Executive summary

Switzerland's recovery has been broadly balanced despite strong appreciation of the Swiss franc. *Capital markets' concerns regarding sovereign debt in several countries have led the Swiss franc to appreciate to record levels. While deteriorating price competitiveness was partially compensated by strong global demand for Swiss goods and services, exports have recently begun to weaken. The SNB has introduced an upper limit on the euro/Swiss franc exchange rate to stop appreciation. While keeping interest rates low for some time is appropriate, unusually low interest rates have boosted mortgage lending and house prices. To avoid building up imbalances, additional macroprudential tools should be introduced.*

Tax reform can reduce incentives to leverage wealth and could increase potential growth. *The tax burden in Switzerland is low in international comparison, mostly reflecting the substantial weight of non-tax compulsory contributions for the health and pension systems managed by private institutions. Shifting from the taxation of personal income to taxation of goods and services by widening the base of the VAT and increasing the standard VAT rate would be growth-enhancing. There is scope for such reform as personal income taxation contributes an unusually large share of tax revenues while taxation of goods and services is low. Such a reform could be accompanied by steps to cushion real income losses for low-income households. Generous provisions allowing the deductibility of interest payments from taxable personal income should be limited as it raises households' incentives to leverage and redistributes income towards wealthy households.*

Implementing the planned reform of the regulation of the biggest two banks will reduce financial risks. *The largest two banks remain highly leveraged, reinforcing the potential risks for taxpayers and the economy. Parliament has approved new legislation which will make substantial progress in addressing these risks. The reform introduces substantially higher risk-based capital requirements and a leverage ratio of about 5%. The two big banks will be required to develop emergency plans to ensure the maintenance of systemically relevant functions in case of a threat of insolvency. Procedures for orderly resolution will require international co-ordination. In this context a more stringent requirement for the leverage ratio and a higher contribution from highest-quality capital would offer substantial benefits for financial stability at little cost to the economy. The SNB should be given powers to set macro-prudential requirements on the banking sector to slow excessive lending growth.*

Meeting greenhouse gas emission reduction targets requires more cost-effective policies. *Greenhouse gas emissions are relatively low in Switzerland, but it may be difficult to meet emission reduction targets with the existing climate policies. Making the policy mix more cost effective could be achieved in three areas. Introducing a carbon price on transport fuels could address CO_2 emissions from road transport, the sector with the largest potential to reduce emissions at low cost in Switzerland. Further improvement of the rental law and revising the use of the CO_2 levy on fossil fuels may help to increase the incentive of home-owners to invest in energy-saving renovations. Switzerland would benefit from linking its emission trading system to the EU scheme, and there is a need to improve the incentives to reduce emissions in the industry sector.*

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