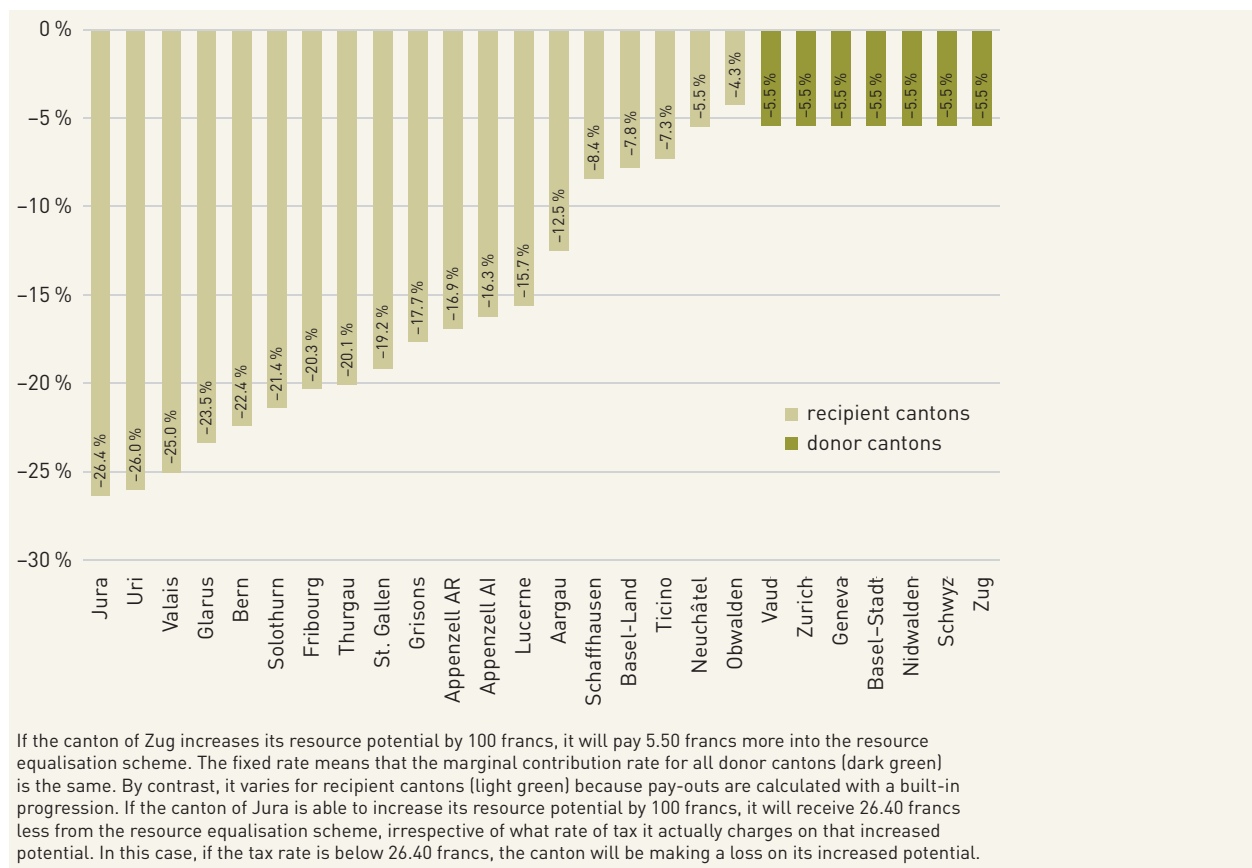
The second research contribution uses data for the 26 Swiss cantons for the 1980–2013 period to investigate the importance of federalism to economic capacity and economic growth at a cantonal level. The effect differs depending on which element of federalism is being examined. The competitive element of Swiss federalism – namely fiscal competition – is particularly conducive to economic capacity and to growth in Switzerland.

An economy's competitiveness is reflected in its economic development, in particular. As the latter is significantly easier to measure than the former, the relationship between federalism and economic growth is investigated in this contribution using the example of the Swiss cantons. Federalism is likely to affect cantonal economic growth via a variety of channels. For example, the public sector is better able to adapt its services to the prevailing regional and local circumstances, and to changing economic conditions. Fiscal competition is also said to limit local authorities' power over tax, because businesses can relocate relatively easily from one jurisdiction to another.

The analysis reveals a positive correlation between the competitive element of Swiss federalism, namely fiscal competition, and economic capacity and eco-

nomical growth. As expected, it also shows a positive connection between economic growth and the cantonal share of direct federal tax. By contrast, fiscal equalisation payments appear to impair a canton's economic capacity. Although the data situation means that the findings should be interpreted with caution, the results do indicate that the fiscal equalisation system has a restrictive effect on economic capacity. The new system of fiscal equalisation and division of tasks between the Confederation and the cantons, which came into force in 2008, has mitigated this undesired effect, although high marginal contribution rates still exist (Figure 6).

Figure 6: Average marginal contribution rates under the resource equalisation scheme, 2017



3.3 Federalism and administrative efficiency

The third research contribution looks into the effects of federalism on public efficiency. As part of a field experiment, an e-mail survey was conducted of the responses of more than 1,000 executive politicians in Germany, Italy, France and Switzerland. As the results show, officials in federal states are more likely to be willing to provide information and be accountable than those in centralised states.

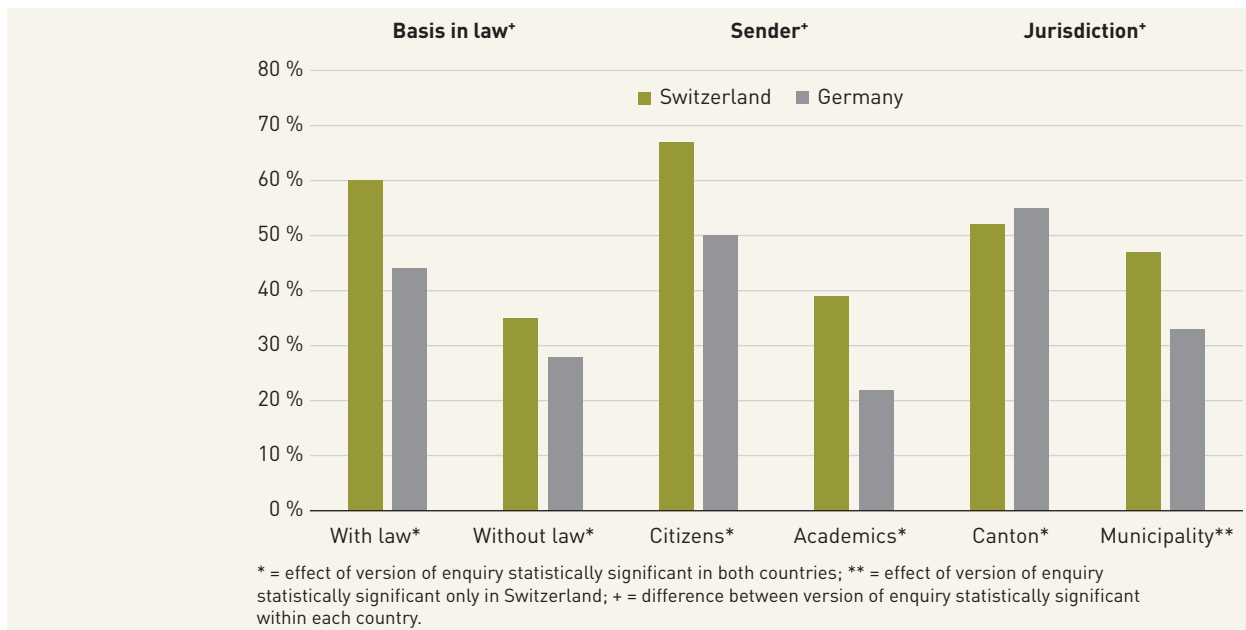
The efficient provision of public services is one of the factors in a country's competitiveness. This empirical study uses a field experiment to overcome the difficulty of measuring public-sector efficiency. Researchers wrote to 1,044 members of government at constituent state, regional and local level, and asked them to answer three questions on the state of public finances. Four separate versions of the e-mail were sent, each differing on two points. One of these was the inclusion or omission of a reference to a basis in law (such as the Freedom of Information Act in the case of Switzerland), and the other concerned the sender (private citizen or academic). Executive members of government from

Switzerland (48 per cent) and Germany (38 per cent) had the highest response rates. Meanwhile, officials from Italy (17 per cent) and France (10 per cent) responded so rarely that a statistical analysis of their responses proved impossible.

The detailed findings for Germany and Switzerland that are illustrated in Figure 7 show that the response rate among executive politicians is higher if a request for information refers to a basis in law. It can thus be observed that institutions have a positive influence on politicians' actions in these two federal countries, by strengthening accountability obligations. There were also systematic differences in response rates depending on who sent the enquiry. Private citizens and academics should expect to be treated equally, but this was not the case in either country.

The low response rates in France and Italy make an international comparison difficult. They permit only the supposition that politicians in federal countries with several levels of government are more aware of voter interests than officials within centralised systems of government. No substantiated statement can be made, however.

Figure 7: Response rates in Germany and Switzerland



3.4 Federalism and regulation

In addition to an efficient public sector, regulation is also thought to be a decisive factor in an economy’s competitiveness. The fourth research contribution thus examines how federalism affects legislative activity in Switzerland. A descriptive analysis of regulation at cantonal level reveals that the cantons exercise their legislative powers in very different ways. This confirms the existence of a functioning “laboratory” for federalism which offers scope for regulatory experiments.

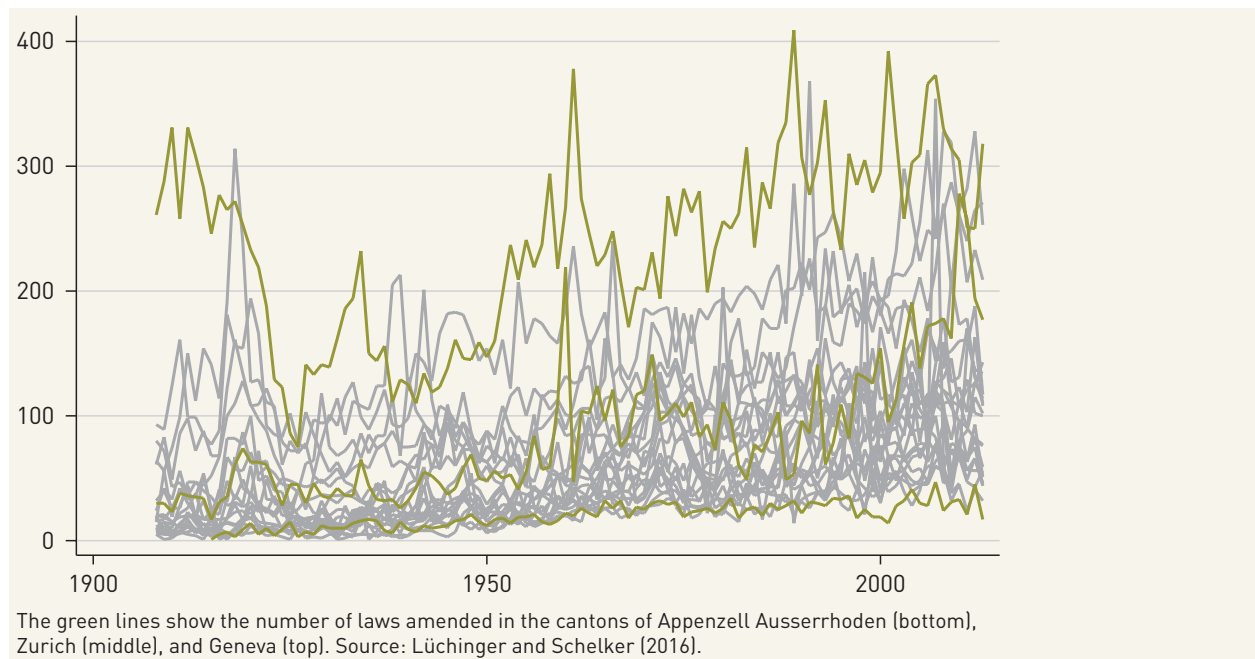
This “laboratory” approach to federalism is reflective of the fact that it is not generally possible to plan innovations in the social sphere rationally. It enables individual jurisdiction to experiment with new policies and regulations within their own areas, and to learn from each other.

A descriptive analysis of cantonal regulation does not indicate moves either towards a race to the bottom, or towards alignment between the cantons, both of which might rob Switzerland of one of its great strengths. Rather, this shows broad heterogeneity with some linguistic-regional differences. For example, urban and French and Italian speaking cantons have a greater density of regulation than the rural cantons of German-speaking Switzerland. As Figure 8 shows, this is a long-standing phenomenon. Regulatory activity at the

cantonal level is characterised by considerable volatility over time.

The findings lead to the supposition that, despite their small size, the cantons have sufficient autonomy to operate within widely differing legal frameworks. This diversity is an indication that federalism is alive and well, as well as of a functioning “laboratory” which enables the cantons to experiment with new solutions in a process of competitive and selective trial and error.

Figure 8: Overall regulatory activity in all cantons 1908–2013



3.5 Federalism and income (re)distribution

Despite similar general effects as a result of global trends, the individual industrialised countries show very different trends in the distribution of income. The fifth research contribution therefore analyses the extent to which federalism impacts income distribution and redistribution in Switzerland. Based on cantonal data on incomes for the 1945–2013 period, the findings show that, under certain conditions, Swiss federalism leads to a narrower spread between rich and poor, thus limiting the need for redistribution.

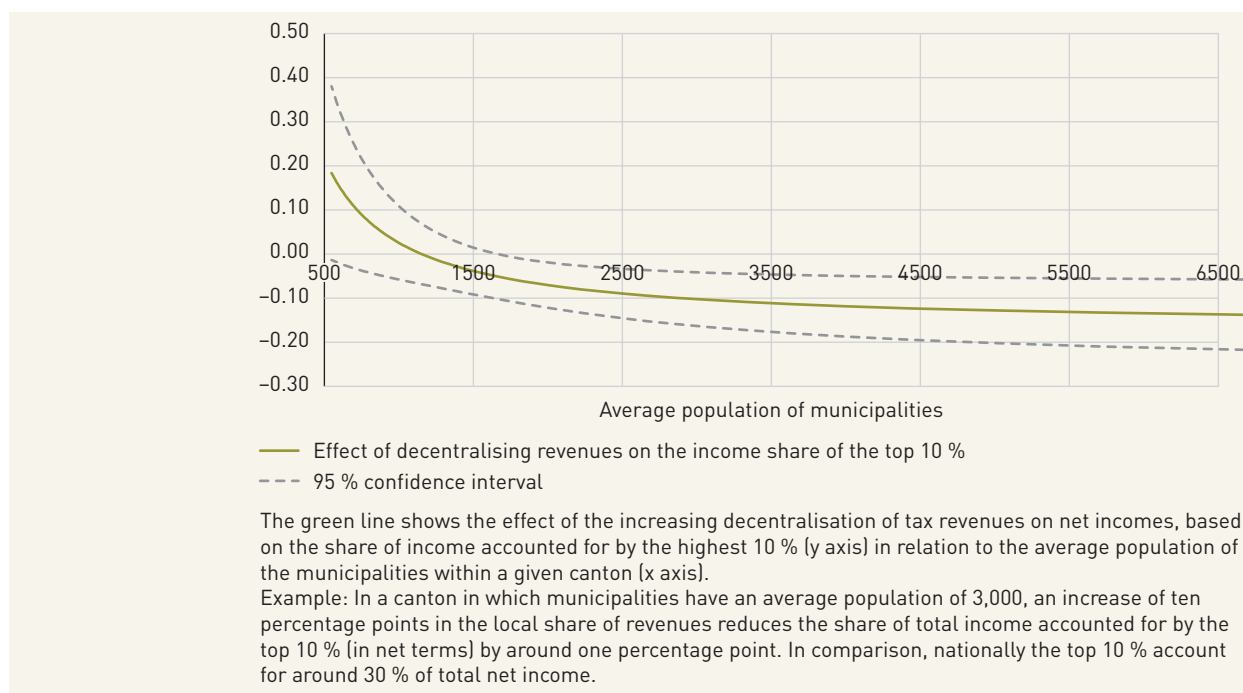
In addition to rising prosperity, public debate attaches great importance to income distribution within the economy. Although the great majority of industrialised states exhibit similar underlying trends, such as technological change, globalisation and demographic shifts, there are significant differences in the way in which income distribution has developed over time. Can political systems apply certain mechanisms to narrow or to expand the income gap?

From a purely theoretical standpoint, it can be argued that competitive federalism makes it more difficult for the state to redistribute incomes. In the struggle to attract good taxpayers, who are generally very mobile, cantons and municipalities endeavour to tax high incomes at rates that are as low as possible. At the same time, social security payments are kept to a

minimum to prevent people moving to the area purely to benefit from the system. In combination, these two factors would lead us to expect greater disparity in incomes. The findings of this research do not substantiate these theoretical fears, however. On the contrary – they show a more even distribution of incomes in cantons in which tax revenues are more decentralised (i.e. with a higher degree of fiscal autonomy), and which are more fragmented in terms of the average population of the municipalities within the canton. This nonetheless applies only up to a certain point: fiscal autonomy reduces inequality only where the municipalities in question are not too small, with an average population across the canton of at least 1,225 (Figure 9). At the same time, greater fragmentation reduces inequality only up to a certain degree of municipal fiscal autonomy, i.e. the municipality's share of total cantonal and municipal tax revenue does not exceed 53 per cent. Consequently, if there is too much fiscal autonomy or too much fragmentation, their combined effect will increase inequality. It therefore requires the right degree of fiscal autonomy and fragmentation for federalism to result in a more equal distribution of incomes.

It should be pointed out, however, that this positive effect of federalism is not the product of greater redistribution through taxes on income, but of a more even distribution of gross (pre-tax) income. The results might be interpreted as a federal system having an indi-

Figure 9: Effect of revenue decentralisation on inequality



rect effect on income distribution by promoting greater equality by means of public factors such as education which meets specific local needs.

3.6 Federalism and regional redistribution and stabilisation

The sixth research contribution investigates whether or not Swiss federalism is able to provide a buffer against regional economic shocks. It analyses the role that fiscal mechanisms such as direct federal taxation, the national fiscal equalisation scheme, and transfer payments within the social security system play in stabilising incomes in the short term and in long-term income redistribution between the cantons in Switzerland. The redistribution effect of these fiscal mechanisms is approximately 19 per cent in total. The stabilisation effect, i.e. the way in which they compensate for short-term drops in income, is just under 10 per cent.

If an economy is not able to smooth out economic volatility, its long-term competitiveness is likely to suffer. Here, federalism might offer a kind of buffer for the federal government and the cantons in the face of unexpected changes in the economic climate. For example, if economic output in one canton were to collapse, fiscal

equalisation systems might come into play to stabilise the cantonal budget in question. A federal system thus enables the cantons to share the risk of economic shocks between them. In Switzerland there are a variety of fiscal mechanisms available to safeguard against short- and long-term income disparities between the cantons. The research examines the influence of direct federal taxation (DFT), the national fiscal equalisation scheme (FEP), and transfer payments made as part of the federal government's social security system, specifically unemployment insurance (UI), and the AHV state pension.

As can be seen from Figures 10 and 11, the analysis ascribes a redistribution effect of just under 20 per cent to the fiscal mechanisms that were examined. A long-term difference in income of one franc thus results in a long-term difference in disposable income after taxes and transfers of an average of 81 centimes. Direct federal taxation and the AHV scheme have the greatest compensatory effects, at just under seven percentage points each. At four percentage points, the fiscal equalisation system is a further major contributor. This result is in line with the corresponding findings from Anglo-Saxon countries (Figure 3).

The short-term stabilising effect of the fiscal mechanisms examined in the research is 9 per cent, the largest share of which is accounted for by the AHV scheme, at six percentage points. The reason for the low

stabilising effect of the fiscal equalisation scheme and direct federal taxation is likely to be found in the way in which these systems are structured, as they have a built-in time lag between changes in income and the response in terms of taxes and transfer payments. The stabilisation effect is also relatively minor in an inter-

national comparison. This indicates that the more closely integrated factor markets – such as the labour or capital markets – covering Switzerland’s small geographical area are already absorbing much of any drop in incomes, and thereby make further stabilisation largely unnecessary.

Figure 10: Redistribution effect of fiscal mechanisms

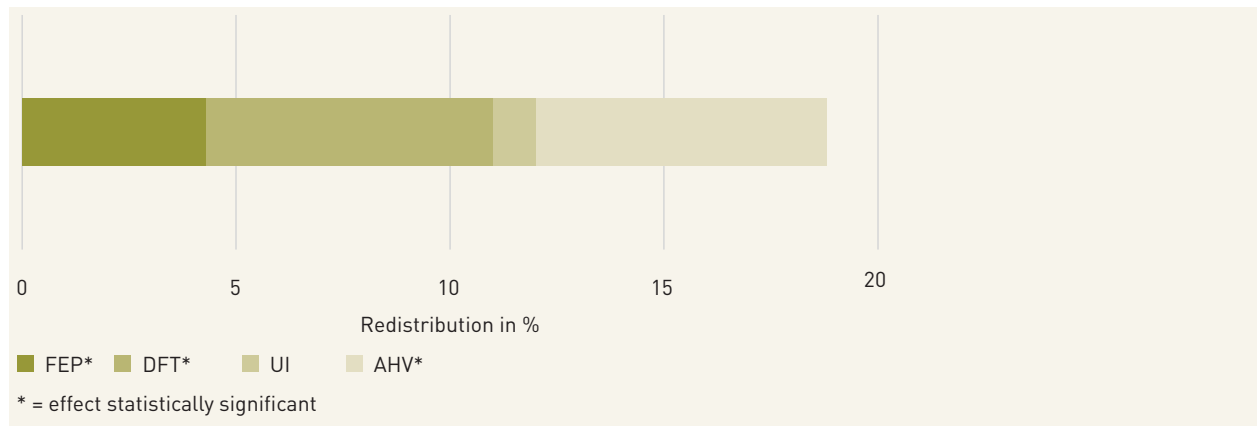
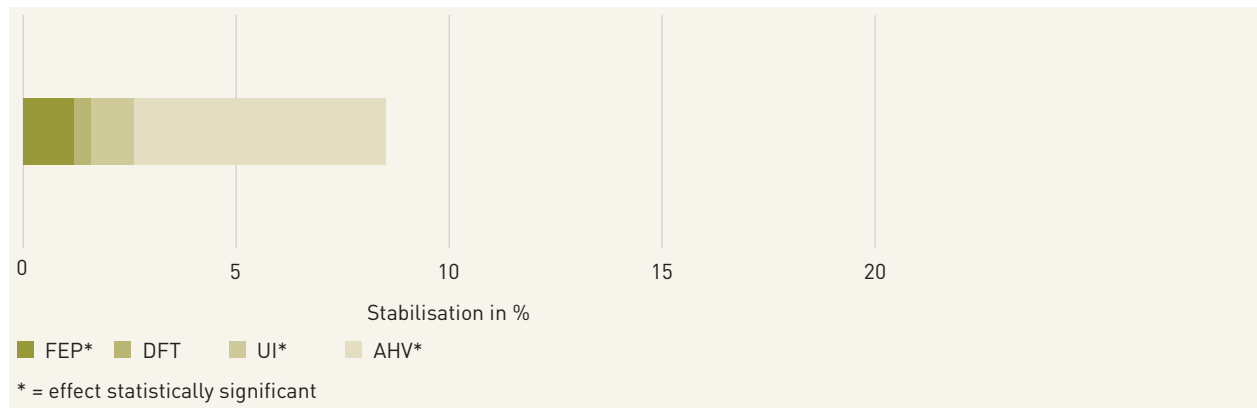


Figure 11: Stabilising effect of fiscal mechanisms



4. Conclusions

An overview of the literature on existing research into federalism shows that federal systems tend to have a positive effect on a country's competitiveness. This is especially true for Switzerland, which to date has profited considerably from its highly decentralised and competition-focused brand of federalism. These findings are confirmed by the six new research contributions with a special focus on Switzerland.

Federalism permits public services to be adapted in line with differing regional and local needs. The resulting differences in the range of services that are available boost local propensity to innovate and inter-cantonal competition, which in turn supports economic growth. With the direct involvement of politicians and their closeness to the people they serve, federalism also enhances efficient governance. In addition, opportunities to shape policy and exert influence at the local and regional levels increase social capital and quality of life. Last, but not least, federal systems reduce inequalities in the distribution of income in society, and thus limit the need for government action here.

These findings show that there is no need for a fundamental overhaul of federal structures. Rather,

thanks to its positive effect on factors such as public finances, economic growth and income distribution, Switzerland's brand of competitive federalism can help to manage major economic policy challenges. There are conditions attached to these benefits, however. The cantons must have the autonomy they need for competitive and "laboratory" federalism to thrive. In addition, within the fiscal equalisation system the relationship between solidarity and competition must be carefully balanced so that economically poorer cantons have an incentive to improve their own situations, by attracting business, for example.

However, the successful Swiss model of competitive federalism is at risk of being undermined by increasingly complex arrangements between different levels of government for the fulfilment of certain public tasks, with the combined financing models that these imply. A renewed focus on the principles of subsidiarity and fiscal equivalence – in other words decision-making, financing and usage remaining within the same jurisdiction area – is required to counter such moves towards centralisation and inter-dependency, and to strengthen Swiss federalism for the future.

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