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Executive Summary

"Competition and Dynamism in Tax Policy – An International Comparison of Major Reforms and their Lessons for Switzerland."

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The study presents an analysis of recent major tax reforms in OECD countries. It provides an overview of significant reforms implemented since 1998 in the area of corporate and individual taxation. It places particular emphasis on changes of direct taxes in the 15 older EU member states, Australia, Japan, New Zealand, Norway and the USA and compares them to Switzerland. The report also briefly outlines developments in some Eastern European countries as well as in the area of indirect taxes. This study's objective is to derive trends from international developments and draw the appropriate conclusions for the future design of the Swiss tax model.

Recent years have seen growing pressure for reforms of national tax systems. On the one hand this pressure results from **external factors**: tax policy is increasingly being used as an instrument to attract foreign investment; the growing cross border mobility of tax-payers and of means of production poses such a challenge to tax authorities that they have no choice but to act; domestic policy is constrained by the push for tax harmonisation in the EU and the OECD; and the enlargement of the EU to the east has intensified pressure on the older members' tax systems.

On the other hand national tax systems are also subjected to **internal pressure** from a number of sources:

- Firstly, there is a greater desire among the population for a more transparent, efficient tax system. Calls are being heard for a sweeping simplification of taxes e.g. tax rates and assessment of the tax base.
- Secondly, there is growing awareness that in many cases tax policy is not an appropriate instrument with which to pursue certain political goals. A multitude of different objectives places excessive strain on tax systems and distorts the economic behaviour of companies and individuals.
- Thirdly, in both federal and centralised states the debate is growing louder on the question of how to divide fiscal and administrative responsibility between the national and local levels in order to maximise the efficiency of government.

- Fourthly, there is growing resistance against economic double taxation that emerges from the coexistence of different kinds of taxes, taxable subjects and objects.

Developments in fiscal policy cannot be transposed wholesale from one country to another, given that national tax models inevitably reflect the history and characteristics of their own country. However, it is possible to identify general **developments and trends** in other countries' reforms and so find a source of inspiration for improvements to our own national system. The taxation model of any given democratic state is the result of an ongoing process of optimisation that takes place within the given economic and social constraints to which all systems are subject. Global competition has affected these constraints and prompted countries to make better use of the possibilities afforded by effective fiscal policy. Furthermore, it is clear that the overall tax burden, measured by the total tax-to-GDP-ratio, has reached a turning point: since 1990 it has fallen in many countries. Until now, there have only been a few instances of genuinely radical reform: the "3 Box System" in the Netherlands; a dual income tax system with separate taxation of capital and labour income in Scandinavia ("Nordic Model"); an attempt to introduce consumption based taxation in Croatia; and flat-rate tax models in Slovakia and other countries. Considerations relating to political viability and acceptability have led most governments to implement partial reforms through a series of single measures. In some countries, e.g. Ireland, Belgium, USA, this has resulted in a fundamental shift in the tax system. Today, countries are clearly more willing to undertake reform than in the past - innovative ideas and even radical concepts are seriously discussed, being phased in or tested in pilot projects and sometimes, also withdrawn, e.g. consumption based taxation in Croatia.

The changes in **company taxation** can be summarised as follows. Smaller economies, such as Ireland, the Netherlands, Belgium, Denmark, Austria, as well as some Eastern European countries have prepared themselves for international tax competition, often by lowering tax rates (e.g. radical cuts in corporation tax in Ireland; flat rate taxes on company earnings, income and consumption in Slovakia; tax cuts in Poland, Hungary, the Czech Republic and Austria). Most other countries found themselves unable to resist the downward pressure on tax rates, consequently there have been widespread cuts in taxes on company earnings. Governments have compensated for this to some extent by expanding the tax base. From a business's point of view, the company tax system of a given country plays a crucial role in deciding whether or not to invest there. Of particular importance are regulations relating to depreciation, asset valuation, loss relief, consolidated taxation, dividend taxes, the ratio of equity to debt, avoidance of international double taxation as well as special dispensations and tax relief for certain activities. Most countries have recognised the need to enhance their own competitive advantage and, at least in part, have shown greater flexibility in creating business-friendly regulations, e.g. Austria, Belgium, Denmark, Ireland, Luxembourg, the Netherlands, and also Italy, Spain and Sweden. International tax competition has been somewhat reined in by EU and OECD efforts to limit the so-called “harmful tax practices”, but it still plays a key role in attracting firms to a country and keeping them there.

It is more difficult to identify common trends in the **taxation of individuals**, given that the models applied vary greatly from one country to the next. In many countries, individuals are taxed at higher rates than companies. This is due both to the lower mobility of individuals as well as to tax policy itself: greater importance is attached to the creation of a favourable tax environment for business than to tax relief for natural persons. The bulk of the tax burden is borne by middle and high earners with rates being applied on a progressive basis. One of the reasons that the overall tax burden of individuals differs so greatly from country to country is that systems of social insurance and social insurance contributions also vary considerably. Furthermore, governments have to devote far more attention to political factors (special interest groups, election tactics) when considering the question of individual taxation. However, there is a clear trend towards reducing high taxes, which discourage taxpayers from working and focusing tax relief on families and socially disadvantaged groups. There has also been a clear trend towards the abolition of general net wealth tax.

When distributed company profits are subjected to both income tax and corporation tax, the result is **double taxation** (taxation of both the company's earnings and shareholders' dividends). Most countries have found ways to avoid or at least lessen double taxation, with either the company or the investor benefiting from tax relief. One objective of such policies is to encourage companies to distribute their earnings rather than hold them in reserve. In so doing, they benefit the economy by re-introducing money into circulation. There is a new trend towards the introduction of "dual income tax systems" or "the Nordic model", where taxation of labour income and capital income is separate. Labour income is taxed at a progressive rate, while (the far more mobile) capital income is taxed at a lower flat rate.

In the EU member states the debate on the ideal mix of direct and indirect taxes has essentially been settled. Indirect taxes are levied almost exclusively on **general consumption**. Specific excise duties and energy taxes are widespread, some specifically designed to provide incentives for particular forms of behaviour. Value added tax is now an accepted form of taxation worldwide. Of the OECD countries, only the USA and Canada do not apply a uniform consumption tax. VAT rates in the EU are dictated primarily by the relevant EU regulations, which set a minimum rate of 15% and limit the possibility of applying special rates. VAT creates relatively high administrative costs for business, furthermore, there is growing awareness that high VAT rates lead to distortions and reduce countries' competitive advantage (e.g. in the financial services sector).

Together with a tax system's quantitative elements, **"soft factors"** also play an important role. The general tax climate is a significant factor in attracting investment. Almost all countries have made efforts to improve legal certainty and the predictability of the business environment (e.g. provision of legally binding advance rulings) as well as trying to enhance cooperation between the authorities and taxpayers (especially companies). Constant changes to the tax system (some even applied with retroactive effect) and concomitant legal uncertainty cause great harm to countries' attractiveness for investors.

The report's surveys on adjustments to national tax systems in many OECD-countries reveal the following basic trends in taxation policy:

Trends in Tax Systems

- As a rule, tax systems are complex and are likely to remain so.
- Competition between diverse tax models will remain a key factor.
- Most countries are obliged to take the effects of globalisation into account when framing tax policy.
- Uncertainty with regard to tax harmonisation in the EU will probably persist.
- Providing an attractive environment for investment is both an opportunity and a necessity for smaller countries.
- "Soft factors" such as the general tax climate are indicators of quality.

Trends in Types of Taxes

- There is a marked trend towards high indirect consumption taxes and social insurance contributions.

- There is a tendency towards lowering company taxes while at the same time expanding the tax base.
- Labour income and capital income are increasingly being taxed separately.
- Double taxation of distributed profits has been reduced almost everywhere.
- Targeted forms of tax relief on labour income are becoming more common.
- Tax amnesties only address the symptoms, not the root cause.

Social Trends in Tax Policy

- People are more savvy about taxation than in the past.
- Governments' willingness to undertake tax reform has generally grown stronger.
- Calls for simpler tax systems are becoming louder.
- A piecemeal approach to tax reform can reduce a tax system's transparency.

The Need for Tax Reform in Switzerland

The goal of this report is to use empirical evidence to **evaluate the Swiss tax system in an international context** and so highlight those areas where a change in policy is necessary. The publication of economiesuisse from the year 2000 - "Taxation - a Blueprint for Switzerland" provides a framework with which to consider this study's conclusions on necessary tax reform in Switzerland in the following areas:

1. International competition for investment (globalisation and increased mobility) has injected *new dynamism* into the area of taxation. Switzerland cannot turn a blind eye to these developments. Despite some international organisations' efforts to harmonise taxation (EU, OECD, UN) countries are clearly endeavouring to maximise the effectiveness of their remaining tax autonomy.
2. Switzerland runs the *risk of being left behind* by the rapid changes in foreign tax systems. There are a number of major reform projects on the political agenda, but they are moving forward slowly, if at all (e.g. rejection of the Tax Package on 16 May 2004). "Tax policy paralysis" would be fatal for the economic growth and competitiveness of our small country, which is so dependent on its ties to other economies.
3. In order to keep pace with its international competitors to attract investment, Switzerland must play to its strengths and *make targeted use of its tax autonomy* in the light of international developments and reforms abroad.
4. Reforms as radical as those that have been introduced in some of the new EU member states would be difficult to implement in Switzerland. Therefore, once legitimate objectives have been identified, full implementation should *proceed in consistent stages with recognition* being given to the country's unique political structure (in particular the special form of democracy and the federal model).
5. This study belies the *myth of the unassailable position of the Swiss tax model*, in regard not only to its attractiveness for investors (increasing mobility) but also to the overall tax burden (fiscal quota including all mandatory contributions and levies). Switzerland must continue to rank among the best. While in part its position is still relatively good, prevailing trends give cause for concern. Unless Switzerland takes steps to remedy the situation, it will find itself relegated to a lower league.
6. In Switzerland, *government spending has mushroomed* more than in any other OECD country. This situation is compounded by the acute financial challenges resulting from demographic changes. Switzerland must therefore spare no effort in bringing spending under control again or in reducing government spending as a percentage of GDP through a comprehensive growth plan. This is the only way to provide the necessary financial capacity for urgent tax reforms.

7. An international comparison shows that, alongside the USA system, the *Swiss federal finance model is unique*. However, in order to tap its full potential, efficiency must be enhanced (avoiding redundancy at the cantonal level) while Switzerland's competitive edge would benefit from better exploitation of its tax autonomy. Tax competition makes economic and financial sense and results in a more efficient allocation of public funds.
8. In the international context, Switzerland's *personal income tax regime is no more than average*, while *varying considerably from canton to canton*. Reform is necessary in the area of family taxation (abolition of the so-called "Marriage Penalty"), the taxation of shareholders (economic double taxation) and in the setting of tax rates. The income tax burden on medium-sized entrepreneurs should be reduced (e.g. through shallower progression of tax rates) and the practice of administering taxes at the local level should be maintained.
9. *Switzerland's lead* in the area of company taxes *has shrunk* in recent years (in particular in the face of pressure from Ireland and the new EU member states). A country's tax rates *send a clear signal* to investors and it is therefore in Switzerland's best interest to improve its standing and cut taxes. It must also reform its tax base assessment (extension of loss relief, consolidated taxation, targeted tax relief for research and development) and dismantle taxes which are unrelated to earnings (capital tax, stamp duty, property purchase tax, etc.).
10. Switzerland is one of the last OECD countries to subject shareholders to *full economic double taxation* on company profits paid out in the form of dividends. This disadvantage should be eliminated as quickly as possible. The international trend has been to apply a lower taxation to investors' capital income than to other income. As long as net wealth tax is levied, capital gains tax (or a more narrowly defined capital gains tax on corporate equity) will remain unthinkable.
11. Switzerland is one of the few OECD countries to levy a general *net wealth tax on natural persons* at the cantonal and communal level. Such taxes on assets are outdated. The elimination of economic double taxation of shareholder's capital and wealth is a matter of urgency.
12. Switzerland must *continue to offer the tax advantages to multinational enterprises* (international holding companies, headquarters and service companies) which have proved themselves to be so successful in the past. The Swiss network of double taxation agreements must be improved and expanded, while rules which are harmful to Switzerland's competitive advantage must be avoided. Measures that cause serious harm to Switzerland's competitive advantage (e.g. issuance tax and securities transfer tax) should be completely dismantled.
13. Switzerland's *low VAT rate* constitutes a considerable competitive advantage that *should not be lost on any account*. Furthermore, VAT collection can be improved and made more business-friendly. Government must liberalise current practice and build up a "ruling culture".