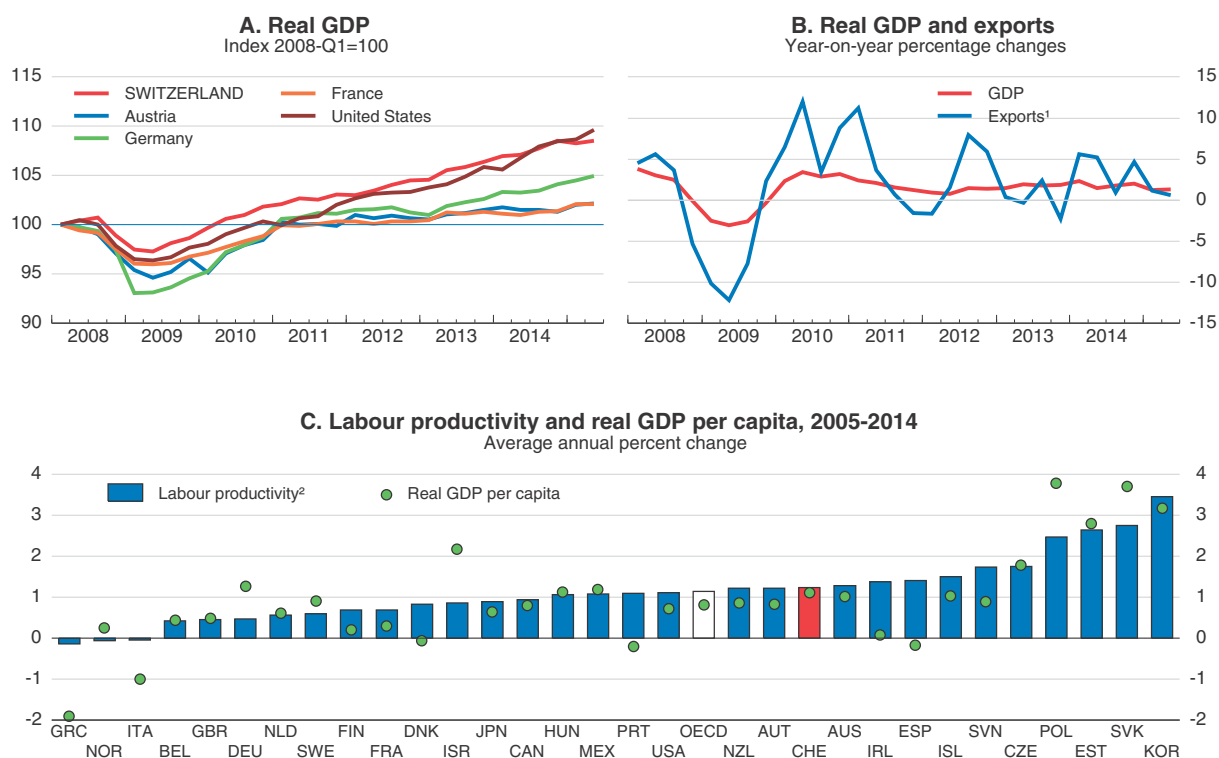


Assessment and recommendations

- *Recent macroeconomic developments and prospects*
- *Boosting medium-term growth prospects*
- *Policies to tame the housing cycle*
- *Raising efficiency in public spending*
- *Adjusting to international best practice on tax issues, including information exchange*

Following a recession in 2009, economic growth in Switzerland bounced back strongly, outpacing its main European trading partners and matching the strength of the US recovery (Figure 1, Panel A). As the recession hit, the Swiss National Bank (SNB) implemented an ultra-low interest rate policy and in 2011 enforced a ceiling on the franc versus the euro. The rebound in growth has been led primarily by exports, which recovered quickly after the 2009 recession (Panel B), and household consumption. Switzerland's performance in terms of per capita GDP growth over the past decade has been near the OECD average, as has its labour productivity performance (Panel C).


Figure 1. Real GDP growth and its main components



1. Excluding non-monetary gold and valuables.

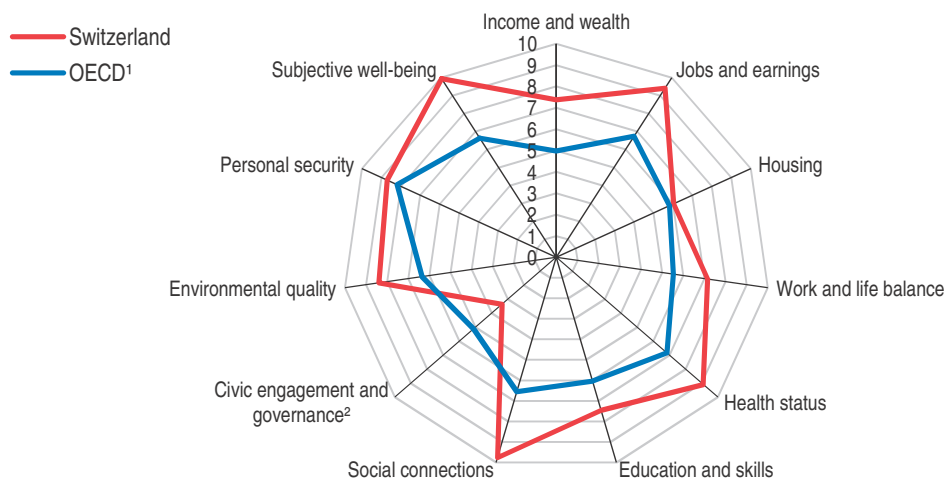
2. Productivity measured using hours worked.

Source: OECD, *Economic Outlook 97 Database* (and updates); OECD *National Accounts Database*; and SECO.

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Well-being and happiness indicators are also high, with several major Swiss cities regularly ranking among the world's best places to live. In the OECD Better Life Index (Figure 2), all but one of Switzerland's component scores exceeds the OECD average, with particularly high scores in life satisfaction and health. Although Switzerland ranks highly in the provision of basic housing facilities, the high cost of housing drags down the

Figure 2. The OECD Better Life Index for Switzerland



1. Unweighted average.

2. The civic engagement index is partially based on average voter turnout. Direct democracy in Switzerland means that there are a disproportionately large number of national polls, with relatively low average turnout.

Source: OECD Better Life Index, www.betterlifeinitiative.org.

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aggregate score. This issue is discussed in detail in Chapter 2. While the redistributive impact of taxes and transfers is comparatively small, Switzerland remains in the more equal half of OECD countries after taxes and transfers. Even so, inequality in GDP per capita across the regions is high by OECD standards (Demmou et al., 2015).

The dynamic and open Swiss economy is continuing to attract immigrants, and as pointed out in the previous *Survey*, this accounts for a significant part of Switzerland's robust economic growth. In February 2014, a popular initiative on "mass immigration" was passed, which obliges the government to impose quotas on immigration by 2017, including from the European Union. This measure calls into question a key source of Switzerland's growth model and already appears to be weakening confidence. These developments imply that in the medium term growth will have to rely increasingly on productivity gains.

More immediately, the economy was hit with a shock when, on 15 January 2015, the SNB removed the ceiling on the franc, leading to a sharp appreciation, especially against the euro. With almost two-thirds of Swiss exports going to Europe, this exchange rate shock has affected exports and growth, and has been pushing down consumer prices.

Against this backdrop, the key messages of this *Survey* are:

- Switzerland has long benefited from a strong inflow of foreign workers. Restrictions on this inflow means that policy will need to focus on improving productivity performance by allowing resources to be directed to their most productive use. This requires flexible labour and product markets and increased public spending efficiency, as well as liberalisation of the agricultural and energy sectors.
- Real estate prices in Switzerland have grown rapidly in recent years, the residential mortgage debt-to-GDP ratio, at 120%, is the OECD's highest, and banks are very exposed to the property sector, with over 80% domestic of bank loans being mortgages on aggregate. While pressure seems now to be abating, aided by measures taken by banks and authorities over the past three years, policies are needed to make supply more responsive.

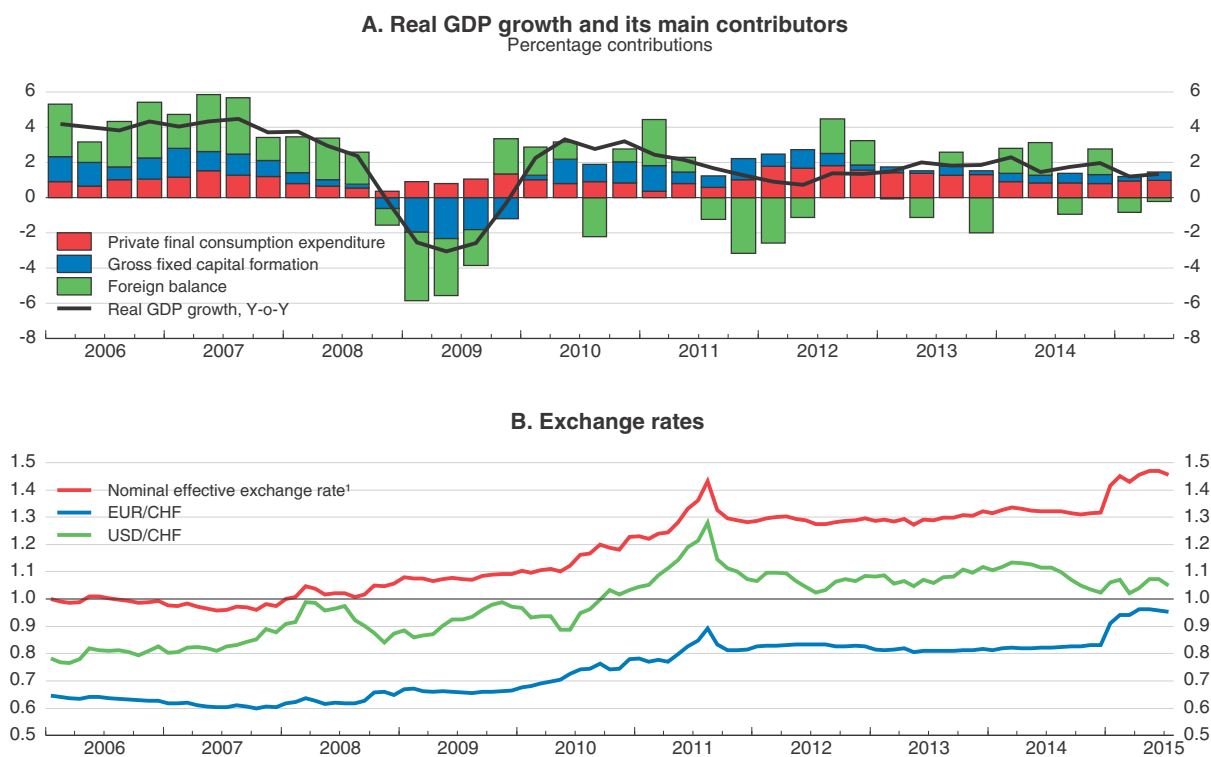
- Public expenditure in Switzerland was just 33.5% of GDP in 2014, one of the lowest in the OECD. But as the population ages, demands for public services will rise and revenues will be undermined, calling for improvements in public spending efficiency.

Recent macroeconomic developments and prospects

With GDP contracting 0.2% in the first quarter, economic activity in Switzerland was hit hard by the sharp 15% appreciation of the franc against the euro in early 2015, following the removal of the currency ceiling (Figure 3, Panels A and B). The appreciation put an end to the trade-led momentum in 2014. However, the economy already rebounded by 0.2% in the second quarter, supported by solid domestic demand. The sectoral composition of growth has also switched from consumption-related components to manufacturing (Figure 4, Panel A). As confidence has suffered, demand for credit is at its lowest point in three years even though it is still growing faster than GDP (Figure 4, Panel B). At the same time, Swiss households are making the most of the strong franc, with cross-border shopping up nearly 30% in some places (Bloomberg, 2015).

Falling global oil prices and the currency appreciation resulted in consumer prices falling 1% year-on-year in June 2015 (Figure 4, Panel C). To remain competitive with imports (whose prices fell 4.9% year-on-year in May), Swiss companies have had to cut their prices: the GDP deflator dropped 0.9% in the first quarter. However, as with the 2011 appreciation

Figure 3. **Components of GDP growth and exchange rates**



1. Vis-à-vis 40 trading partners; January 2006 = 1.

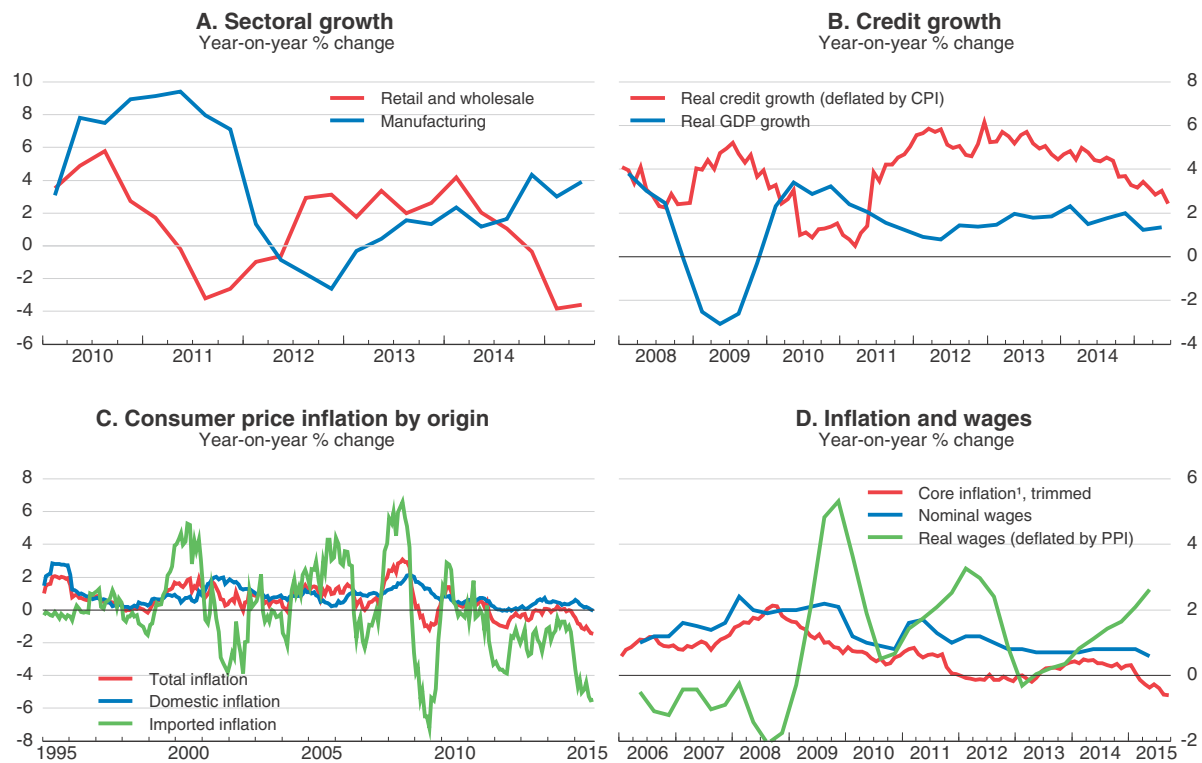
Source: OECD, Economic Outlook 97 Database (and updates); SECO; and SNB.

episode, falling prices are the result of the exchange rate pass-through, rather than entrenched deflation expectations, with a majority of households not expecting prices to fall. This is evidenced by the strongly negative contribution of imported goods to CPI inflation (Figure 4, Panel C).

Employment growth picked up to 1.2% year-on-year in the second quarter of 2015. Although the unemployment rate of 4.3% (labour force survey measure) remains low by international standards, some worrying trends are emerging. As the government extended support to short-time work (employees working fewer hours while the government tops up their pay) to include businesses having difficulties resulting from the discontinuation of the exchange rate ceiling, firms doubled their recourse to this measure compared to a year earlier, and more businesses consider current employment levels to be too high than too low (KOF, 2015a). Real wages (deflated by producer prices) grew by 1.6% in 2014 – already in excess of productivity gains of 0.3% – and have accelerated into 2015 (Figure 4, Panel D).

At around 7% of GDP in 2014 and projected to be close to 10% for the first half of 2015, Switzerland's current account surplus is still very large, led by the goods and services balance of 12% of GDP. The contribution from merchandising has flattened off in recent years, but income inflows from licensing fees and research and development services are continuing to surge, together now amounting to over 3% of GDP. With high real unit labour

Figure 4. Macroeconomic indicators



1. The trimmed mean is a measure for core inflation based on a reduced basket of items. It factors out those 15% of items with the highest and those 15% with the lowest annual price increases from the CPI basket.

Source: OECD, Economic Outlook 97 Database (and updates); SECO; and SNB.

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costs, exporting firms were already operating with thin margins. That said, Swiss exports are heavily concentrated in relatively price-insensitive goods such as pharmaceuticals and watches, so weathering the loss of competitiveness in those industries will be easier (Auer and Sauré, 2011; KOF, 2015b). However, Switzerland continues to underperform with regard to trade (OECD, 2013a), and the authorities should therefore continue to promote trade links, especially with non-European markets, and make progress on extending Switzerland's network of free-trade agreements, including with India and the United States.

Table 1. **Macroeconomic indicators and projections**

	2011	2012	2013	2014	2015	2016
	Current prices CHF billion	Percentage changes, volume (2010 prices)				
GDP at market prices	618.3	1.1	1.8	1.9	0.7	1.1
Private consumption	333.4	2.7	2.2	1.3	1.2	1.5
Government consumption	66.4	2.1	1.3	1.3	2.4	0.6
Gross fixed capital formation	144.6	2.9	1.2	2.1	1.3	1.3
<i>Of which: Business</i>	106.2	3.8	1.4	2.1	0.7	1.1
<i>Housing</i>	19.3	1.5	1.7	1.6	1.0	1.1
<i>Government</i>	19.1	-1.1	-0.7	0.0	0.4	0.5
Final domestic demand	544.4	2.7	1.8	1.5	1.4	1.3
Stockbuilding ¹	21.5	-3.4	-2.5	0.6	-0.8	-0.4
Total domestic demand	565.9	-1.2	-0.9	2.4	2.3	0.9
Exports of goods and services ²	406.7	1.1	15.2	-6.9	-2.1	0.0
Imports of goods and services ²	354.3	-2.6	13.4	-8.1	-0.1	-0.6
Net exports ¹	52.4	2.2	2.6	-0.1	-1.3	0.3
Other indicators (% change, unless otherwise specified):						
Potential GDP	-	1.8	1.7	1.6	1.5	1.5
Output gap ³	-	-1.0	-0.9	-0.6	-1.4	-1.7
Employment	-	1.2	1.1	1.5	1.5	1.0
Unemployment rate ⁴	-	4.1	4.3	4.4	4.3	4.3
GDP deflator	-	-0.2	0.0	-0.7	-1.0	-0.3
Consumer price index	-	-0.7	-0.2	0.0	-1.2	-0.5
Core consumer prices	-	-1.0	-0.2	0.1	-0.4	-0.2
Household saving ratio, net ⁵	-	18.7	19.0	18.2	17.7	16.9
Trade balance ⁶	-	10.4	12.1	11.3	10.9	11.3
Current account balance ⁶	-	10.3	11.1	7.3	9.8	9.9
General government fiscal balance ⁶	-	0.2	-0.3	-0.2	-0.3	-0.4
Underlying government fiscal balance ³	-	0.1	0.2	-0.2	0.0	0.1
Underlying government primary fiscal balance ³	-	0.5	0.5	0.0	0.2	0.2
General government gross debt ⁶	-	45.8	46.0	46.2	46.5	46.8
General government net debt ⁶	-	7.1	7.3	7.4	7.7	8.0
Three-month money market rate, average	-	0.1	0.0	0.0	-0.8	-0.7
Ten-year government bond yield, average	-	0.6	0.9	0.7	0.0	0.1

1. Contributions to changes in real GDP, actual amount in the first column.

2. On 30 September 2014 the Swiss authorities published revised figures for the national accounts in compliance with ESA 2010. Revised export and import data now include non-monetary gold and merchanting, which are more volatile. Together with valuables, they accounted for nearly half of exports in 2013-14.

3. As a percentage of potential GDP.

4. As a percentage of the labour force.

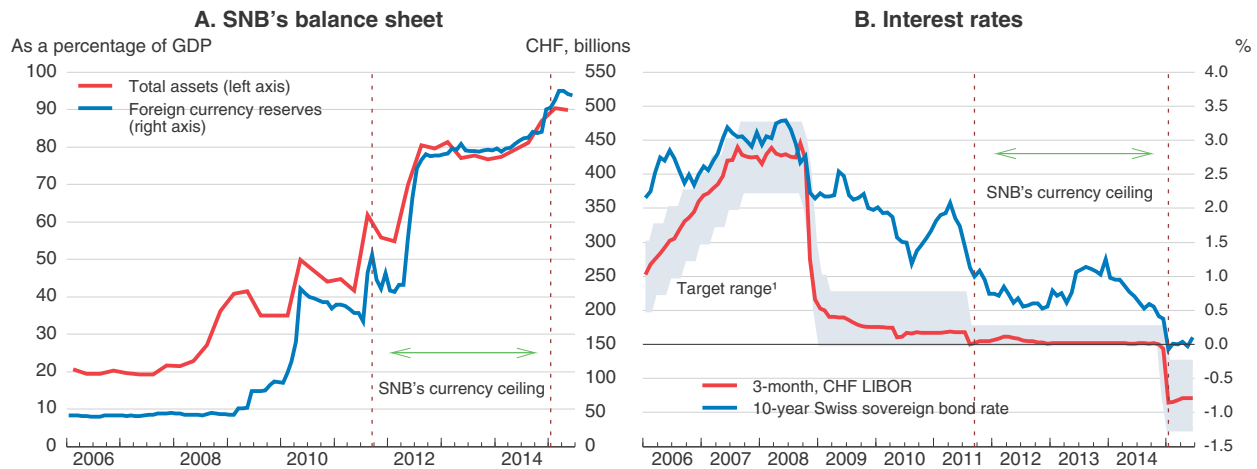
5. As a percentage of household disposable income.

6. As a percentage of GDP.

Source: OECD Economic Outlook 97 Database (and updates).


Monetary policy has been expansionary, with near-zero policy rates since 2009 and the currency ceiling against the euro between mid-2011 and the beginning of 2015, and more recently, negative interest rates. That said, given persistent negative inflation, real policy rates have not been as expansionary as nominal rates would suggest. In late 2014, to defend the currency ceiling the SNB had to intervene again in foreign exchange markets resulting in rapid reserve accumulation and SNB balance-sheet expansion (Figure 5, Panel A). In December 2014 foreign currency reserves jumped almost 7% (5% of GDP) due to interventions and significant valuation effects. Given the expected divergence in the trajectories of monetary policy between the United States and euro area, the exchange rate ceiling was deemed to be unsustainable and was abandoned in January 2015. Simultaneously the SNB cut rates further, charging 0.75% on all deposits with it that exceed a specific exemption threshold (Figure 5, Panel B). For domestic banks the threshold currently corresponds to 20 times the minimum reserve requirement and is adjusted to the amount of cash held. For other account holders the threshold is CHF 10 million.

Figure 5. **Monetary policy has been stimulative**



1. The SNB implements its monetary policy by fixing a target range for the three-month Swiss franc Libor. The Libor is a reference interest rate in the interbank market for unsecured loans. It is a trimmed mean of the rates charged by 11 leading banks and is published daily by the International Commodities Exchange (ICE).

Source: Swiss National Bank, *Monthly Statistical Bulletin* and *Monthly Bulletin of Banking Statistics*, August 2015; and OECD *Economic Outlook 97 Database* (and updates).

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Given the long period of very low or negative inflation, such expansionary policy is appropriate. However, the unintended consequences of negative interest rates are becoming more evident. For example, pension funds that were already finding it difficult to reach their legal target returns on portfolios are struggling even more. While negative interest rates could make real estate investment even more attractive and thus risk cancelling out the effect of recent macro-prudential measures (see below), mortgages rates have not fully reflected the change in the policy rate. Negative or very low positive rates may also lead to low-quality investment in other assets. Furthermore, at some point, individuals and institutions may respond by holding cash rather than bank deposits (a “rush to cash”) even though there have been few signs of this as yet. The SNB should evaluate how low interest rates can go and for how long.

Immediately after the exchange rate ceiling was abandoned in January 2015, the Swiss franc appreciated dramatically against the euro but then settled at around 1.05 which constituted a 12.5% appreciation. Since September the franc has weakened to around 1.09 to the euro as volatility in markets declined, safe haven effects abated and the interest rate differential effect became important (Figure 3, Panel B).

Fiscal policy remains broadly neutral. Due to lower-than-expected revenues from direct taxes, a federal deficit emerged in 2014 for the first time since 2005, though the general government remained in small surplus. Federal government gross debt is only 45% of GDP and there is room under the debt break. Therefore, the automatic stabilisers should be allowed to play fully as the economy absorbs the exchange rate shock.

Stability of the financial sector

The banking sector is large relative to GDP and is dominated by two big banks, UBS and Credit Suisse, which together hold approximately half of all banking assets. The 2012 *Survey* included a special chapter on the financial system and made a number of recommendations to reduce the risks that the sector poses to the broader economy. Since then progress has been steady. In the past couple of years the two big banks have improved their capital position and now meet most requirements of the Swiss “too-big-to-fail” regulations and the international Basel III framework, both of which will apply fully from 2019. Given perceptions of continuing risks, prudential requirements are currently being reviewed by both domestic authorities and international bodies which may result in more stringent requirements.

Risks to financial stability remain, however. The two big banks must remain well capitalised, among others to withstand a downturn in real estate prices (see below) as well as other more general risks, both domestic and foreign in origin such as those related to exchange rate volatility. However, while their risk-weighted asset ratios and leverage ratios are at or above target, the latter are below average in international comparison. Given the ultra-low interest rates, increased imbalances in real estate markets now appear more likely, as such investment has become increasingly attractive for investors, further exposing banks to the sector. Already at the end of 2014, UBS and Credit Suisse had domestic loans outstanding totalling CHF 323 billion, 82% of which in the form of mortgage loans (SNB, 2015). At the same time, negative interest rates, the end of banking secrecy and meeting domestic and international regulatory requirements, are likely to weigh on revenues. Swiss authorities are currently considering higher leverage ratios for the bigger banks.

Growth is expected to recover in 2016

After contracting in the first quarter of 2015, reflecting the impact of the exchange rate appreciation, activity rebounded already in the second quarter on the back of solid consumption and investment growth and a rebound in goods and services exports. The discontinuation of the ceiling on the Swiss franc (on January 15 this year) is therefore having a limited impact on the economy so far. Annual growth is projected to reach 0.7% for 2015 and accelerate to 1.1% in 2016 (Table 1). Higher real wage gains, lower oil prices and ultra-low interest rates will support consumption in the coming quarters. Rising growth in the EU should also help the export sector offset part of the negative competitiveness effect of the appreciation. The partial reversal of the currency appreciation in recent months will also support the economy moving forward.

Developments in the rest of Europe (including the repercussions from the current refugee crisis) and ripples from the slowdown in China and weakness in other emerging markets could once again affect the exchange rate (up or down) and could change the short-term outlook significantly. In particular, a further appreciation following renewed concerns about the euro area, or geopolitical tensions, could harm growth prospects and extend the duration of negative inflation. With interest rates so negative, sustained housing investment increases could also fuel overheating concerns, especially given the high level of household indebtedness and banks' exposure to the mortgage market (see below). The negative implications of the implementation of the popular initiative against mass immigration, including the possible abrogation of the associated treaties with the European Union, may be significant.

Recommendation for macroeconomic policies

- Retain the debt brake, but allow the automatic stabilisers to operate fully.

Boosting medium-term growth prospects

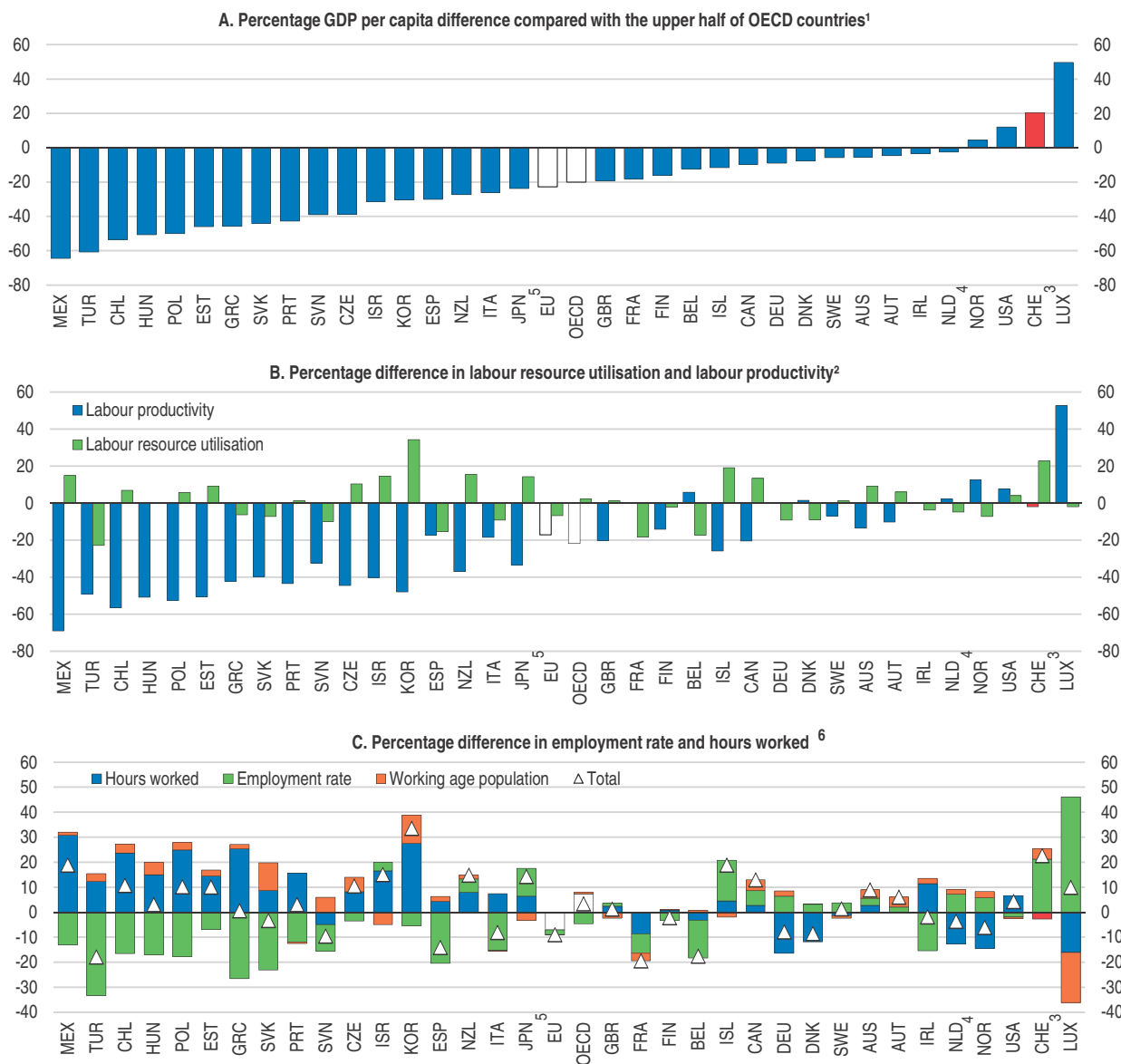
The level of per capita GDP in Switzerland is above the OECD average (Figure 6, Panel A), but rather than being underpinned by superior levels of labour productivity, it is high labour utilisation that is responsible (Panel B). The labour force participation rate is 84%, unemployment is low (4.5% in 2014) and the proportion of the working-age population in work is high (80%). With the possibility that immigration will be curtailed in 2017 and demographic ageing, the focus of economic policy needs to shift more to promoting productivity growth, exploiting remaining underutilised labour resources, including women (who participate in the labour market but tend to work only part-time), improving educational outcomes and better integrating first- and second-generation immigrants. The business environment could also be improved, particularly by reducing regulatory burdens. Some sectors of the economy could be more exposed to competition, including the telecommunications and agricultural sectors. Challenges posed by climate change need to be tackled, including those posed by the transition out of nuclear power to renewable sources of energy (as discussed in detail in the previous *Survey*).

Productivity issues

Real wages have risen sharply over the past several years, squeezing firms' profits (Figure 7). In contrast, labour productivity per hour, which is comparatively high in level terms, has been relatively stagnant. Part of this disappointing productivity performance may be related to the rising share of low-productivity sectors in job creation: public and semi-public employment was up 25% between 2003 and 2013, versus overall gains of 15%.


As discussed in the previous *Survey*, a number of OECD countries, including Australia, Chile, Denmark, Mexico, and New Zealand have productivity commissions that act as review and advisory bodies on microeconomic policy reform and regulation, with the aim of achieving better informed and motivated policy decisions through independent, published analysis and advice. However, Switzerland already relies heavily on expert commissions and other public consultation exercises and establishing such an independent body may be problematic given the political framework. A report entitled

Figure 6. **GDP per capita is one of the highest in the OECD due to high labour resource utilisation, 2013**



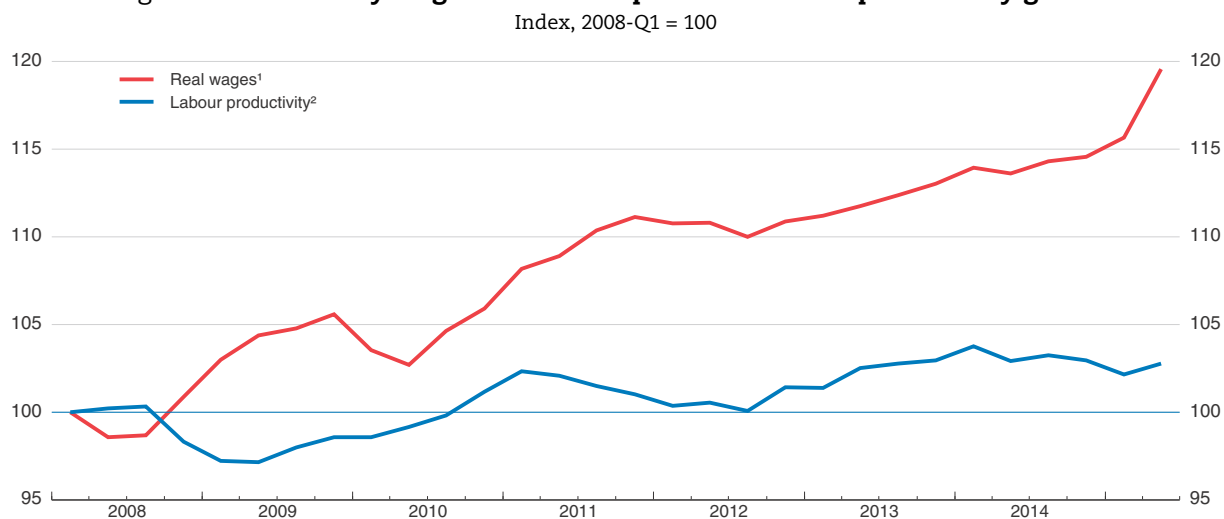
1. Compared to the simple average of the 17 OECD countries with highest GDP per capita in 2013 based on 2013 purchasing power parities (PPPs). The sum of the percentage difference in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita difference since the decomposition is multiplicative.
2. Labour productivity is measured as GDP per hour worked. Labour resource utilisation is measured as the total number of hours worked per capita.
3. In the case of Luxembourg, the population is augmented by the number of cross-border workers in order to take into account their contribution to GDP.
4. Data refer to GDP for mainland Norway which excludes petroleum production and shipping. While total GDP overestimates the sustainable income potential, mainland GDP slightly underestimates it since returns on the financial assets held by the petroleum fund abroad are not included.
5. Average of European Union countries in the OECD.
6. Employment rate is measured as total number of employed people divided by working-age population. Hours worked are measured as total number of hours worked per employed person. Working-age population is measured as working-age population divided by total population. The total of the three components is not exactly equal to labour resource utilisation as presented in panel B since the decomposition is multiplicative.

Source: OECD, *Going for Growth* 2015.

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“Principles for a New Growth Policy” was published by the government in January 2015 – the fourth in a series of quadrennial studies on productivity and other economic challenges (SECO, 2015). Examination of productivity issues should be institutionalised to better focus policymaking on raising productivity.


Figure 7. **Real hourly wages have decoupled from labour productivity growth**



1. Deflated by PPI.

2. Productivity measured using hours worked.

Source: OECD, *Economic Outlook 97 Database* (and updates).

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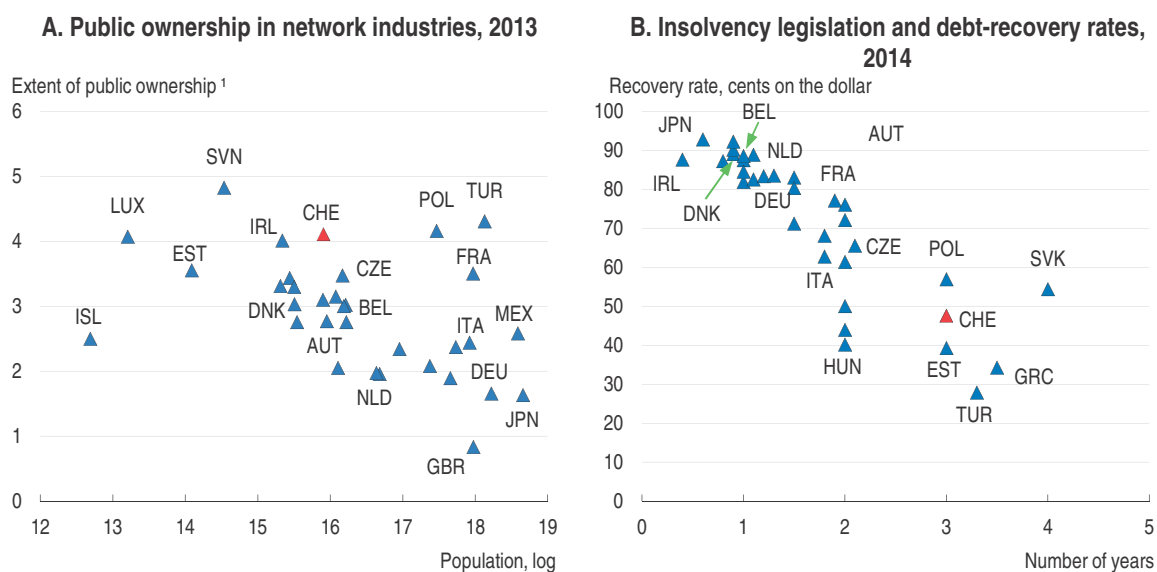
The latest tranche of reforms to the corporate tax system (Corporate Tax Reform III), currently before parliament, appropriately seek to strengthen Switzerland’s competitiveness as a business location and includes measures such as introducing patent boxes (see below). Implementation needs to be expedited as delays are adding to business uncertainty. More could also be done to improve the regulatory environment, including by allowing businesses to compete even in segments of the economy heretofore considered the preserve of the public sector. This includes electricity generation and transmission, telecoms and postal services. Moreover, greater competition could be promoted by opening up sectors such as agriculture, public health, public procurement and protected professions, all of which have been insulated from competition. Previous *Surveys* have discussed these issues in detail.

While Switzerland performs at around the OECD average in terms of the restrictiveness of its product market regulation, the 2013 index shows that it ranks poorly in the domain of state control – 28th out of 33. Switzerland’s mobile telecommunications sector remains the most concentrated of the 24 OECD countries studied by Sung (2014). While provision of utilities is more costly in a small economy like Switzerland, the stringency of the regulation of ownership in these sectors is well above that of other similarly sized countries such as Austria (Figure 8, Panel A). Rules that favour public ownership are particularly rigid in post, telecoms and energy. For instance, Swisscom, which enjoys a 59% market share in mobile communications (the second highest market share for a single telecoms company in the OECD) and 70% of fixed line market, is legally limited to a maximum outside ownership of 49.9% (Swisscom, 2014; OECD, 2013b).

Swisscom is 51% owned by the Swiss Confederation and the government continues to define the company's strategic goals including universal service obligations. In June 2007, the Communication Commission (ComCom) designated Swisscom as a Universal Service Provider thereby obliging the company to provide universal services nationwide for the period 2008 to 2017. The public control of Swisscom raises questions of governance and potential conflicts of interest, and an unfairly lower cost of capital given that it might be seen that Swisscom enjoys an implicit government guarantee (Standard and Poor's, 2015; Moody's, 2012). More needs to be done to increase competition in the critical telecoms and energy sectors, including going ahead with the privatisation of Swisscom.


Increasing the efficiency of the business insolvency regime could further facilitate structural change, thereby directing economic resources away from shrinking and toward emerging sectors (OECD, 2015b). Switzerland ranks rather poorly in terms of debt-recovery rates and the average time it takes to settle insolvencies (Figure 8, Panel B). That said, a number of recent reforms have made resolving insolvencies easier. This included introducing a moratorium period while the debtor is preparing a reorganisation agreement. Nevertheless, the authorities should make greater efforts to streamline insolvency procedures by reducing the time required to implement an insolvency or restructure, and to lift recovery rates.

Figure 8. **Public ownership of telecommunications and utilities, and insolvency in the OECD**



1. Index scale of 0 to 6, from lower to higher levels of public ownership.

Source: OECD Product Market Regulation Database; OECD National Accounts Database; and World Bank Doing Business Database.

StatLink  <http://dx.doi.org/10.1787/888933292360>

Services trade leads to the exchange of ideas and technology and helps firms to exploit potential scale economies (by, for example, participating in global value chains), thereby lowering costs and boosting competitiveness. However, Switzerland's services trade regime is relatively restrictive. The Services Trade Restrictiveness Index (STRI) shows that Swiss trade and investment barriers and domestic regulations impede trade in many services sectors. Switzerland's STRI is above the OECD average in 13 of the 17 sectors for which data are available and is particularly restrictive in accounting, legal, broadcasting, courier and computer services.

As noted in the 2011 *Survey*, the Swiss tax system is heavily geared towards the taxation of household income, which is more harmful to economic activity than taxation of consumption, which is low in Switzerland. In addition, complexities related to the many VAT exemptions are burdensome for businesses and should be removed by moving to a single VAT rate. Options to apply the VAT to financial services should also be explored in order to avoid favourable treatment of this sector. As part of plans to better fund the first pillar of the pension system, the Parliament is discussing an increase of the VAT rate.

As discussed in the previous *Survey*, significant productivity gains could be made in the agricultural sector. As an illustration, if the surplus labour could be shifted to the rest of the economy, the output of the whole economy could rise by nearly 3% if used according to best practice, or more than 1% if only an average level of relative productivity is assumed (OECD, 2012). While the shift from price support to direct payments has reduced distortions in agriculture, direct payments still represent nearly two-thirds of the agricultural contribution (0.7%) to the Swiss GDP (648 billion CHF), leaving just one third from valued-added. Barriers to trade also weigh on production efficiency, with tariff protection averaging 32% for agricultural products, versus 1.4% in Australia and 9% in the United States (WTO, 2013, 2014 and 2015). Spending efficiency could be raised by making some of the general direct payment conditional on implementing productivity-enhancing methods and on increasing the share of revenues coming from market activities.

Demographic issues

In recent years the Agreement on the Free Movement of Persons with the EU, which entered into force in 2002, has allowed strong inflows of high-skilled migrants, many coming from Germany (Box 1). But this growth model based on strong employment increases and correspondingly weak productivity gains is now jeopardised by the passing of the February 2014 public initiative against “mass immigration”.

Medium-term growth prospects could be boosted by better utilising female labour resources. As pointed out in the last *Survey*, Swiss women have one of the highest participation rates in the OECD, but also one of the lowest levels of average hours worked (OECD, 2013c). The lack and high cost of childcare options, as well as burdensome marginal income tax rates, create disincentives to work more. It is also unhelpful for women wishing to start businesses or take up leadership positions in companies. In addition, with comparable qualifications and experience, men still get paid 7% more than women for the same job. Removing those distortions and boosting the supply of childcare could boost female labour supply. Given that young Swiss women are now on average more educated than their male counterparts, it could also boost productivity.

Climate change issues

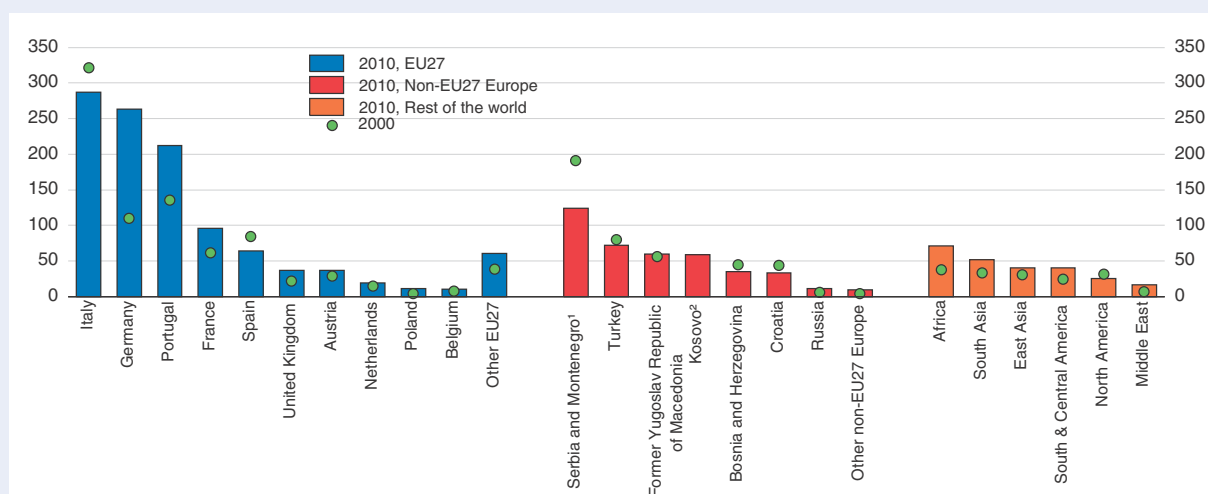
Switzerland has low greenhouse gas (GHG) emissions per capita compared to other countries, which reflects its strong reliance on low-emissions energy sources, especially nuclear and hydroelectricity, and its lack of heavy industry. GHG emissions have remained almost unchanged since 1990, as increases from the transport sector have been offset by reductions in the residential and industrial sectors (Figure 10). Because of technical progress, the average CO₂ emitted by new passenger cars fell by one third between 1996 and 2013 (FSO, 2014), but this was offset by higher transport volumes so that emissions from passenger cars actually rose slightly. In 2013, transport accounted for 31% of emissions, ahead of industry (22%) and buildings (29%; 20% from housing).

Box 1. The popular initiative against mass immigration

Switzerland has relied heavily on foreign labour for many decades. Traditionally this has been seasonal and unskilled labour in the construction and tourism sectors, but more recently skilled workers have also been attracted to Switzerland. Currently, annual net migration and the stock of foreign-born residents represent 0.9% and 28% of the population respectively, both among the highest rates in the OECD. In 2010, 63% of foreign-born residents were from EU27 countries, up from 58% in 2000, with lower numbers from Italy and Spain offset by increases from Germany and Portugal (Figure 9). This large inflow of migrants into Switzerland from EU countries was facilitated by the Agreement on the Free Movement of Persons, which came into force in mid-2002. The right of free movement is complemented by the mutual recognition of professional qualifications, by the right to buy property and by the co-ordination of social security systems. The same rules also apply to citizens of EFTA member states.

Figure 9. Foreign-born population by origin, 2000 and 2010

Thousands



1. The 2010 data are aggregate data from Montenegro and Serbia.

2. 2000 data for Kosovo unavailable.

Source: Swiss Federal Statistical Office.

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On 9 February 2014, a vote on a popular initiative (the “Mass Immigration Initiative”) aimed at restricting immigration was passed by a narrow margin. The initiative mandates the re-introduction of quotas for almost all immigration categories and imposes limits on foreigners’ ability to bring their family members to live in Switzerland, to access Swiss social security benefits and to request asylum. The deadline for implementing this is 2017. When implemented and if re-negotiation with the EU fails, the 1999 Agreement on the Free Movement of Persons with the EU might be abrogated. This agreement forms part of a package of seven co-dependent treaties (the “Bilateral I” package) that also deal with technical obstacles to trade, public procurement, agriculture, research, civil aviation and overland transport. All seven expire if any one of them is abrogated (the “Guillotine Rule”). Because the EU is Switzerland’s largest trading partner and a source of skilled migration, this poses a serious risk to the Swiss economy. In July 2014 the EU turned down a request from the Swiss government for a renegotiation of the treaties. However, negotiations with the EU are ongoing with regards to the legislative implementation of the referendum. In November 2014 a popular initiative aimed at reversing the “Mass Immigration Initiative” got underway, but this process can take up to three and a half years.

Recommendations for boosting productivity and medium-term growth

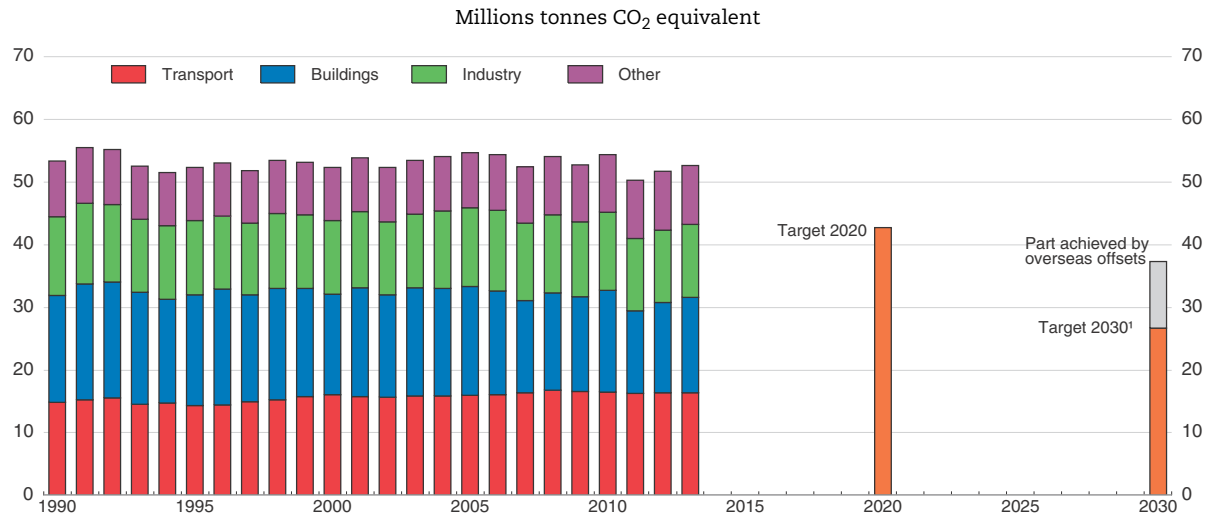
Key recommendations

- Increase competition in the telecoms and energy sectors, including privatising Swisscom.
- Push forward with reforms in the agricultural sector.
- Focus economic policy on measures increasing productivity growth.
- Extend the network of free-trade agreements, including with India and the United States.
- Take measures to promote more intensive participation of women in the work force such as by increasing the supply of childcare facilities and introducing individual as opposed to family taxation.

Other recommendations


- Move to a single VAT rate with as few exemptions as possible.
- Streamline insolvency procedures to facilitate more efficient business adjustment to structural change.

Figure 10. GHG emissions by sector and targets in Switzerland



1. The target of 50% below the 1990 levels by 2030 stipulates that at least 30% be achieved domestically, and the remainder achieved by overseas offsets.

Source: Swiss Federal Office for the Environment (FOEN).

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Given Switzerland's already low emissions levels, its estimated marginal abatement costs are relatively high, and so meeting its 2020 target of a 20% emissions reduction below the 1990 level will not be easy. The bulk of the emission cuts are expected to come from buildings. One of the main measures is a CO₂ levy on thermal fuels (heating oil and natural gas), the revenues of which are redistributed to the households and the business community. One third (max. CHF 300 million) is earmarked for the buildings programme, which promotes refurbishments and renewable energies and CHF 25 million per year go to a technology fund. CO₂ intensive industries are exempt from the CO₂ levy, if they commit to reducing emissions in return. Large installations are covered by an emissions-trading scheme. Measures regarding transport fuels are CO₂ limits for passenger cars and duties on imports of transport fuels.

In February 2015 the government announced that it aims to reduce Switzerland's GHG emissions to 50% of 1990 levels by 2030, with at least 30% achieved domestically and the rest through purchasing foreign offsets. In order to meet these targets, in addition to what is already planned, more cost-effective initiatives will be needed. Implicit tax rates vary widely across sectors. Taking into account the mineral oil tax, they seem particularly high for transport (though with some exemptions for off-road and public transport), but are not explicitly a CO₂ levy. Depending on the valuation of the non-CO₂ external costs of transport, cost-effective emissions reduction may need much higher taxation on emissions outside transport, even though transport emissions are rising fast. This could be combined with the introduction of a variable congestion charge that would be higher in geographic areas under stress and during peak demand periods to help deal with other external costs of increasing use of road transport.

The use of subsidies and feed-in tariffs (FIT) may not be the best way to encourage the switch to renewable energy sources. The FIT scheme, introduced in 2009, pays producers higher prices over a period of 20 to 25 years and is funded by a levy on all electricity. In 2015 a number of refinements were made to this scheme, including a one-off investment grant for very small producers like households, which will cover up to 30% of the costs of a new installation. However, the cost overhang of the long-term payment commitment inherent in FIT schemes needs to be avoided or at least minimised. Instead of using a FIT, Switzerland should move to solutions that are more responsive to changing market conditions including using tendering in allocating feed-in subsidies and feed-in premiums.

Raising the cost of CO₂ emissions in the household sector is necessary, but the impact can be limited if information is not easily available and the dwelling ownership structure inhibits the incentive effects of price signals. Existing regulations concerning energy-saving renovations of rented dwellings could be better designed, including redefining how costs should be passed on to renters and the compulsory provision of information on the energy efficiency of rental properties (SFOE and SFOH, 2015). Mitigation in the industrial sector would be more cost-effective if the intended linking of the Swiss and the EU emissions trading systems goes ahead; bringing transport fuel (including refineries and importers) into this system would be even more effective. Implicit subsidies to carbon emissions through specific exemptions to the CO₂ levy and other charges should be rationalised.

Recommendations for climate change

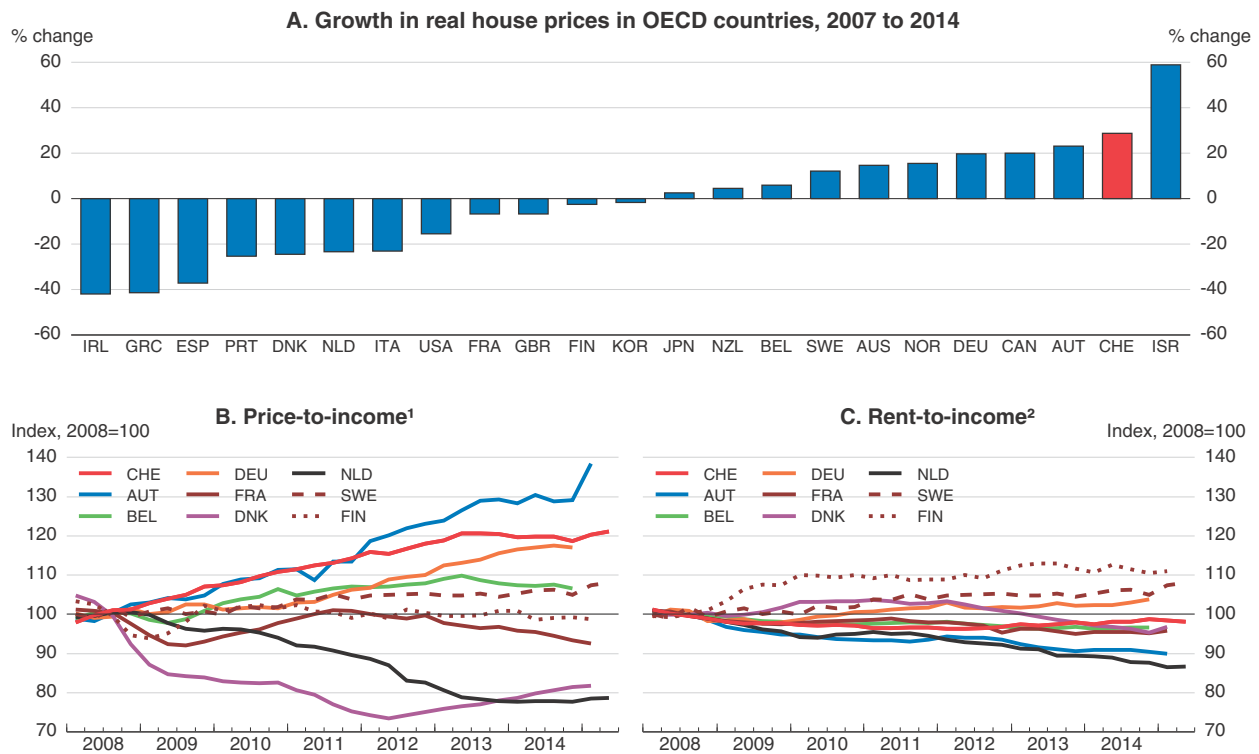
Key recommendations

- Increase the CO₂ levy, and remove exemptions to this and other green taxes
- Move forward with linking the Swiss and the EU emissions trading systems.
- Make greater use of market mechanisms to lower the cost of the transition from nuclear to renewable energy. This includes redesigning the current feed-in tariff scheme.

Policies to tame the housing cycle

By some measures, between 2000 and 2014, the average price of apartments in Switzerland almost doubled, and that of single-family homes rose by around 60%. Price increases have been particularly rapid since 2007. Within the OECD only Israel has had larger real house price increases over this period (Figure 11, Panel A). That said, the current


Figure 11. Real house price and rent indicators



1. Nominal house prices divided by per capita nominal disposable income.

2. Nominal rent prices divided by per capita nominal disposable income.

Source: OECD House Price Database.

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house price cycle has been considerably more modest in amplitude than its two predecessors that ended in 1974 and 1989. This rapid rise in prices is reflected in Switzerland's price-to-income ratio, which has increased more quickly since 2008 than in most neighbouring countries (Panel B), suggesting worsening affordability. In contrast, its rent-to-income ratio has been flat over the past decade, reflecting the role of rent controls (Panel C; see Chapter 2).

In Switzerland, tenant protection from abusive rents is a constitutional right. Apartments that come onto the market for the first time are exempt from rent control and the level of rent is determined by market forces, even though the tenant has recourse to subsequently contest the rent. As soon as the lease has been signed, tenancy law takes over, and the rent can be adjusted for inflation, the reference interest rate and other cost factors. After the contract ends, the owner can raise the rent for the next tenant to the local market level, which can again be disputed, and the landlord has to prove compliance with the law. One of the parameters considered is the rent prevailing in neighbouring residences. In times of high demand for rental apartments, the tenancy laws can lead to market distortions, as market rents increase much faster than ongoing contract rents. Long-term tenants therefore have no incentive to move even if the quality and size of their current apartment surpass their needs. These lock-in effects can prolong housing shortages. One solution would be applying differentiated rent-setting rules when large

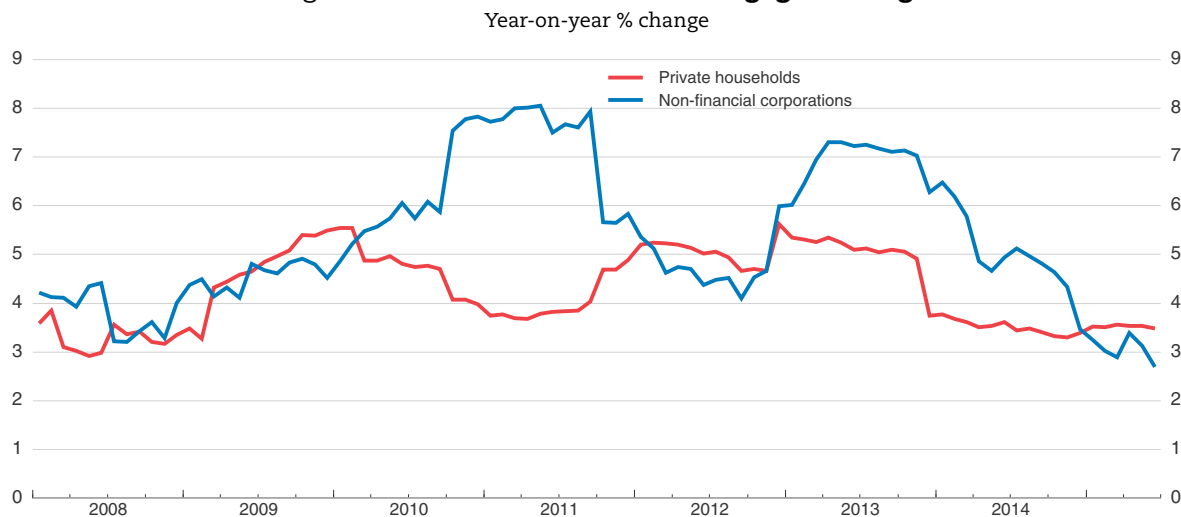
residences are occupied by few people, although such a formula should take into account the ability of low-income households to pay for moving. Moreover, broader deregulation of the tenancy laws would possibly lead to higher rents, harming low-income groups. To support them, targeted housing allowances and/or more social housing would be needed.

Although Swiss households' net wealth is very high, they are among the most indebted in the OECD and have become more so over the past decade. In 2013 gross household debt in Switzerland reached 200% of disposable income, with mortgages making up over 92% of all household financial liabilities. The flipside of highly leveraged households is banks' exposure to the real estate market through mortgage lending. Their exposure is the sixth highest in the OECD, with mortgages on aggregate making up around 84% of all domestic bank loans excluding interbank credit.


The large urban areas like Geneva, Zurich and Basel have experienced the biggest price increases. Indeed, between 2007 and 2014 the price of apartments in Geneva increased by over 70% and those in Zurich by around 50%. Price rises for single-family homes have been more modest and the larger gains concentrated more in the less densely populated urban-satellite cantons such as Zug, Lucerne and Fribourg. Transactions activity has also been robust, with growth in mortgage volumes strongly outpacing income gains.

Since 2010 growth in mortgage lending to non-financial corporations has averaged around 6% per annum while for households it has averaged only 4.5% (Figure 12). While mortgage lending growth to both groups has trailed off substantially since the end of 2012, increases in mortgage lending to both remains above long-term historical averages. This mirrors what happened during the late-1980s housing boom and subsequent banking crisis in Switzerland, during which non-financial corporations became overextended as the economy slowed and house prices began to fall. Moreover, despite having increased somewhat over the past few years, the private homeownership rate in Switzerland is only around 40%, one of the lowest in the OECD, meaning that investment in rental properties plays an especially prominent role – whether by private individuals, commercial property

Figure 12. **Growth in domestic mortgage lending**



Source: Swiss National Bank, Monthly Statistical Bulletin and Monthly Bulletin of Banking Statistics, August 2015.

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developers or institutional investors such as pension funds and insurance companies. Mortgage lending for the investment property segment should be monitored closely, as it may not be as responsive as households' borrowing to recent regulatory measures designed to rein it in (see below).

House price growth in Switzerland has been underpinned by strong immigration-driven population growth, shrinking household size (averaging 2.3 people in 2013, down from 3.4 in 1960), as well as unprecedentedly low mortgage interest rates, access to pension funds for pledges and down payments, and institutional and other private investors turning to real estate investment as yields on other asset classes have declined.

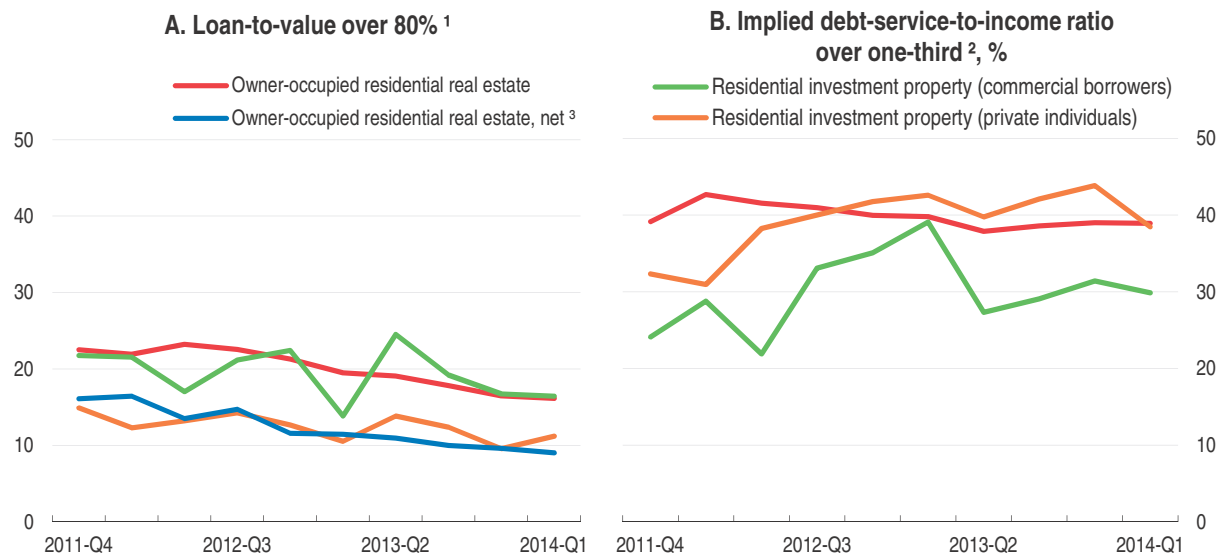
In Switzerland home owners are subject to a tax on imputed rental income, against which mortgage interest and other expenses such as maintenance and insurance costs are deductible. However there is a systematic undervaluation of imputed rent of up to 30-40% across the most populous cantons (Bourassa and Hoesli, 2010) and maintenance costs are frequently inflated so that in net households often claim a net tax deduction with regards to housing. The system would be made fairer if imputed rent calculations were calculated more frequently to better reflect market values and if limits were imposed on the tax deductibility of mortgage interest so that, combined with maintenance outlays, it does not exceed to the amount of declared imputed rent.

At the same time, the supply of housing in Switzerland has failed to respond to the surge in prices. Andrews et al. (2011) found the supply response to price changes in Switzerland to be the lowest in their sample of 21 OECD countries. The reasons for this muted supply response include the stringency of planning and building regulations, as was discussed in the 2009 Survey. The revised Federal Law on Spatial Planning strongly promotes densification, especially in areas with above-average accessibility by public transport. Cantonal construction laws are currently being reviewed to address conflicts with planning regulations, including those that inhibit densification. Yet the technical capacity of smaller municipalities to administer planning regulation may be curbing activity. In the end it is the owner of the property who decides on such works, and owners may be unaware that there exists a potential for higher density on the property. The capacity for increased densities in existing zones and structures (inner development) should be re-examined, a programme of individual property audits that assess the potential for added-value densification instituted and this information provided to property owners.

Managing risks from the housing market

Switzerland's prudential regulation of its mortgage lenders is a combination of self-regulation by the banks (often under pressure from the authorities) and legal directives. Self-regulation is harmonised across institutions by Swiss Bankers Association (SBA) guidelines, which are approved by the Swiss Financial Market Supervisory Authority (FINMA). In the domain of mortgage financing, SBA guidelines stipulate general rules as well as minimum standards, which are reinforced by legal directives laid down in the Capital Adequacy Ordinance (CAO). Based on the general rules, banks define their internal policies. For instance, internal policies contain guidelines for mortgage lending including that the loan-to-value ratio (LTV) should be around 80% for owner-occupied housing. Current SBA guidelines also cover valuation standards and calculation of a level of sustainable income, while banks' internal policies set the interest rate used in imputing interest payments (SBA, 2014). Nevertheless, LTVs exceed 80% in one in six new mortgages (Figure 13, Panel A).

Figure 13. **Share of new mortgages with high loan-to-value and implied debt-service-to-income ratios**




1. Proportion of new mortgages with LTVs above 80%.

2. Proportion of new mortgages with LTIs where imputed costs would exceed one-third of gross wage or pension income (private properties) or rental income (investment properties), respectively, at an interest rate of 5% as well as 1% for maintenance costs and 1% for amortisation costs.

3. Net figures including pledges from pillar 2 and 3a pension funds.

Source: SNB (2014), *Financial Stability Report 2014*, Zurich.

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While recent self-regulation has concentrated on appropriate LTV ratios, affordability (debt service coverage) is equally if not more important. Banks are free, within the SBA guideline, to set their own policy in this regard. In calculating the debt service coverage, the use of a reference interest rate of 5% is commonly set by internal bank policy, with an additional 1% for maintenance costs and 1% for amortisation costs. Banks typically require that debt service payments not exceed one-third of household gross income. However, they often use a reference interest rate below 5% and are also flexible in other aspects such as which components of household income are included in affordability measures. The SNB survey indicates that in 2014 more than 40% of new mortgages for owner-occupied residences exceeded the one-third debt-service-to-income ratio threshold when applying a 5% interest rate (Figure 13, Panel B).

As to legal directives, a number of measures have been taken by the banks and authorities over the past three years to shore up banks' exposure and to take the heat out of the market. These include minimum standards implemented by SBA guidelines and reinforced by legal directives requiring that down payments comprise at least 10% of the purchase price from a borrower's own funds, and not include pledges or early withdrawals from the second pension pillar. Also, since 2014 amortisation must reach an LTV of two-thirds within 15 years. A counter-cyclical buffer (CCB) was activated at the beginning of 2013, which obliges banks to hold additional common equity Tier 1 capital based on their risk-weighted positions secured by residential real estate in Switzerland. In January 2014 the CCB was increased from 1% to 2%.

While there are signs of cooling, particularly in hotspots like Geneva and Zurich, house prices remain high and the risk to the banking sector elevated. In the light of this, the current range of policy measures should be given time to work. Moreover, the SNB and other regulators should maintain their communications strategy of warning households and investors of the growing risks of borrowing to purchase real estate. However, given the importance of affordability in terms of the exposure of the banking sector to a correction in the housing sector, consideration should be given to establishing a legal framework for explicitly addressing affordability risk, to be used if needed to contain financial stability risks related to imbalances in the housing and mortgage markets.

Recommendations for managing the housing cycle

- Establish a framework for explicitly addressing affordability risk, to be used if needed to contain financial stability risks related to imbalances in the housing and mortgage markets.
- Monitor closely mortgage lending to firms or households for rental properties, which may not be as responsive as the owner-occupied segment to recent regulatory measures.
- Review spatial planning regulations to make it easier to build denser housing.
- Limit the tax deductibility of mortgage interest so that, combined with maintenance outlays, it does not exceed the amount of declared imputed rent. Update the imputed rent calculations more frequently to better reflect market values.

Raising efficiency in public spending

Switzerland scores highly in various public policy outcomes. For instance, it ranked fifth in the 2012 PISA mathematics evaluation and, at 82.9 years, enjoys the second highest life expectancy at birth in Europe (EUROSTAT, 2015). Switzerland also had the OECD's lowest ratio of administrative costs to net revenue collection in 2013 (OECD, 2015c). As the population grows and ages – *Avenir Suisse* (2013) has calculated that the ratio of workers to retirees will fall from 3.8 in 2010 to 2 by 2050 – the country is going to face rising demand for public services and, unless productivity trends improve, downward pressure on revenues. A heavy focus on the efficiency of public expenditure is therefore critical.

The efficiency of public expenditure can be assessed by benchmarking outcomes against inputs in a variety of countries. Such analysis shows that Swiss public spending is indeed effective but not efficient (see Chapter 2). For instance, Germany and Switzerland had about the same score in the 2012 PISA reading assessment, but Switzerland spent 21.4% more per student than Germany.

Making the education system more inclusive and responsive to changes in the labour market

In the OECD's PISA assessments, in most countries pupils who attended early childhood education and care for more than one year achieved significantly better reading outcomes (OECD, 2014c). Thus, raising enrolment in pre-primary education promises high returns. But, as illustrated in the previous *Survey*, Swiss childcare services are both expensive and in short supply. Cantons and municipalities should increase direct public spending on additional early childhood education and care facilities and copy successful childcare voucher systems like those in the Canton of Lucerne.

Fostering access to early childhood education and care may be especially important for native-born children of immigrants. A survey of parents conducted in Basel and its environs showed that children with a migration background have the least opportunity to access facilities provided outside the family, thereby hampering their ability to master an official language early (CSRE, 2014). OECD research suggests that, despite improvements, immigration remains a risk factor for low academic performance which may have long-lasting consequences for individuals as they leave school and enter post-secondary education, training or the labour market (OECD 2012b; OECD, 2015d). At the same time, evidence shows that almost three quarters of the immigrants' under performance at school are to be accounted for by socio-economic determinants (Cattaneo and Wolter, 2015). Recent research also suggests that Switzerland performs relatively well regarding educational achievements of second-generation immigrants (Kunz, 2014).

At around 30%, university dropout rates are high (OECD, 2010b). In particular, baccalaureate graduates from certain cantons are overrepresented in university dropouts across Switzerland, suggesting that the quality of a baccalaureate is lower in these cantons. The impact of the baccalaureate rate in the canton of origin has indeed been shown to significantly increase the risk of dropping out (Wolter et al., 2014). In addition to being unfair and inefficient, this imposes additional costs on the other cantons, which finance the universities, and the Confederation, which funds institutes of technology. One way to address this problem is to set up a bonus-penalty system to encourage such cantons to reduce the number of university dropouts. Another option would be to increase resources for guidance counselling for high school students, in particular with regards to field-of-study choices. The dropout rates are particularly high among some foreign students who pay very low tuition fees by international comparison.

Another trend, although not specific to Switzerland, is the growing demand on the labour market for graduates trained in certain fields including science engineering, health care, and teaching. That demand is not being met by Switzerland's below-average share of tertiary type-A graduates (especially women) in STEM subjects. At the same time, because in many cases (such as health) similar qualifications can be obtained both from professional education and training, which does not require an academic or vocational baccalaureate for regular admission, and universities of applied sciences (UAS), about 30% of employed UAS graduates were in jobs not requiring a university degree. The government should look closely at labour market changes, the skills in need and job mismatches, and this information should be communicated to prospective students including through high school counselling.

Fostering value-based competition and better governance in health care

The Federal Law on Health Insurance requires Swiss residents to purchase basic health insurance, which insurers are required to offer to everyone, regardless of age or medical condition. In the Swiss health system, the cantons are accountable for guaranteeing access to medical services and monitoring that individuals hold basic health insurance. They also take care of disease prevention and health education. Municipalities do what is delegated by cantons, for example providing nursing and home care. As for the Confederation, it is responsible mostly for the regulation of health insurance.

Switzerland's excellent health-care system comes at a price. In 2012 it had the OECD's highest health-care spending per capita in PPP terms. Data envelopment analysis also shows that it is in the bottom quartile of health-care expenditure efficiency (Chapter 2). Some of this

inefficiency stems from excessive fragmentation in the health-care system's structure and governance. It is estimated that, at around CHF 3 billion per year, inadequate co-ordination due to poor governance is the largest of all the system's inefficiency costs (SAAS, 2012). In the absence of a single-payer system, fragmentation in funding is also an issue. As the Swiss people rejected a single-payer public health insurance system by referendum in 2014, improvements will have to be made to the system as it currently operates.

A by-product of the system's fragmentation is an over-supply of health-care services. For instance, a comparatively large number of hospital beds has led to greater use of in-patient services. There are too many regional hospitals that tend to conduct too few operations to be cost effective and up to date with modern treatments and technology. For instance, there are 120 hospitals conducting vascular surgery in Switzerland, versus 8 in the whole of London (*La Tribune de Genève*, 2015). A reduction in their number should be encouraged. Inducing the insured to seek care within a restricted network of providers in exchange for lower insurance premiums ("managed care") would likewise raise efficiency. In any case, over-consultation can be mitigated by "gatekeeping", i.e. requiring patients to be referred by generalists in order to access specialists or hospitals.

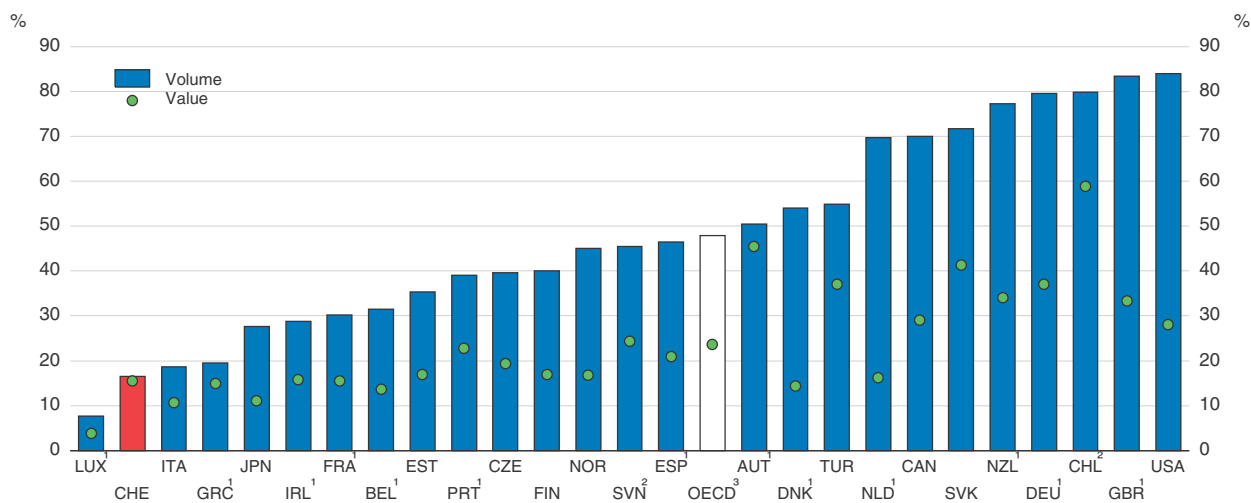
Consumers often have little information about the quality of health-care providers in order to better inform their choices. Similarly, health professionals lack registries publishing the results of specialised treatments. Switzerland would benefit from systematic data collection across the full spectrum of health-care services. Besides the quality indicators published by the Federal Office of Public Health, an organisation called the *Association nationale pour le développement de la qualité dans les hôpitaux et les cliniques* (ANQ) is now responsible for co-ordinating and producing quality indicators at hospitals and clinics. A set of quality indicators for primary care and outpatient activity is still lacking, however.

A dearth of data also hinders the assessment of appropriate base rates charged by hospitals. The payment per case is calculated by multiplying the so-called base rate (which is agreed between insurers and hospitals and approved by cantonal governments) by a coefficient (which is disease-specific yet uniform at the national level). Differences in treatment costs across hospitals are taken into account in the negotiation. If no agreement is reached, administrative tribunals settle the dispute. They recently validated base rates of CHF 10325 in Lucerne, significantly more than the recommended base rate of CHF 8 974 calculated based on exploratory benchmarking in the cantons of Zurich and Thurgovie (Confédération Suisse, 2014). Costs per case rose by 2.5% in 2013 (Interpharma, 2015). More and better information via registries and systematic cost-effectiveness analysis would help benchmark costs per procedure and limit the rise in spending. If rulings by administrative tribunals do not succeed in limiting the upward pressure on base rates, new regulation may be needed to circumscribe the ability of hospitals and insurers to set base rates.

Drugs, which accounted for 9.2% of total health-care costs in 2012, tend to be relatively expensive in Switzerland. Due to the rule for setting their prices, generics in particular are on average nearly three times as expensive as in neighbouring countries. That rule requires that generics be priced, depending on sales volume, at least 10 to 60% below the price of the original patented medicine at the time of its patent expiry. In addition, health insurance reimburses both the generic and the original drug, thereby decreasing the incentive to choose the generic, resulting in overconsumption of branded drugs and a low share of generics by value in international comparison (Figure 14). In order to force prices down, reimbursement should be set to a pre-determined fixed amount, as is done in more than

20 other European countries (Confédération Suisse, 2014). According to Santésuisse (an association of insurers), such measures could save CHF 125 per patient per year, which is CHF 1 billion overall. Reviewing drug prices at least every year (rather than every three years) to better reflect exchange rates would also help.

Figure 14. **Share of generics in the total pharmaceutical market, 2013 (or nearest year)**



1. Reimbursed pharmaceutical market.
 2. Community pharmacy market.
 3. Simple average of the 26 countries with available data.
- Source: OECD, *Health at a Glance 2015*.

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Transport infrastructure is also a good candidate for raising spending efficiency

At recent trends the annual cost of Swiss traffic congestion is estimated to have reached CHF 1 billion, three times as much as in 2000 (OFR, 2013). More efficient use of transport infrastructure would, over the long term, reduce the need to invest in more of it. Congestion could be reduced by charging a higher price at peak traffic times, a system known as peak-load pricing. Electronic tolling station or satellite-based registration could be used for roads and time-based pricing further built into rail transportation. To avoid undesired substitution effects, a comprehensive approach should be adopted. Only once such a pricing system is in place can policymakers see clearly when true infrastructure shortages justify greater investment spending.

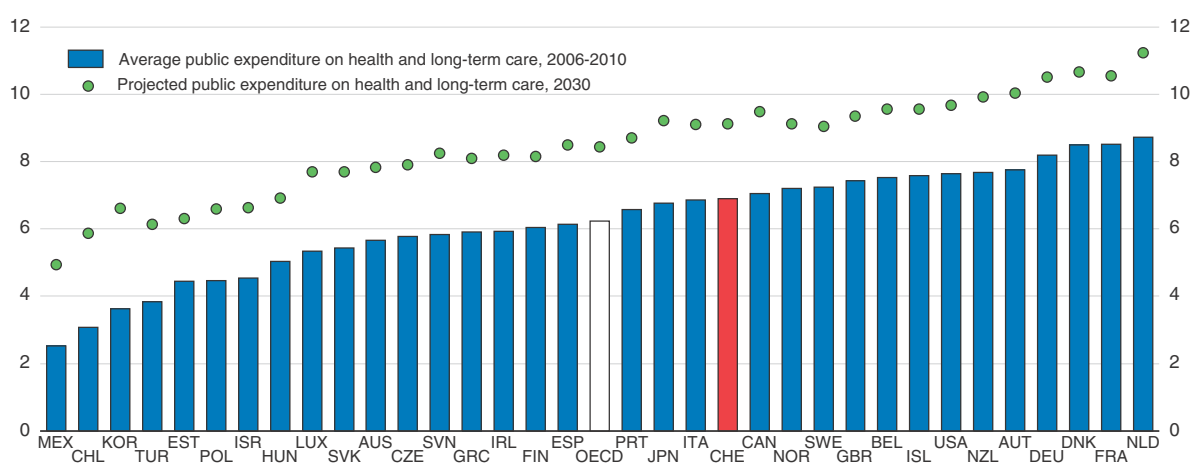
Broadening the use of public tendering

More tendering of public contracts can also boost the efficiency of public spending. Despite liberalisation of the system in the 1990s and the launch of a centralising web-based platform in 2009, outside procurement as a percentage of public spending (23%) is still below the OECD average of 29% (OECD, 2013d). About 20% is carried out by the federal, 35% by the cantonal and 45% by municipal governments. Potential for improving efficiency remains high due to a lack of homogeneity in procedures. A revision of legal frameworks is currently underway and includes an alignment of cantonal and federal legislation with the revised WTO General Procurement Agreement, which came into force in April 2014. This should lead to greater standardisation in procedures and foster fair and transparent competition. Switzerland should implement standardised procedures across all of its jurisdictions.

Addressing rising welfare expenditure

While federal and cantonal debts are back to acceptable levels, the outlook for social security spending is increasingly beholden to demographic forces. The number of workers per pensioner fell from 6.2 in 1950 to 3.8 in 2010. Depending on cost containment scenarios, public health and long-term care expenditures are projected to increase between 1.9 and 2.6 percentage points of GDP by 2030 from about 7% of GDP today (Figure 15). If the 1990-2007 growth rates for social and health-care spending were to continue, they would absorb 70% of all public expenditure in 2030, versus 38% today (économiesuisse, 2012). Such spending risks crowding out other important expenditures.

Figure 15. **Public expenditure on health care is set to increase in the medium term**
As a percentage of GDP



Source: De la Maisonneuve, C. and J. Oliveira Martins (2013), "A Projection Method for Public Health and Long-Term Care Expenditures", OECD Economics Department Working Papers, No. 1048, OECD Publishing.

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In a comprehensive assessment of social security reform, Keuschnigg et al. (2011) find that increasing the retirement age is the most effective means of limiting the negative impact of aging on economic growth and fiscal sustainability. A rise in the VAT came second in terms of effectiveness. A comprehensive pension reform (Prévoyance Vieillesse 2020) is currently being discussed in Parliament. The main proposals are a harmonisation of the retirement age at 65 years, currently 64 for women), an increase in the VAT rate by 1.5 percentage points to fund the first pillar, more flexibility in the transition to retirement, and a decrease from 6.8 to 6% in the rate of return on retirement savings accumulated in the second pillar (the "conversion rate").

Another option is to boost labour supply of older workers by paying higher pensions to people who have worked beyond the normal retirement age. For instance, pensions are raised by 12% in Portugal for every year of additional work, 10.4% in the United Kingdom and 8.4% in Japan. In Switzerland pensions go up only between 5.2% and 6.3% (OECD, 2013a). Incentives for early retirement, especially in the second pillar, ranging from mandatory early retirement to very attractive packages for the most successful employees, should be reduced (OECD, 2014d). In Switzerland, only 665 companies (slightly above 1%) employ staff who are beyond the legal retirement age (*Le Temps*, 2015). Also, on-the-job

training for people aged 55-64 without a university degree is seven times lower than for workers with a degree. Targeted programmes should be developed to raise the skills of older workers without degrees.

Improving fiscal equalisation

Switzerland has a system of fiscal equalisation that uses financial transfers across heterogeneous cantons (totalling CHF 4.5 billion or 0.7% of GDP in 2014) to provide minimum acceptable levels of public services across all cantons. It has two main components: resource equalisation and cost compensation, and there is also a cohesion fund, totalling CHF 366 million, to cushion the effect of recent reforms. Because some cantons have greater revenue potential than others, resource equalisation aims at levelling the playing field in terms of attracting residents and businesses by, for instance, allowing lower-revenue-potential cantons to offer competitive tax rates. However, the current system creates little incentive for less wealthy cantons to raise their resource potential: the equalisation framework operates so that cantons face a corresponding decrease in fiscal transfers, on average equal to 80% of the revenue raised (Conseil Fédéral, 2014). The implicit marginal tax rate of 80% should be reduced. In parallel, putting a smaller weight on firm profits in the calculation of resource potential should foster attractiveness while limiting the rise in revenue potential, as discussed in Corporate Tax Reform III. Cost compensation, by contrast, aims at offsetting higher public service costs due to geographic or demographic features. But the current 50-50 allocation between socio-demographic and topographic factors is detrimental to cities and should be revised by raising the percentage dedicated to the former.

Recommendations for increasing public spending efficiency and improving the fiscal framework

Key recommendations

- Increase public spending on early childhood education and care, especially for children with disadvantaged socio-economic backgrounds (including those from immigrant backgrounds), which could be combined with a generalisation of the childcare voucher system in the Canton of Lucerne.
- Evaluate solutions to reduce the drop-out rate in the university system.
- Boost the supply and attractiveness of fields of study that are in high demand in the labour market. Further clarify study streams across the tertiary education system.
- Switch the system for setting generic drug prices to reimbursing a pre-determined fixed amount.
- Encourage systematic benchmarking of hospital costs. If rates keep rising despite recent reforms, consider new legislation to control them using cost benchmarks.
- Fix the retirement age at 65 for both sexes and thereafter link it to life expectancy. To cut early retirement, reduce existing incentives and pay a larger pension premium for those who choose to work longer.

Other recommendations

- Increase the share of public expenditure allocated via tenders, and harmonise procurement procedures across all levels of government.
- Create incentives for people to join managed-care networks.

Adjusting to international best practice on tax issues, including information exchange

Cantonal tax regimes and ring fencing

For decades special cantonal tax regimes have existed for resident companies that carry on only limited commercial activities within Switzerland, so income of such companies from foreign sources is taxed less than Swiss-source income. Since the entry into force of the 1990 Federal Act on the Harmonization of the Cantonal and Municipal Income Taxes, the cantonal rules applicable to these companies have been harmonised.

In line with Switzerland's commitment to the OECD-G20 Base Erosion and Profit Shifting (BEPS) Project, which commenced in 2013, and the joint declaration between Switzerland and the EU signed in October 2014, Switzerland undertook to amend the relevant features of its corporate tax system. The resulting Corporate Tax Reform III package, proposed by the Federal Council to parliament, is a comprehensive set of measures aiming to ensure alignment with the international tax rules, to provide for a competitive tax environment and to ensure the flow of corporate revenues. These aims are to be reached by different measures, such as:

- The existing regimes are to be discontinued. Thus, cantonal tax status as well as administrative practices concerning principal companies and Swiss finance branches will be abrogated.
- A patent box on cantonal level in line with the principles on preferential tax regimes agreed in the OECD – G20 BEPS Project is to be introduced. Additionally, the cantons may implement super-deductions for research and development (R&D) expenditure. While the patent box provides support for the output of the R&D process, the super-deduction for R&D expenditures provide for support for R&D inputs by allowing a deduction of more than 100% of this expenditure.
- Cuts in corporate income tax rates are within each canton's sovereignty.
- The Confederation will support the cantons by increasing their share of federal corporate tax revenues from 17 per cent to 20.5 per cent and an adjustment of the system of financial equalisation.

The reform is expected to be completed by 2017-19 or later, in case of a referendum.

The OECD's Base Erosion and Profit Shifting (BEPS) initiative

International tax arrangements have come under intense scrutiny since the financial crisis. The OECD-G20 BEPS Project undertook to review the international tax system to ensure that the rules align taxation of profits with underlying economic activity and value creation, and increase transparency. Switzerland is popular as a location for registering business intangibles, such as patents, property rights and brands (OECD, 2013c). For this reason, its active engagement in the development of the measures to counter profit shifting is very welcome, as is its adherence to the 2013 Declaration on Base Erosion and Profit Shifting, which recognises the pressing need to address the asymmetries in domestic and international tax rules, and work towards a level-playing field in this area.

The OECD BEPS Action Plan consists of 15 Actions aimed at revising the international tax rules to address the mismatches and loopholes that allow the location of profits to be separated from the underlying economic activity and value creation, which often results in little or no corporate income tax paid by multinational firms (OECD, 2013a). The first seven

deliverables were published in September 2014 and the final reports regarding all actions are to be published in October 2015. The full package of BEPS measures will be finalised at the end of September, and Switzerland should continue to play an active role in working towards a consensus agreement on the package of measures. Looking ahead, it will be important for all countries, including Switzerland, to work quickly to implement the measures agreed to ensure a level playing field. As part of those efforts, Switzerland has recently agreed to participate in the ad hoc group for the negotiation of the multilateral instrument (Action 15 of the BEPS Action Plan), which will allow countries to quickly implement the tax-treaty-related BEPS measures in their existing networks of bilateral tax treaties.

Implementing international standards regarding exchange of information in tax matters

Exchange of information on request

The Global Forum on Transparency and Exchange of Information for Tax Purposes monitors the effective implementation of the internationally agreed standard for the exchange of information (EOI) on request where it is foreseeably relevant to the administration and enforcement of the domestic tax laws of the requesting jurisdiction. Through a two-phase Peer Review process, it assesses compliance with that standard and publishes its reports and overall ratings. Switzerland is an active member of the Global Forum; it is a member of its Steering Group, Peer Review Group and Automatic Exchange of Information Group.

In March 2009, Switzerland committed to the international standard and withdrew its reservation to Article 26 of the OECD Model Tax Convention. The Global Forum's Phase 1 review of Switzerland was finalised and published in 2011. The Phase 1 report concluded that in a number of significant regards, including access to bank information, Switzerland's legal and regulatory framework did not meet the EOI standard. The Phase 1 report concluded that progress to Phase 2 should be conditional on improvements of its legal and regulatory framework, improvements that needed to be evaluated in a supplementary review.

Following changes made to its legal and regulatory framework, Switzerland's request for a Supplementary review was accepted, and it was launched in July 2014. The ensuing report, which was published in March 2015, concluded that Switzerland had met the conditions to progress to Phase 2 review. Switzerland's Phase 2 review will be launched in the fourth quarter of 2015 and is expected to be published by mid-2016. This Phase 2 review will assess Switzerland's implementation of the EOI standard in practice. At that stage, Switzerland will be assigned an overall compliancy rating by the Global Forum.

The Global Forum is also currently involved in a review of its Terms of Reference. The changes will include the requirement for jurisdictions to ensure the availability of beneficial ownership information in line with FATF requirements. All Global Forum member jurisdictions will be reviewed for compliance with the updated Terms of Reference in a second round of reviews during the period 2016-20.

Automatic exchange of information

Alongside the international framework for the EOI on request, in September 2013 the G20 endorsed the OECD proposal for a global Standard for Automatic Exchange of Financial Account Information in Tax Matters (AEOI). This Standard, which was approved by the OECD

in July 2014, requires jurisdictions to automatically exchange financial account information with other jurisdictions on an annual basis. The AEOI Standard sets out the financial institutions required to report such information, the account information to be exchanged, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by these institutions. Importantly, unlike EOI on request, AEOI data is transmitted without recipient countries having to send a specific request.

Switzerland has committed to implementing the new AEOI standard and making the first exchanges under AEOI by September 2018, and is working to pass the necessary laws and put in place the other necessary implementation measures. In November 2014, Switzerland became the 52nd jurisdiction to sign the Multilateral Competent Authority Agreement (MCAA), which is an important tool that will assist Switzerland in undertaking AEOI with its partners. In May 2015, it entered into an agreement with the EU for the automatic exchange of information in accordance with the Standard. In June 2015 the Swiss Federal Council submitted draft implementing legislation to Parliament that also includes legislation to ratify the MCAA and the multilateral Convention for Mutual Administrative Assistance in Tax Matters (the Convention). The Parliament is expected to begin deliberations on the proposed legislation in autumn 2015. The legislative process provides for the possibility of a referendum. By giving effect to the Convention and the MCAA, which are international instruments in which all jurisdictions can participate, Switzerland will be able to exchange financial account information on an automatic basis with a wide range of partner jurisdictions.

Recommendations on international tax issues and information sharing

- Follow the recommendations and participate in the implementation and post-2015 follow-up of the OECD-G20 BEPS Project.
- Address the recommendations made by the Global Forum on Transparency and Exchange of Information for Tax Purposes, and ensure compliance with the Exchange of Information on request standard.
- Prioritise the legislative implementation of automatic exchange of information.

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