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Making the Tax System
Less Distortive
in Switzerland

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ABSTRACT/RÉSUMÉ

Making the tax system less distortive in Switzerland

The tax burden in Switzerland is low in international comparison, largely reflecting the substantial non-tax compulsory contributions towards the health and pension systems which are managed by private institutions. Taxation of personal income and labour earnings is relatively high, whereas the taxation of consumption is low. Empirical research on OECD economies and on Switzerland specifically indicates that shifting taxation away from personal income towards the taxation of consumption would strengthen incentives to engage in economic activity. The structure of the corporate tax burden could be improved to remove disincentives for small firms to grow. Reducing the generous provisions which allow interest payments to be deducted from taxable personal income would reduce incentives for households to excessively leverage their wealth, with benefits both for financial stability and equity in the tax system. While tax competition among sub-national authorities has reinforced fiscal discipline, adverse side effects on equity could be reduced, including through greater reliance on real estate taxation in municipalities. This Working Paper relates to the 2012 *OECD Economic Survey of Switzerland* (www.oecd.org/eco/surveys/switzerland).

JEL classification codes: H2

Keywords: Switzerland, taxation.

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Réduire les distorsions dues au système fiscal en Suisse

En Suisse, la pression fiscale est faible par comparaison avec les autres pays, ce qui s'explique dans une large mesure par l'importance des contributions obligatoires non fiscales aux systèmes de santé et de retraite qui sont gérés par des institutions privées. L'imposition des revenus des personnes physiques et des rémunérations du travail est relativement élevée, tandis que les impôts sur la consommation sont faibles. Une modification de la structure fiscale qui consisterait à réduire la part des impôts sur le revenu des personnes physiques au profit de celle des impôts sur la consommation renforcerait l'incitation à exercer une activité économique. La structure de l'impôt sur les sociétés pourrait être améliorée afin de supprimer les facteurs qui dissuadent les petites entreprises de se développer. Si l'on réduisait les dispositions avantageuses qui permettent de déduire les versements d'intérêts du revenu imposable des personnes physiques, les ménages seraient moins incités à exercer un effet de levier excessif sur leur patrimoine, ce qui serait bénéfique à la fois pour la stabilité financière et l'équité du système fiscal. Si la concurrence fiscale entre les autorités infranationales a renforcé la discipline fiscale, il serait possible de réduire ses effets collatéraux défavorables sur l'équité, notamment en ayant davantage recours à la fiscalité immobilière dans les communes. Ce Document de travail se rapporte à l'*Étude économique de l'OCDE de la Suisse*, 2012 (www.oecd.org/eco/etudes/suisse).

Classification JEL : H2

Mots clefs : Suisse, fiscalité.

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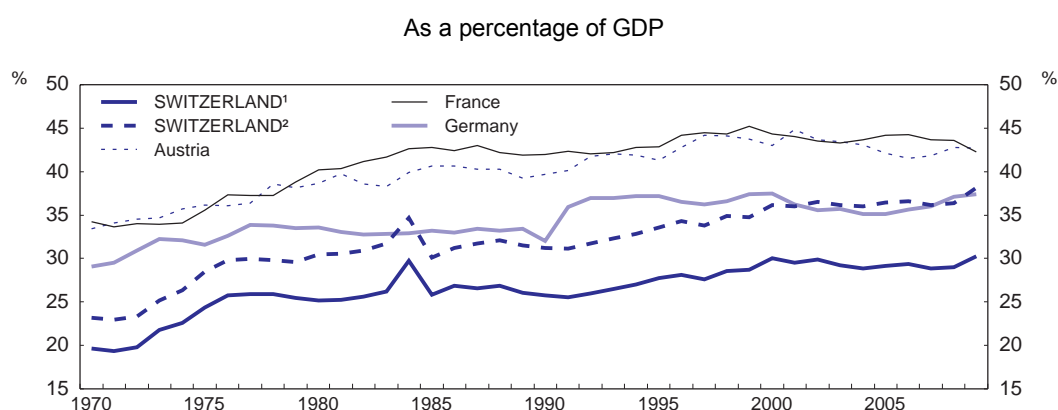
MAKING THE TAX SYSTEM LESS DISTORTIVE IN SWITZERLAND

By Andrés Fuentes¹

The main characteristics of the Swiss tax system

The Swiss tax system has three main features that set it apart from most other OECD countries. *First*, tax revenues and tax burden indicators are very low in comparison to other high income economies. An unusually large share of social services and transfers are financed from compulsory contributions that do not flow to general government but rather to private non-profit organisations. These include a substantial part of pension and most health insurance benefits, which are largely funded from tax revenues in most other OECD countries.² The funded second pillar pension system is managed by employers' and workers' representatives at the firm level. Adding the revenues from compulsory contributions to tax revenues, the total burden is similar to the tax burden in neighbouring high-income European economies and has gradually trended upwards (Figure 1). Empirical evidence indicates that taxation of consumption and real estate are less harmful for economic activity than income tax. In Switzerland taxation is heavily geared towards the taxation of personal income, while the taxation of consumption and real estate are low, as detailed in the following section. Hence, the room for growth-enhancing tax reform is relatively large in Switzerland.

Figure 1. Swiss tax and compulsory contribution revenues in comparison to tax revenues in neighbouring countries



1. Total tax revenue.

2. Total tax revenue plus compulsory 2nd pillar pension, health and accident insurance contributions.

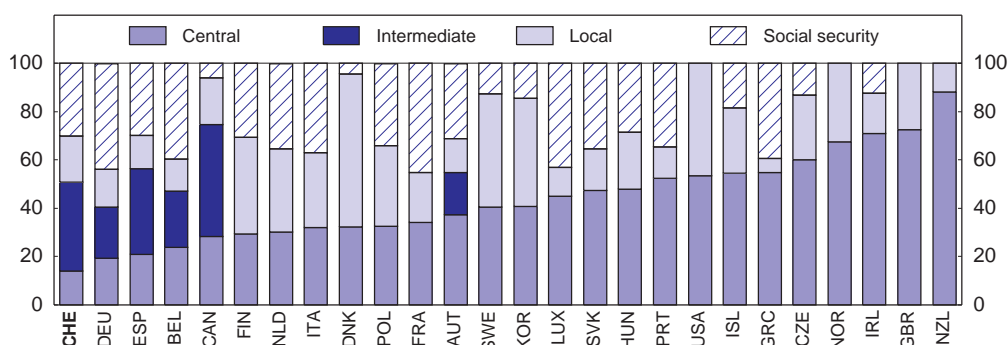
Source: OECD, Revenue statistics 2010; OFAS.

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- This paper is based on the OECD Economic Survey of Switzerland published on 24 January 2012 under the authority of the Economics and Development Review Committee. Special thanks are due to Patrizio Sicari for providing all statistical research and Maartje Michelson for editorial assistance. The author is also indebted to Andrew Dean, Robert Ford and Pierre Beynet as well as to Swiss government officials for helpful comments. All mistakes remain the author's.
 - Compulsory contributions also fund accident insurance and some child benefits. These are also not taxes but are relatively minor.

Second, regional and local governments play a more important role in government finances than in most OECD countries (Figure 2). The cantons obtain most tax revenues from taxes which they set themselves, as transfers from the federal government play a minor role. As Box 1 shows, sub-national governments' tax setting powers are wide-ranging, including in personal income and in corporate taxation, where cantons and the confederation set tax rates. The small size of cantons reinforces the extent of tax competition that their wide-ranging tax setting powers generate. This could generate benefits but also some distortions as discussed later. *Third*, popular votes also play a significant role in tax setting.

Figure 2. Expenditure by level of government

Per cent of total general government expenditure, 2009¹



1. Excluding transfers paid to other levels of government. 2008 data for Korea and New Zealand. In countries where data on regional government spending is not available it is included in local government.

Source: OECD (2010), OECD National Accounts database.

Box 1. Tax setting powers

The Constitution gives **the federal government** the exclusive right to raise a general consumption tax, customs duties, a withholding tax on capital income, and stamp duties on the trading and issuance of securities. Important specific consumption taxes reserved for the federal level include excise duties on tobacco and transport fuel. The constitution also determines that the tax bases on personal income, net wealth and on corporate profits have to be the same across all levels of government. Tax-setting powers are otherwise not constrained at the federal level, although there is no federal wealth tax.

Cantons can freely set taxes except where the constitution assigns this competency to the federal level. They have to tax the common bases fixed in the constitution. Hence, **cantons**, for example, must set taxes on corporate and personal income as well as on personal net wealth, although they can set schedules freely, subject to the requirement not to impose regressive schedules on personal income. Ten cantons set specific taxes on the value of real estate (*impôt foncier*) themselves. In 7 cantons these taxes are set by the cantons and their municipalities jointly. Six cantons do not allow taxes on the value of real estate (Bureau d'information fiscale, 2006). **Municipalities'** tax-setting powers are determined by the cantons. They can typically set personal income tax rates as a surcharge on cantons' taxes so do not change cantonal tax structures. Personal income taxation makes up most of their tax revenues. Municipalities may also contribute to setting wealth taxes in this way. The municipalities in 4 cantons have the exclusive right to set real estate taxes, subject to limits. The municipalities also set some taxes on the purchase of specific goods and services.

The people can legislate, including on tax issues. Increases in the rates of federal taxes are subject to a compulsory nation-wide referendum. A referendum is also carried out if 50 000 signatures are gathered. 6 referenda on tax issues were carried out between 2004 and 2010 at the national level. The most recent popular tax initiative (November 2010), which aimed at harmonizing personal income tax rates on high incomes across the country, was defeated. The latest compulsory referendum (September 2009) approved a temporary increase in VAT rates, with revenues earmarked to fund disability insurance benefits. An earlier proposal of a permanent increase in VAT rates for the same purpose was defeated. Referenda are also quite frequent at the cantonal level. Of 6 referenda conducted in the cantons of Zürich and Bern since 2003, five entailed a reduction of tax burdens.

This paper first analyzes how shifting the tax burden further towards consumption and real estate would encourage activity. This could include introducing a valued-added tax in the financial sector, which would have the benefit of levelling the playing field with other sectors. The paper then examines how taxation could be reformed to reduce incentives towards excessive household leverage, which could increase macro-economic risks and result in costly financial intermediation to minimize tax liability. Finally, the paper analyzes how some adverse side-effects of tax competition on efficiency and equity could be corrected.

Making the tax system more supportive of growth

Shifting taxation from direct to indirect taxes would reduce economic distortions

Shifting the taxation of income to the taxation of consumption may be beneficial for boosting economic activity (Johansson *et al.*, 2008 provide evidence across OECD economies). These benefits may be bigger if personal income taxes are lowered rather than social security contributions, because personal income tax also discourages entrepreneurial activity and investment more broadly.³ Swiss empirical studies estimate a favourable effect on welfare when indirect tax revenues are substituted for personal income tax revenues, whereas results are ambiguous when social security contributions are reduced (Bodmer, 2007).

Direct taxes make up a larger share of overall tax revenues than in most OECD countries (Table 1). This is especially true for personal income taxes. The share of social security contributions, which are levied on payrolls and income of the self-employed, is modest in international comparison. However, the compulsory contributions to the 2nd pillar pension system, which are not included, generate revenues equivalent to about 5 ½ per cent of GDP and are assessed on the same income base as the social security contributions. The compulsory health insurance contributions raise revenues equivalent to about 2 ½ per cent of GDP. In several respects compulsory payments to fund pension and health contributions are well-designed to minimise disincentive effects to engage in economic activity, but some disincentives are unavoidable, especially in the case of contributions to health insurance which tend to be universal, as in Switzerland (see further below).

3. In the case of Switzerland, social security contributions are also assessed on income of the self-employed, so they also may discourage self-employment income. However, the level of social security contributions (which mostly fund pension and unemployment benefits) bears some relationship with the level of benefits received, limiting disincentive effects.

Table.1. Structure of tax revenuePer cent of total revenues, 2009¹

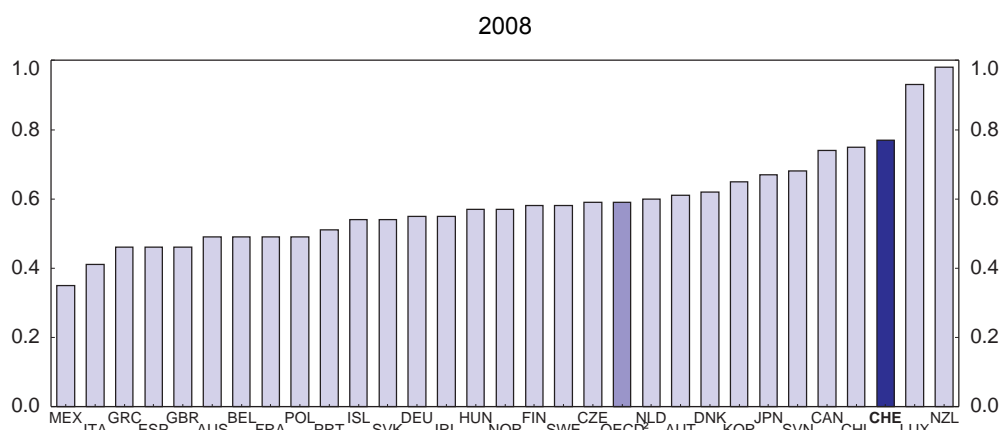
	Personal income tax	Corporate income tax	Social security contributions	Property tax	Goods and services tax
Australia	37.4	18.7	0.0	9.6	29.1
Austria	22.5	4.6	34.5	1.3	28.0
Belgium	28.1	6.2	32.5	6.9	25.4
Canada	35.0	10.7	15.3	11.3	24.4
Chile ²	38.4	0.0	7.0	3.6	51.3
Czech Republic	10.3	9.8	44.7	1.3	33.4
Denmark	50.6	5.7	2.1	4.0	31.7
Estonia	16.0	4.0	38.7	1.1	39.8
Finland	30.0	6.0	29.8	2.7	31.5
France	16.9	4.9	38.8	8.5	25.0
Germany	24.4	4.2	39.1	2.3	29.5
Greece	17.0	8.1	34.6	5.6	37.1
Hungary	17.8	3.3	30.7	3.1	42.8
Iceland	35.5	4.6	11.6	6.8	35.5
Ireland	27.0	9.2	20.3	5.6	36.9
Israel	19.1	9.0	17.2	9.6	40.0
Italy	27.2	6.5	31.5	4.7	25.8
Japan	20.0	9.6	40.9	10.1	19.1
Korea	14.3	13.9	22.8	11.4	33.9
Luxembourg	21.4	14.4	29.6	7.2	27.1
Mexico ²	28.6	0.0	16.7	1.7	50.2
Netherlands	22.8	5.3	36.1	3.9	30.7
New Zealand	37.5	12.4	0.0	6.9	39.3
Norway	23.8	22.6	22.8	2.9	28.0
Poland	14.6	7.2	35.7	3.9	37.0
Portugal	17.9	9.1	28.8	3.8	39.6
Slovak Republic	8.2	9.0	43.3	1.5	36.4
Slovenia	15.2	5.0	40.3	1.6	37.3
Spain	21.7	5.5	37.7	6.1	26.7
Sweden	28.0	7.6	25.0	2.4	29.5
Switzerland	32.3	10.8	23.3	7.4	21.8
Turkey	14.1	7.3	24.5	4.1	47.9
United Kingdom	28.6	8.7	19.1	12.1	30.9
United States	32.1	10.9	26.2	12.9	17.9
OECD³	24.7	8.4	26.6	5.5	32.5

1. 2008 for Australia, Greece, Japan, Netherlands, Poland, Portugal and the OECD aggregate.
2. Data shown in the first column covers both personal and corporate income tax.
3. Unweighted average.

Source: OECD, Revenue statistics database.

Conversely, taxes on consumption of goods and services are low, especially in relation to total tax and compulsory contribution revenue. The OECD VAT revenue ratio is relatively high in international comparison (Figure 3), which indicates a broad tax base and effective tax collection. Nonetheless, several goods and services are subject to exemptions from the VAT (OECD, 2010). Exemptions distort after-tax prices of intermediate goods and services across different final uses, generating dead-weight losses in the whole production chain. Since exemptions preclude the deduction of VAT payments on purchases of intermediate goods and services, they create a cascading effect as the non-deductible tax on inputs is embedded in the subsequent selling price and is not recoverable by taxpayers down the supply chain. Their removal is therefore particularly desirable on efficiency grounds.

Figure 3. VAT revenue ratio¹



1. The VAT revenue ratio (VRR) is defined as the ratio between the actual value added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm. It is calculated as: $VRR = \text{VAT revenue} / ([\text{consumption} - \text{VAT revenue}] \times \text{standard VAT rate})$.
2. Unweighted average excluding Israel, Turkey and the United States.

Source: OECD (2011), Consumption tax trends 2010.

In January 2011 the standard VAT rate was raised marginally, from 7.6 to 8%, for a period of 7 years. The reduced rate for hotel services was raised from 3.6 to 3.8% and the rate for basic goods, notably food, from 2.4 to 2.5%. The additional revenues are earmarked to cover a deficit in the public disability insurance, before ongoing reforms of disability insurance generate sufficient savings and allow disability benefits to be funded without these revenues from 2018 onwards. There is scope for raising the tax rates further and using the revenues to lower personal income taxes. Some steps to lower tax compliance costs permanently were also introduced.⁴ Draft legislation introducing a single tax rate of 6% and abolishing most exemptions and zero rates was rejected by one chamber of parliament in 2009. Recent parliamentary initiatives propose to maintain most exemptions and tax hotel and restaurant services at lower cost. The decision on the reform of VAT is still pending. According to estimations by Bodmer (2007), the simplifications contained in the rejected draft legislation would yield gains of between 0.3 and 0.8% in GDP, in part because administrative costs of business subject to the tax are estimated to fall by 18%. VAT reform should be pursued further, notably to remove exemptions. The introduction of a single rate as originally planned is desirable.

4. These include widening access to the simplified regime for small businesses and facilitating access to the deductibility of VAT payments on intermediate goods and services.

Taxes on environmentally harmful behaviour, notably taxation of transport fuels (see the 2011 OECD *Economic Survey of Switzerland*), are also low. Conversely, property taxes account for a relatively large share of tax revenues. A general wealth tax and taxes on securities transactions, rather than real estate tax, make up the bulk of these revenues (Table 2).

Table 2. Property taxesPer cent of GDP, 2009¹

	Recurrent taxes on immovable property	Taxes on financial and capital transactions	Other ²	Total
United Kingdom	3.4	0.6	0.2	4.2
France	2.5	0.6	0.6	3.6
Canada	3.0	0.2	0.3	3.5
United States	3.1	0.0	0.1	3.2
Israel	2.3	0.5	0.3	3.1
Korea	0.8	1.8	0.3	2.9
Japan	2.1	0.3	0.3	2.7
Luxembourg	0.1	0.4	2.2	2.7
Iceland	1.8	0.4	0.3	2.5
Australia	1.5	1.0	0.0	2.5
Switzerland	0.1	0.5	1.6	2.2
New Zealand	2.1	0.0	0.1	2.2
Italy	0.6	1.1	0.3	2.0
Denmark	1.4	0.3	0.2	1.9
Spain	0.8	0.8	0.3	1.9
OECD³	1.1	0.4	0.3	1.8
Ireland	0.9	0.5	0.2	1.6
Netherlands	0.7	0.5	0.3	1.5
Belgium	0.1	1.0	0.2	1.2
Poland	1.2	0.0	0.0	1.2
Greece	0.2	0.8	0.2	1.2
Portugal	0.6	0.5	0.1	1.2
Norway	0.3	0.2	0.7	1.2
Hungary	0.3	0.3	0.6	1.2
Finland	0.6	0.3	0.3	1.2
Sweden	0.8	0.3	0.0	1.1
Turkey	0.2	0.8	0.1	1.1
Germany	0.5	0.2	0.1	0.8
Chile	0.5	0.2	0.1	0.8
Slovenia	0.5	0.1	0.0	0.6
Austria	0.2	0.3	0.0	0.5
Czech Republic	0.2	0.2	0.0	0.4
Slovak Republic	0.4	0.0	0.0	0.4
Estonia	0.4	0.0	0.0	0.4
Mexico	0.2	0.1	0.0	0.3

1. 2008 for Australia, Mexico, Netherlands, Poland, Portugal and the OECD aggregates.

2. Including wealth and transactions taxes.

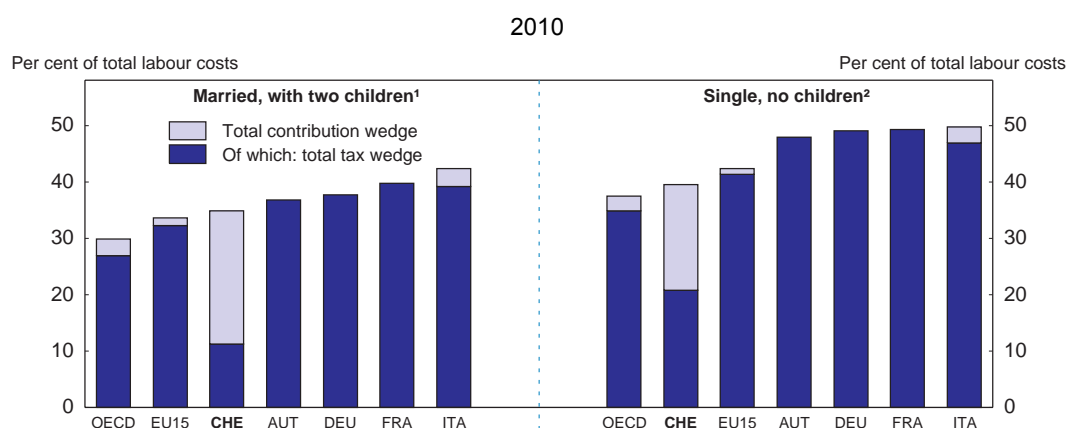
3. Unweighted average.

Source: OECD, Revenue Statistics database.

Reducing the overall contribution wedge on labour

The tax wedge on labour seems low in international comparison. However, once payments to the compulsory 2nd pillar pension and the contributions to the health-care system are taken into account, the total tax and contribution burden on labour is higher than in the OECD average (Figure 4).

Figure 4. Total contribution wedge and total tax wedge by main family-type and wage levels in international comparison



1. With wage level between 100% and 133% of average wage.
2. With wage level equal to 100% of average wage.

Source: OECD, Taxing wages 2010.

A shift from direct to indirect taxation requires steps to compensate households on modest incomes

The federal personal income tax schedule has a marked progressive structure, with modest incomes being subject to zero or low marginal rates. The cantons' personal income taxes tend to be less effective in redistributing income, because incentives to attract high-income earners lower the progressivity of tax schedules and because there is some tendency for high income earners to reside in low-tax cantons (see below). A tax reform which raised federal consumption taxes and lowered federal personal income taxes could therefore raise the tax burden on low-income households. One option to make households on modest incomes benefit from such a reform would be to raise the transfers the federal government pays to low-income households to lower the cost of compulsory health insurance (see Box 2), phasing them out more slowly as personal income rises.

Box 2. Health insurance contributions and support for low income households

The health insurance contributions are fixed as lump sum payments for each insured individual. Their level depends on the canton of residence, the insurer and the co-payment regime chosen (lump sum payments are also lower for children than for adults). The federal and cantonal governments subsidize contributions paid by low-income households with cash transfers, and contributions from households with insufficient income are subsidised in full. The subsidies to these contributions are assessed on a comprehensive measure of income and wealth.⁵ Since the subsidies are withdrawn as income rises, they generate disincentive effects akin to personal income taxation. The withdrawal of these subsidies as household income rises raises effective marginal taxes and pushes them above 100% in some cases (Balthasar *et al.*, 2008).

5. OECD data on the compulsory contribution wedges include information on *premia* for compulsory health insurance but do not incorporate the subsidies to reduce their cost for low-income households.

Redistributive social security benefits could be more fully funded from general tax revenue

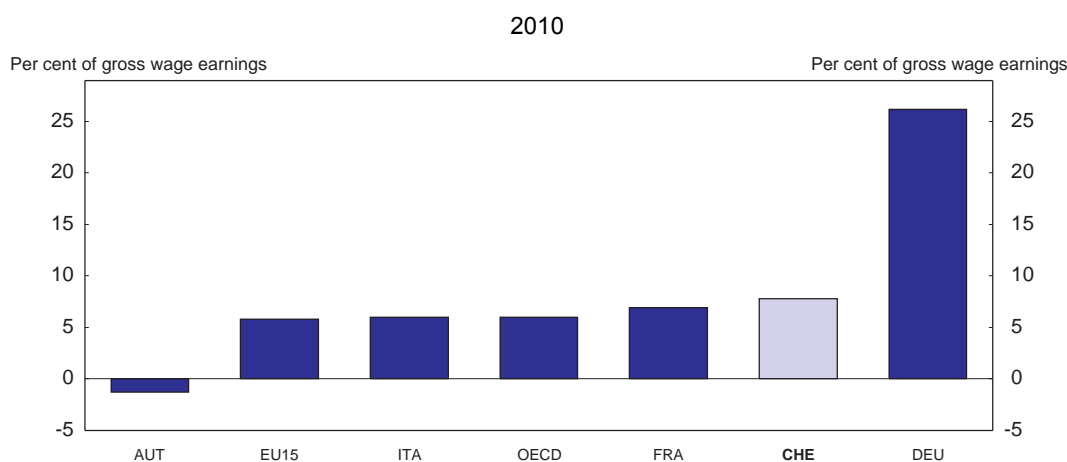
Most social security contributions fund benefits which are earnings-related, notably pension and unemployment insurance benefits. Contributions based on labour earnings are appropriate when benefit entitlements are linked to the level of labour earnings, as in this case such contributions may not be fully perceived as taxes by workers. Contributions to the 2nd pillar pension system bear a close relationship with benefit entitlements. However, some social security benefits redistribute income towards households with low incomes, so are less closely related to contributions. This is particularly true for pension entitlements in the first pillar, which has a marked redistributive component. In particular, within a generation of pensioners, it redistributes income from workers with relatively high average earnings over their active life to workers with relatively low earnings (OECD, 2011a). Funding redistributive transfers to low-income households from general tax revenues improves horizontal equity as it avoids the burden of funding such transfers falling on the assessment base of social security contributions only, which excludes some types of income.

The federal government's budget contributes a fixed share of 19.6% to the funding of pensions and disability benefits from general tax revenue. In addition, 8% of VAT revenues are earmarked to contribute to the pension system. While the extent of such redistribution is difficult to assess, the redistribution of income within the first pillar pension system could be fully financed from tax revenues.

Work incentives for second earners could be improved

One positive aspect of the system of per capita health insurance contributions is that it helps mitigate disincentive effects for second earners to take up work. If the main earner's income is sufficient so that the household does not qualify for subsidy payments, further potential earners have to contribute to the funding of health insurance, regardless of whether they work or not. Hence, potential second earners in households are expected to make a contribution to the funding of health insurance even if they do not engage in economic activity.

While the health insurance contribution system helps preserve incentives for second earners to take up work, the income tax wedge on second earners is higher than on main earners (Figure 5). Moreover this difference is bigger than in some other European countries, despite some measures to widen basic tax allowances for two-earner households introduced in 2008 (see the 2007 Economic Survey). The relatively high tax burden on second earners reflects the joint taxation of the personal income in the federal income tax schedule. Most cantonal tax laws also provide basic income tax allowances for partners even if they do not work which tends to raise the tax burden on the earnings of a working partner relative to the tax burden of the main earner.

Figure 5. Measure of the income tax wedge for the second earner relative to the main earner¹

1. Difference between the tax rate on the earnings of the main earner and the tax rate on the earnings of the secondary earner within married families with two children, assuming wage levels equal to 100% and 67% of AW, respectively.

Source: OECD, Taxing wages 2010.

Higher tax wedges for second earners than for main earners are particularly harmful for economic activity because women respond more elastically to changes in the after-tax wage rate than men. Moreover, the decisions on the taxation of households with multiple earners at one government level affect the tax bases of the other government levels. As a result of these spillovers, there is a risk that such decisions at any one government level do not fully take into account their full effect on the tax base. Taxing each wage earner within a household equally, for example by introducing separate assessment for income tax purposes, has significant economic benefits. There is also a case for harmonising the rules governing taxation of households with multiple earners across government levels, thereby introducing separate assessment of each household member throughout.

Leveling the playing field between financial services and other sectors

Transactions of equity and debt securities intermediated by Swiss financial companies are subject to a tax of 0.15% on domestic securities and 0.3% on foreign securities, although numerous exemptions apply. This tax raises revenues of 0.3% of GDP. Since few countries impose taxes on such transactions, they create a competitive disadvantage for such trade to be carried out in Switzerland and for securities markets to develop. They raise capital costs especially for those Swiss businesses which cannot easily substitute foreign issuance for domestic issuance. On the other hand, they allow the government to exploit the comparative advantage of Switzerland in the provision of financial services for the purpose of generating tax revenues. The Swiss government is evaluating whether to abolish this transaction tax as well as options to make up for the revenue shortfall.

As in other OECD countries, banking services are exempt from VAT.⁶ Taxation of financial services is desirable in order to align the tax treatment of banks with other sectors which are subject to VAT and broaden the base of taxation. Subjecting banks to VAT would remove distortions, which result from the taxation of intermediate goods and services used as inputs (as in other exempt sectors, see above). As argued by the IMF (2010, and references therein, *e.g.* Huizinga, 2002), it is possible to include all services

6. Insurance services are also exempt from VAT. Taxes on specific insurance transaction appear to provide a close substitute and are not subject to the pitfalls of other financial transaction taxes which are discussed below. See Bühler *et al.* (2011).

provided by financial intermediaries into the VAT regime, although no country does so in practice. This could be achieved by treating all financial inflows as taxable sales and all outflows as tax-deductible. The government is evaluating whether to charge VAT on commission income in order to offset part of the revenue loss from abolishing the transactions tax (Bühler *et al.*, 2011). However VAT on commission income alone creates compliance costs and may yield little revenue, as similar transactions can be remunerated on a commission basis or on a margin basis. The government should explore the feasibility of applying a VAT on financial services.

To offset the exemption of banking services from VAT, an additional tax could be applied on the sum of profits and salaries of financial intermediaries, as proposed by the IMF (2010). In addition, a higher tax rate could be imposed on profits above a notional return on equity and high levels of remuneration at a higher tax rate. As argued by the IMF, such a step could perhaps help to tax the rent component in financial sector value added more heavily, and could avoid adding to tax-generated incentives for banks to prefer debt to equity finance. An exemption on a notional return on equity from the taxation of profits could also encourage banks to hold more common equity, the most reliable form of capital. However, a tax on profits and wage earnings would be difficult to reconcile with the VAT regime that applies in other sectors and could therefore generate distortions. For example, the tax could generate further cascading effects on the price of financial services used as intermediate products if it cannot be deducted from VAT by downstream producers. The treatment of exported financial services would also be difficult to reconcile with the VAT regime applied to other sectors. The advantages and disadvantages of introducing an additional tax on the sum of profits and salaries therefore need to be carefully weighed.

Reducing distortions in households' financial decisions

While Swiss households' financial wealth and housing wealth is high, Swiss households are also among the most highly indebted in the OECD area. Although 61% of Swiss households rent their dwelling, a higher share than in most other OECD countries, most debt consists of mortgage loans. Indebtedness in the business sector is modest in international comparison and the distinction of debt of non-incorporated businesses and households may not always be clear-cut. Nonetheless, tax-induced incentives for households to leverage could potentially aggravate any future episode of financial and macroeconomic instability, especially in the context of vigorous mortgage lending activity. For example, the consequences of an increase in interest rates, a fall in house prices and the stock market or a credit crunch could be magnified by the large stock of outstanding household debt, even in the presence of high net household wealth. This consideration may be particularly relevant for Switzerland which is more exposed to financial risks for other reasons, notably the presence of very large financial intermediaries.

The tax system generates incentives for households to leverage their wealth. All interest payments are tax deductible, subject to a ceiling which is defined as the sum of taxable return on assets and an additional 50 000 Swiss Francs per year (equivalent to about two thirds of average disposable income). Incentives to leverage financial and housing wealth are reinforced by the absence of taxation on the returns of an important part of household wealth. While interest and dividend income held outside pension funds is subject to personal income taxation, capital gains on household equity stock holdings are generally not taxed. While capital gains on housing are taxed by most cantons in principle, taxation of these gains is limited by several provisions. Rates are typically reduced quickly as the holding period lengthens. Exemptions apply when a household moves from one dwelling to another. Indeed, when house prices are expected to rise, such capital gains contribute significantly to the expected return of housing. Revenues on housing assets are taxed in principle, including imputed rents of owner-occupiers. However taxation of imputed rents appears to be ineffective: it generates little revenue, in part because owner-occupiers declare substantial expenses and imputations are difficult to adjust to actual market prices. A study for the canton of Berne (Peters, 2009) reports that the abolition of the taxation of imputed rental income would actually *increase* tax revenue. Finally, the wealth tax does not diminish incentives to leverage as it is assessed on net household wealth.

Tax subsidies also apply to the returns on savings in pension plans. The tax-free accumulation of interest within the pension fund, in particular, generates a more favourable tax treatment of savings within pension funds compared with savings outside pension funds.⁷ Under certain conditions, savings can be withdrawn before retirement, including for the purpose of mortgage repayment. The amount withdrawn is taxed at a reduced rate; the rate varies depending on the specific canton. At the federal level the rate amounts to one fifth of the rate that would be due if the withdrawal were taxed as one-off income. These tax advantages do not depend on the mortgage interest rate, and may therefore be particularly prone to encourage speculative housing investment when interest rates are low. Indeed households frequently withdraw savings accumulated in pension plans before retirement, notably to amortise mortgage loans.⁸

The wide-ranging deductibility of household interest payments from taxable income also generates unwanted redistributive effects. High income and wealthy households benefit relatively strongly because the maximum interest payments that can be deducted rises in line with taxable asset returns received. Moreover, high-income and wealthy households have more scope to raise their gross debt. High-income households would benefit more strongly from the abolition of taxation of imputed rents, as home ownership is concentrated among the wealthy (OECD, 2009a). However, this effect is likely to be limited, owing to the evidence suggesting that taxation of imputed rents net of deductions does not generate significant revenue. Moreover, since tax subsidies for mortgage borrowing tend to result in higher house prices, especially in countries where housing supply is inelastic, as in Switzerland, households with modest income tend to be crowded out from the housing market (Caldera-Sánchez and Johansson, 2010 and OECD, 2009a). High-income households also have more scope and incentives to engage in rent-seeking activities that reduce the imputed rent liability, for example by incurring tax-deductible expenses to improve home amenities. These are unlikely to raise the rent imputed for tax purposes. According to a study from the year 2000, 52% of home owners with taxable income of more than 150 000 CHF declared negative net imputed rental income whereas this was true only for 34% of home owners with less than 50 000 Swiss Francs of revenue (Commission Valeur Locative, 2000).

There are no strong efficiency arguments for maintaining the deductibility of interest payments on household debt. Moreover, the current tax regime produces deadweight loss because households have incentives to bear the costs of excessive financial intermediation to benefit from the tax advantages of leveraged wealth. Cutting the tax deductibility of household interest payments would also offer the advantage of broadening the income tax base, allowing income tax rates to be lowered. Such a step would help improve incentives for entrepreneurial activity in non-incorporated businesses (including the self-employed). It should be accompanied by the elimination of the taxation of imputed rents. These reform steps would also contribute to lowering tax administration and compliance costs (Daepf, 2010).

There also is a case for taxing capital gains on households' financial assets. Such a tax would reduce the difference between capital income accruing in the form of interest or dividends, which are fully taxed (outside pension funds), on the one hand, and capital gains, which are untaxed, on the other hand. These differences distort financial decision-making. For example, they create incentives for households to hold stakes in businesses which retain profits so as to avoid taxes on distributed profits. Such incentives can, for example, induce some firms to retain profits and ultimately prevent the allocation of resources from old to new businesses. While capital gains taxes raise the effective tax burden on household capital income, the impact on domestic investment decisions is likely to be modest, as international capital mobility renders savings and investment decisions largely independent from each other at the country level. A capital gains

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7. As in many OECD countries, contributions to these pension plans can be deducted from tax (up to legally defined limits) and interest income accumulated within the funds is tax exempt, while pension annuities are subject to personal income taxation.
 8. According to a non-representative survey quoted by Zimmermann (2011), more than 40% of residents in Luzern with pension savings used pension plans for housing purchase.

tax would broaden the personal income tax base which could help to reduce the tax and contribution burden on labour income along the lines discussed above. Since capital gains accrue disproportionately to wealthy households, it would also contribute to equity objectives.

The capital costs of closely-held small corporations are more likely to be affected by a capital gains tax at the household level, as they may not have easy access to international equity markets. In Switzerland closely-held limited liability and joint stock companies (with at least 10% of capital concentrated in the hands of a single individual) benefit from diminished taxation of dividends. The objective of this provision is to limit the double taxation of income distributed (on account of taxation of profits by corporate income tax and of dividends by personal income tax). To maintain symmetry of taxation of capital gains and dividends, this rule could also apply to the taxation of capital gains on shares in these businesses. Since access to international capital markets is likely to be difficult for some of these companies, such a provision would prevent adverse effects of capital gains taxation on domestic investment activity. However, the special tax status of closely-held businesses may be used for tax planning.

Alleviating some negative impacts of tax decentralisation and competition on efficiency and equity

The evidence on the impact of decentralisation of fiscal policies on economic growth is mixed (see *e.g.* Koethenburger and Lockwood, 2010, and references therein). It is likely that it depends on which tax and spending responsibilities are decentralised as well as on how funding arrangements are set up. Empirical evidence suggests that the mandatory referenda reduced government spending by 19% for the median canton after controlling for demographics and other determinants of spending (Feld and Matsusaka, 2003; Feld, 2004).⁹ For example, the evidence reported in this empirical work shows that mandatory referenda are associated with more efficient service provision as well as higher reported subjective happiness of inhabitants (Feld and Matsusaka, 2003 and references therein).¹⁰

Evidence also suggests that tax autonomy may lead to a smaller and more efficient public sector, helping to limit the tax burden and improve tax compliance (Feld, 2009; Feld, *et al.*, 2010).¹¹ Efficiency-raising effects of tax autonomy and tax competition on the public sector have also been reported in empirical research with Norwegian and German data (Blöchliger and Pinero Campos, 2011, and references therein). Tax autonomy generates opportunities to choose the level of public service provision and taxation, although in practice such “voting with your feet” seems mostly limited to young, highly educated and high-income households. Decentralised tax setting also fosters benchmarking of the performance of jurisdictions belonging to the same government level by voters, even in the absence of “voting with your feet” (Blöchliger and Pinero Campos, 2011).

Corporate income tax decentralisation has favoured low rates but also generates some distortions

Tax competition is likely to have contributed significantly to lowering corporate tax rates in Switzerland over the past 25 years. Indeed, empirical evidence shows that the responsiveness of sub-national governments to tax changes of other subnational governments (“tax mimicking”) is the strongest in the case of corporate taxation (Blöchliger and Pinero Campos, 2011). Corporate tax revenues play a modest role in cantonal tax revenues. As Figure 6 illustrates, high tax rates are found in urban

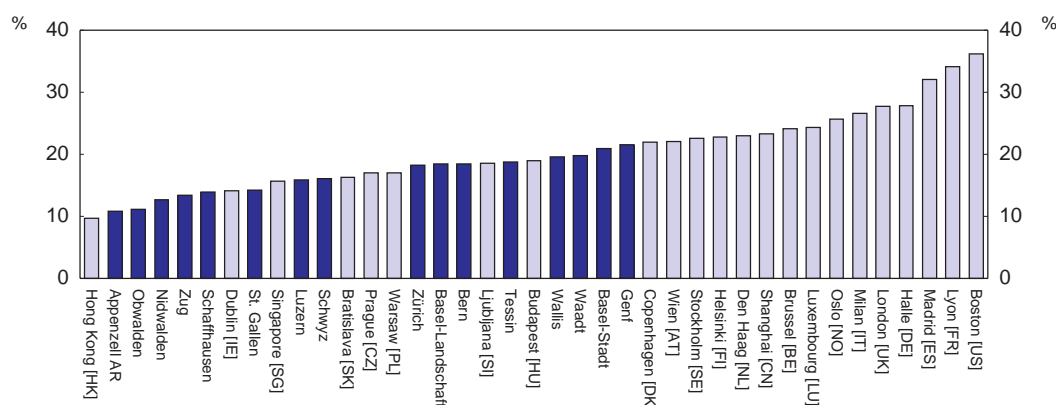
9. Evidence from the US also suggests a damping effect of referenda on sub-national government spending. See *e.g.* Matsusaka and McCarthy (2001).

10. For example, cantons with direct democracy have more efficient rubbish collection according to a study published in 1983.

11. Feld *et al.* 2010 show that public spending in cantons which devolve spending responsibilities more strongly to municipalities spend less than other cantons.

cantons which are likely to offer non-tax locational advantages, notably Basel, Geneva and Zürich. Tax competition may allow rural, economically less highly developed cantons to offset such disadvantages with lower tax rates.

Figure 6. Corporate tax burden of Swiss cantons in international comparison



Source: BAK Basel Economics, BAK taxation index 2009.

Despite low tax rates in international comparison, the contribution of corporate taxation to tax revenues is broadly in line with other OECD economies, which indicates a broad tax base and the attractiveness of Switzerland as a location. Low corporate tax rates encourage entrepreneurship and economic activity and limit tax incentives for businesses to leverage their funding. Indeed, unlike in the case of private households, business indebtedness in Switzerland is moderate in international comparison.

Some cantonal corporate income tax settings could nonetheless be improved. Several cantons levy progressive taxes with rates rising in line with either profits or the return on equity, although some cantons have abandoned progressive structures in recent years. High profits do not only reflect pure economic rents but, for example, firm size. Progressive corporate income taxes harm incentives for businesses to grow. Since growing businesses are likely to be high performers in terms of productivity, such disincentives are likely to hit high-performing businesses the most, with losses to aggregate productivity performance, which has been modest in Switzerland relative to best-performing high-income countries. Empirical research suggests that it is fast growing new firms, rather than all new firms, which account for most of the new job creation by small and medium size enterprises in advanced countries (Wong and Autio, 2005, and references therein). Progressive taxes also generate incentives for firms to split into smaller units. Effects of progressive taxes on firm size have been reported for US states (Goolsbee, 2004). Eliminating progressive tax structures could remove some disincentives to entrepreneurial activity.

All cantons also charge a tax on firm equity. It creates barriers for the creation of businesses, as newly created businesses are likely to have low returns on equity. The payment of this tax also impairs their liquidity when cash-flow is low and access to loans limited. At the federal level, taxes on the issuance of equity¹² also generate barriers for business creation. While these taxes generate little revenue, the

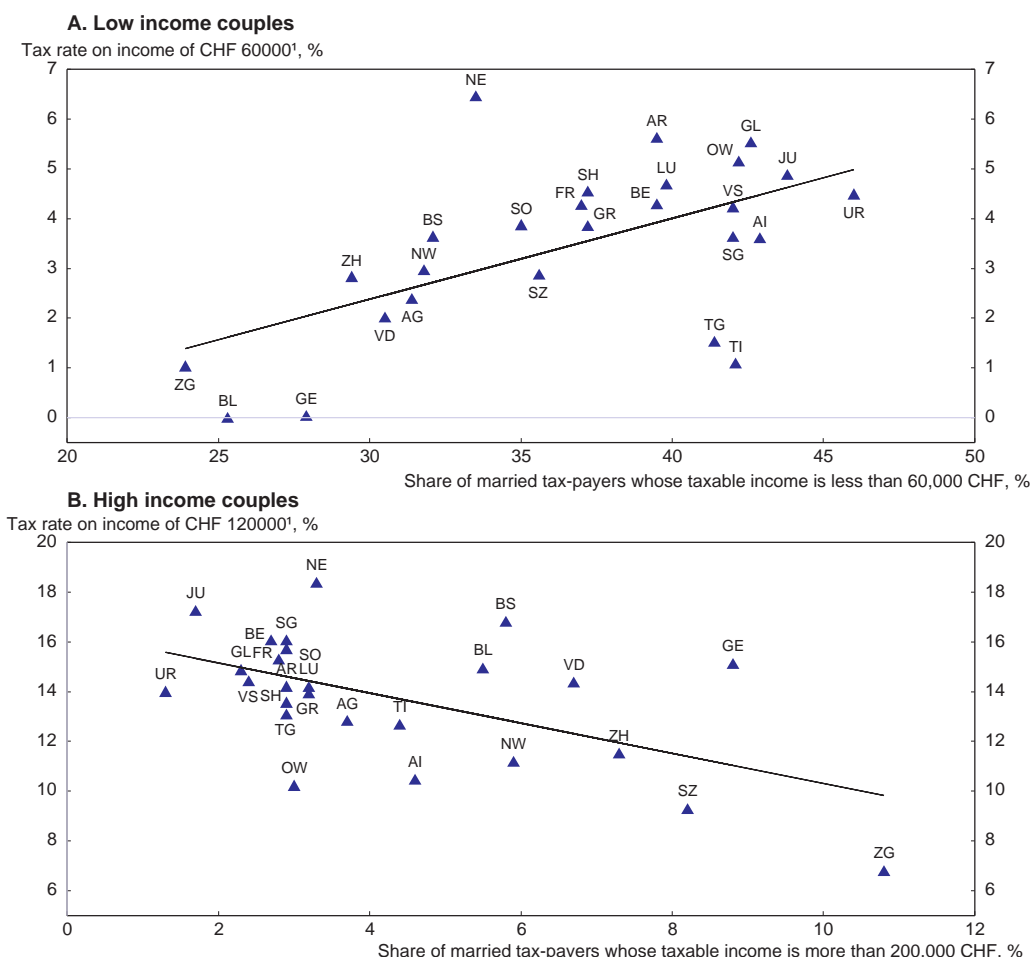
12. The issue tax on equity capital is levied on the emission of participation rights in domestic incorporated companies and cooperative societies. Increases in par value, partial payments, and trading in share certificates are considered equivalent to emission. Upon formation or recapitalisation of a joint stock corporation or a limited liability company, an exemption of CHF 1 million applies to participation rights issued for a fee. The tax rate for the issue tax on equity capital is generally 1%.

distortions may nevertheless be significant, given that firm creation is likely to contribute to productivity growth, especially in industries developing new technologies (e.g. Scarpetta *et al.*, 2008).

Personal income tax competition raises some equity issues

Personal income taxes account for the bulk of cantonal and municipal tax revenues and tax rates differ widely across cantons. There is a tendency for cantons with a large share of households on low and middle incomes to have relatively high cantonal and municipal tax rates for incomes in this range (Figure 7). These households provide the bulk of tax revenues in these cantons, so these cantons are likely to have to rely on relatively high tax rates to fund public services. The large spread in the shares of high and low income households across cantons and the correlation of these shares with average tax rates suggests that cantons and municipalities with a relatively small share of low-income households can set lower tax rates on income and wealth to fund public services. These tax rates attract high-income households, which are the most mobile and who benefit more from tax differences, which may reinforce the concentration of high income households in low tax jurisdictions.

Figure 7. Income distribution and tax rates across cantons



1. Average income tax rate on the labor income of a dependent worker, married with two children; canton capitals or main towns.

Source: OFS; Administration Fédérale des contributions (AFC).

While personal income tax revenues also play an important role in funding subnational governments in some other small European countries (Blöchliger *et al.*, 2011), Switzerland stands out because all three levels of government have substantial personal income tax-setting powers. The assignment of income tax-setting powers to all three levels of government reinforces vertical externalities: a jurisdiction which raises its income tax rate reduces incentives for economic activity, thereby reducing not only its own tax base but also those of the other government levels. Decisions on tax rates may not take the negative effects on other jurisdictions into account. These vertical externalities may contribute to over-reliance on personal income taxation.

In most cantons, cantonal governments or municipalities can also set tax rates on the value of real estate, although setting these tax rates is an exclusive competency of municipalities only in a few cantons. Constitutional legislation restricts the use of revenues from specific taxes on real estate to the funding of public infrastructure for residential development. International empirical evidence shows that real estate taxes are less affected by tax competition (as reflected in tax “mimicking”)¹³ than other taxes, reflecting the immobility of the base.¹⁴ Giving more room for real estate taxes to generate revenues could limit some of the harmful effects of tax competition linked to the selection effects of personal income tax rates, as it would allow local governments to tax a relatively immobile tax base.¹⁵ Such a reform would allow the tax burden to shift from personal income taxation to the taxation of real estate, which is less harmful for economic activity.

Assigning real estate tax setting powers to the municipalities exclusively may have further advantages. Such an assignment may help reduce vertical tax externalities, especially if combined with limitations on the municipalities’ ability to raise personal income tax rates. Moreover, real estate taxes may also be particularly suited to funding municipalities because of the stability of revenues and the relatively close correspondence of revenues with spending needs (Joumard and Kongrud, 2003).

A special tax regime applies for non-Swiss citizens settling in Switzerland.¹⁶ These individuals can apply for lump sum taxation provided they do not engage in economic activity in Switzerland. At the federal government level, these foreign nationals’ tax liability is assessed by applying the personal income tax on the quintuple of the rental payment or the imputed rent for the Swiss residence. In addition, the tax liability must not be inferior to the tax revenue that their income derived from Swiss sources would generate if it were subjected to personal income taxation. Cantons can determine further taxation on these individuals. Some cantons employ this tax regime to attract rich individuals. The federal government has proposed draft legislation raising the minimum tax base to seven times the rental value of the residence.

13. Sub-national governments respond less when other subnational governments reduce property tax rates than is the case for corporate or personal income tax rates.

14. Even in the long term, allowing for the effect of house prices on housing construction, the price elasticity of housing supply is low, especially in Switzerland (Caldera Sánchez and Johansson, 2011). With an inelastic housing supply the real estate tax on housing is fully born by owners. Moreover, in view of the modest tax rates, typically set well below 1% of the house price, tax-induced changes in house prices are small.

15. Even to the extent that housing supply is price elastic in the long term, pushing up housing costs, selection effects are attenuated because the share of housing costs in personal income typically declines as household income rises.

16. In current legislation this tax regime also applies to Swiss citizens who have lived abroad and return to Switzerland. Draft legislation proposes to eliminate this provision.

While this tax regime may reduce administrative tax enforcement costs when income derived from assets outside Switzerland is difficult to trace, the scheme may have adverse effects on the tax revenues of other countries and violates horizontal equity. The beneficiaries face strong disincentives to contribute to domestic output.

Box 3. Recommendations to improve the tax system

Making the tax system more growth enhancing

- Widen the base of the VAT, especially by removing exemptions and unifying tax rates. Over the medium term raise tax rates. Explore the technical feasibility of applying a VAT on financial services. If a VAT on financial services is not introduced, consider an additional tax on profits and remuneration in banking services.
- Reduce personal income taxes. Withdraw transfers paid to low-income households to reduce the cost of compulsory health insurance more gradually as household income rises.
- Lower the tax wedge on second earners, for example, by introducing separate assessment of partner income. Set up uniform rules concerning the taxation of several earners within one household across levels of government.
- Replace progressive cantonal corporate taxes with proportional taxes and abolish capital taxes. Remove taxes on the issuance of equity securities.

Reduce distortions in households' financial decisions

- Limit the tax deductibility of interest expenses of households from personal income tax to mortgage interest on rental housing and phase out the deductibility of other interest payments. Remove the taxation of implicit rents of owner-occupied housing.
- Withdraw tax advantages for early withdrawal of 2nd and 3rd pillar pension fund assets for the purposes of mortgage repayment.
- Introduce taxation of capital gains on households' financial assets.

Alleviate some negative impact of tax decentralization & competition

- Enhance the scope for local governments to raise a higher share of revenues from the taxation of real estate and lower the share of personal income taxation. To this end, eliminate legislation limiting the revenues from specific taxes on the value of real estate to expenditures related to public infrastructure development in residential areas. Consider assigning real estate tax raising powers to municipalities in full and consider limiting local governments' capacity to raise personal income tax rates.
- Abolish the lump sum tax regime for individuals who are not economically active in Switzerland. Subject all residents to standard personal income taxation.

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