

**Tax weather and tax climate**  
Symposium on international tax competition  
Speech by Federal Councillor Hans-Rudolf Merz  
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Perhaps you have also wondered at times why, when speaking of tax policy, we copy the weather forecasters. As an example, very often we refer to tax climate. Climate, as such, refers to the totality of typical weather conditions, of the weather in a region over a particular time. While tax weather therefore deals with naked figures, hard facts, and sober tax policy requirements amongst business locations, tax climate also encompasses environmental factors, we talk primarily about:

- political stability,
- the predictability and continuity of financial policy,
- the credibility of policies,
- the legal framework for the protection of privacy and property,
- the interactions of tax authorities with taxpayers,
- and tax morality.

Unlike meteorologists, who are powerless against the weather, a country and its minister of finance can influence tax weather and tax climate. In this speech, I would like to show you:

- first, that tax competition is an effective means to protect the global tax climate,
- second, that the tax climate in Switzerland is still mild in an international comparison,
- and third, how we can retain this mild tax climate in Switzerland in the medium and long term.

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I shall begin with **tax competition**:

As a small country with rich experience in matters concerning federalism and tax competition at the national level, it is one of our recipes for success. This is why Switzerland is also in favour of international tax competition. We view tax competition as protection against global tax warming. Tax competition is an effective instrument in tax climate policy.

Competition and the rules associated with it constitute the basis of our social market economy. Competition ensures diversity and quality of supply, innovative entrepreneurship, and low prices for consumers. Tax competition also has a positive impact. To a certain extent, citizens

and enterprises have the possibility of choosing their domicile or location. This forces the policies and administration of competing locations to offer an attractive combination of public services and a tax burden that is as low as possible. It is relevant how they do this. The informative *economiesuisse* study, the impetus for today's event, is evidence of how intensively the business community observes the dynamics of tax competition.

Occasionally, the positive aspect of tax competition is also disputed. Tax competition is sometimes claimed to trigger a cutthroat tax-cutting spiral, which may lead to a creeping deterioration of services in the public sector. Efforts therefore exist to harmonize taxes internationally and to limit tax competition. Such a conclusion defies logic, it has not been proven. The *realpolitik* alternative to tax competition is a tax cartel: Cartels, however, are seldom advantageous for the citizen. I would even go so far as to say that cartel tax structures are ultimately more expensive for the citizen, without even a corresponding increase in benefits. This at least is what is shown by our country as an example. Switzerland is a country with an excellent infrastructure, a high standard of education, a sound social network and nonetheless moderate tax burden.

Tax competition provides opportunities which should be used. Above all I see three advantages:

- First, tax competition offers citizens protection from the excessive tax appetite of governments. Tax competition is a significant guarantor of a favourable tax climate. That is to say, it is a regulative that disciplines state decision-makers and forces them to treat the financial means entrusted to them in a disciplined, careful, and economical manner.
- Second, tax competition is then the discovery procedure for the exploration of new and innovative policy designs. Successful strategies are imitated and adapted. Their creators are invited to international events. Unsuccessful strategies, by contrast, are avoided. Tax competition thereby helps those taxation systems gain acceptance which tax payers feel are fair and reasonable. Several times already Swiss cantons have in this way contributed to the further development of our tax system.
- Third, tax competition, however, also serves as a welcome standard of comparison. Citizens can measure the success of a government relative to the success of other governments and take this into consideration in elections. In this way, tax competition makes democracies livelier.

For Switzerland, tax competition is not only a theoretical concept. It represents one of the constitutive elements of our system of state and our self-understanding. Our experiences with tax competition are positive. Nonetheless, with us as well, it will not work without harmonization. However, we clearly differentiate between formal harmonization among cantons, which we strive for, and material harmonization, which we reject. Financial equalization forms the corrective between the objective differences of the cantons. Why should this not also apply to international tax competition? Following the well-known Frank Sinatra song, I believe that "if you can make it there, you can make it anywhere". Our double taxation agreements, the EU taxation of savings income or the cohesion payments are all an expression of these convictions.

And one more remark: Large countries can make use of the advantages of a large internal market. Small countries, by contrast, have a “natural” competitive disadvantage, due to their small internal market. Small countries can, however, keep step with global competition through an attractive tax policy and compensate for their “natural” competitive disadvantage. It is therefore not surprising that small countries distinguish themselves through aggressive strategies in tax competition. Large countries will find this a hard nut to crack. Small countries therefore play a key role in protecting the global tax climate. Where their systems are fair, efficient and democratic, there can be no talk of harmful competition. The current search with a fine-tooth comb for selective tax advantages in the cantons will not alter this.

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Now, allow me to talk about the Swiss climate zone.

International comparisons of tax burdens show: Switzerland has an attractive tax climate. Some locations are among the best internationally with respect to corporate taxation. This is particularly true for corporate taxation when the burden for the investor is not included in the calculation. With regard to the attractiveness of the location, the tax burden plays an important role but not the only one.

The current mild tax climate alone is not a guarantor of stable summer weather. The “flat rate tax revolution” in Eastern Europe is sheet lightning on the horizon and the “dual income tax” is bright “northern lights”. Both have a certain fascination. These are the reactions of small states to the challenges of globalization. Both reform strategies meanwhile are showing encouraging results. They are increasing competitive pressure, which also raises the question of whether reforms of this nature could be transferred to our country. More about this later. Firstly, however, just some information on some homemade low-pressure tax areas. I believe these to include the economic double taxation of distributed corporate profits, the marriage penalty in the taxation of spouses, and the far too complicated value added tax.

Not every tax base is equally sensitive to the weather. Mobile tax bases such as capital react very sensitively. With increasing globalization and increasingly tough tax and location competition, this realisation is becoming more important. Various elements of our system still fail to take changes in our society and economy adequately into account, however. We must therefore improve the tax structure. This is where I view one of my main tasks, and this is how I tailor my tax policy agenda.

The most important measures to counter the homemade low-pressure areas have been initiated:

- The goal is to realize Corporate Tax Reform II, in order to effectively alleviate the economic double taxation of distributed corporate profits, to undertake targeted individual measures for partnerships, and to eliminate nuisances in corporate tax law. The economy will benefit from relief in the region of one billion Swiss francs.
- In the area of taxation of spouses, I would like to dismantle the marriage penalty by way of urgent measures. In this way, we can quickly defuse the problem with a single measure, without prejudicing the difference of systems between individual taxation or joint taxation of spouses. The abolition of the marriage penalty is an important measure for women, whose employment options will be expanded significantly.

- Finally, I am aiming to radically simplify the value added tax. I would like to see an ideal value added tax with a single tax rate. This entails abolishing all 25 exemptions from the value added tax requirement, the broadening of the assessment basis and standardizing the three different value added tax rates. This would result in a lower value added tax rate, somewhere between 5 and 6 per cent. In terms of simplification, this would be a pioneering action for the lowest rate in Europe.

These three tax reforms share overarching goals. We are reducing distortions, i.e., tax policy will act more neutrally, so that individual and entrepreneurial decisions can be made as freely as possible from tax constraints. Moreover, taxation will become simpler and fairer. The effects of the measures on growth and employment will be positive. And finally, financial policy will be able to sustain them. Without these three reforms, the tax policy of our country would come to a standstill when all around us the tax systems were being modernised. Put simply we can ill afford to lean back, to watch the middle-classes maul each other and to permanently be searching for the best solution providing top quality, indeed this does not exist. A tax system is only then a good one if all of those affected are equally dissatisfied.

However, now let us return to long-term tax policy. My division is currently scientifically clarifying the effects of various basic reform options on Switzerland. Primarily, I am interested in the following options:

1. Flat rate tax. What growth and employment effects should be expected from broadening the assessment basis while simultaneously reducing the rate? The flat rate tax, as a shining example of this approach, leads to the justified question whether similar successes could also be expected for Switzerland.
2. The dual income tax. Since the beginning of the 1990's, a number of Nordic states have introduced a so-called dual income tax. The core idea is the differing tax treatment of capital income and earned income. In order to take the requirements of global tax competition into account, capital income is taxed at lower and proportionate rates, while earned income is taxed at higher and progressive rates. The successes in the Nordic states are also encouraging, so that, for instance, the German Expert Council is also recommending a dual income tax for Germany. I would like to know what could be expected from a dual income tax in our country.
3. Income-dependent tax credits. In the low-income brackets, there are currently few incentives to engage in employment. At fault are social systems which serve as salary replacements. As a rule, a recipient of social assistance benefits who engages in employment loses his or her claim to support to the same degree. In this way the social security systems become a trap. Income-dependent tax credits, by contrast, represent a salary supplement that offers a high incentive to engage in employment. This would allow us to strengthen the supply of work directly and the dynamics of growth indirectly. In addition, I hope that a better coordination of social policy tools can lead to a more efficient use of resources in social policy.
4. Much more progress has been achieved in the individualisation of society than is generally considered to be the case. In the 1960s the small family was the norm. Today the most diverse forms of cohabitation have emerged as well as living alone. The introduction of individual taxation as a form of taxation irrespective of marital status would take this societal development into account. If one wishes to retain the

current joint taxation of couples, the alternative then is the introduction of splitting, although it will be difficult to remedy all disparities.

Finally, I am not only concerned with concrete tax reform options, but also with the framework conditions: In order to secure and strengthen tax morality in Switzerland, we must cultivate the reservoir of trust in our society that positively influences our climate. At issue are closeness to the citizen, continuity, credibility, dependability, predictability, modesty, and checks and balances in policies, but also in enterprises. These values are important because the willingness of citizens to pay taxes likely depends substantially on whether they view the levying of taxes as justified. The central question is therefore: Under what circumstances are taxpayers willing to pay taxes, and under what conditions will they attempt to evade taxes? In fact, citizens are more likely to see a moral obligation to pay taxes if they view their compensation in the form of public services as adequate. Direct democratic rights, federalism, and tax competition force us politicians to keep the exchange character of taxes for public services in mind.

In this connection, the transparency of political action is also important, although under no circumstances should transparency be confused with the interference of policy with the privacy of the citizen. The protection of the confidentiality of the private sphere of the taxpayer is not only legitimate, but also necessary, and this is something we will never renounce.

My tax policy agenda aims at creating and sustaining favourable framework conditions for entrepreneurial action in Switzerland. International tax competition is of central importance in this regard. It constantly demands that we analyze the tax weather, that we react to disturbance zones, and that we avoid low-pressure areas, in order to keep the tax climate attractive in the long term.

Finally, the prosperity of a location depends not only on the efforts of the finance minister with regard to a favourable tax climate. Entrepreneurs are also called upon to face competition and to secure the prosperity of the Swiss business location through innovation. Weather and climate are one thing, but proper clothing is another altogether.