

Comments on “Competition, Harmonization and Redistribution: Corporate Taxes in Switzerland”

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This chapter provides an interesting study of corporate taxation in Switzerland. The study is descriptive and thus contains few “results” in the usual sense, but the multitude of tax-structure details that it provides should be of great interest to any public finance economist and especially to those working on corporate taxation.

Although the chapter says little about it, Switzerland is a tax haven. This status can be seen from Figure 1 in Wier and Zucman (2022), which shows pre-tax corporate profits by country as a percentage of local employee compensation. If a country is the domicile of many multinational firms with little physical presence but substantial worldwide profits, this percentage will be large. Wier and Zucman’s figure shows that Ireland, a well-known tax haven, ranks second or third in the world on this measure for the years 2015 and 2019. But Switzerland ranks fourth or fifth. While the measure shown in their figure may be imperfect in capturing tax-haven status, it remains highly suggestive. Further evidence of Switzerland’s status can be seen in Figure 1 from the chapter, which shows taxable profit as a share of GDP rising dramatically in the post-1990 era of globalization.

Switzerland’s appeal to firms seeking to limit their tax burden has two sources. First, the country’s federal tax rate is relatively low, at around 8% since 1998. Second, “domiciliary” firms, which have no physical presence in the country, were exempt from corporate taxes at the cantonal and municipal levels until 2020. Since the combination of the two sub-federal tax rates appears to have been at least as large as the federal rate until recently, exemption from these taxes is an important source of Switzerland’s appeal as a tax haven.

While the chapter offers impressively detailed discussion of the social and political underpinnings of Switzerland's tax structure, it is silent about the reasons for the asymmetric treatment of domiciliary firms at the federal and sub-federal levels, although that logic could be interesting. If the tax exemption had been granted at the federal level instead of the sub-federal level, multinational firms would have faced a wide variety of sub-federal tax rates across cantons, complicating their choice of a domicile. Given this tax variety, a successful push for tax-haven status might have precluded exposure to the country's complex sub-federal tax environment, achieved via an exemption to these taxes instead of the federal tax.

With a national population of only 8.7 million, the average population of the country's 26 cantons is only 335,000, about half the population of an average California county. With autonomy in setting a wider variety of tax rates than in a typical US county (personal income and property as well as corporate rates), it is natural to expect a degree of tax competition, possibly in all the separate tax rates, among Switzerland's cantons. The chapter argues that corporate tax competition is likely responsible for the long secular decline in cantonal corporate rates, which is especially notable since 1980 in Figure 5. Evidently, the end of multinational firms' exemption from sub-federal taxes in 2020 could enhance the incentives for tax competition, as cantons would now compete to attract these firms. On the other hand, the limited physical investments made by such firms may attenuate this incentive.

In Table 1, the chapter provides empirical evidence on tax competition by estimating tax reaction functions. If cantons are competing among one another for corporate investment, the expectation is that tax rates in neighboring cantons will affect a given canton's tax choice. As a result, the neighbors' average tax rate appears as an explanatory variable on the right-hand side of the regression. Theory does not pin down the sign of this tax rate's coefficient, which could

be either positive or negative. Although the coefficients on the uninteracted tax variables are mostly statistically insignificant, Table 1 shows several significantly positive coefficients for a variable that interacts the neighbor tax rate with a post-2008 dummy, which is designed to capture a new equalization scheme after 2008. Thus, the coefficients in the table say that interaction was mostly absent prior to 2008 but was stronger after 2008 under the specifications in columns 1 and 4. Further tests would be required, however, to test whether interaction was actually different from zero in this latter period (a significance test on the sum of the uninteracted and interaction coefficients is needed).

With tax rates jointly determined under tax competition, the neighbor tax rate must be treated as endogenous. Table 1 takes only a partial step in dealing with this endogeneity by using a lagged tax rate on the right-hand side. A superior approach is to use an instrumental-variables approach to control for endogeneity of the neighbor rate. The literature in this area contains criticisms of commonly used instruments, but in a noteworthy 2009 paper, one of the current authors (Raphaël Parchët) offers an approach that surmounts these criticisms, relying on data from Switzerland.

Parchët's paper investigates tax competition among municipalities (not cantons) in setting their personal income-tax rates. Parchët's argues that the neighboring tax rate that matters is the *combined* municipal and cantonal tax rate, which will determine the neighboring cantons' attractiveness tax-wise as places to live. In the regression, this combined rate, along with the own-municipality's cantonal income-tax rate, help to determine the own municipal rate. The neighbor's combined tax rate is endogenous because of tax competition in its municipal component, but Parchët's innovation is to use the neighbor's *cantonal* rate, which can be treated as exogenous, as the instrument for its combined rate. When doing so, Parchët finds significant

tax interaction, with a significantly positive coefficient for the neighbors' combined rate in the estimated reaction function. This clever exercise is possible only because of the richness of the Swiss tax structure. Note that, since the chapter estimates tax reaction functions for cantons, not municipalities, Parchët's approach is not applicable.

The chapter surveys a decades-long effort to achieve corporate tax-base harmonization in Switzerland, starting in 1948 and culminating in the Federal Tax Harmonization Act of 1993. A fascinating detail is that initial efforts were partly spurred by a desire to eliminate special tax deals designed to attract investment, a goal that persisted as efforts continued. Evidently, these deals sometimes involved favorable, targeted adjustments in the tax base for particular firms. Base harmonization was designed to prevent such adjustments and thus to limit the scope for special deals. Harmonization also simplified tax computations for firms operating across multiple cantons, which had faced a variety of different base definitions.

Special state-level deals designed to attract big investments (commonly auto assembly plants) are rife in the United States, and they are often viewed as a governmental transfer from taxpayers to firms with little allocative effect. The logic of this view is that, with multiple states offering similar deals, they cancel one another out, thus leaving firms to select an investment site based on its innate labor-force and transport-access characteristics. Taxpayers lose because the large cost of these deals (usually in excess of \$200 million) diverts money from being spent on public goods and services. More recent deals, such as those designed to attract a second Amazon headquarters or microchip production facilities, are the most costly to date.

Recognizing its costliness and possible ineffectiveness, many state governments would evidently prefer that deal competition were eliminated. However, a voluntary agreement among states is likely to prompt defections that cause its collapse, suggesting that federal intervention

would be required. As in the Swiss case, tax base harmonization might provide one way to limit the special deals, although many of the components of these deals in the US do not involve corporate taxes. Instead, they often include abatement of sales taxes on inputs, state-paid abatement of local property taxes, and subsidies for worker training and transportation improvements. Therefore, federal intervention that bans such arrangements would probably be needed to stop the competitive process.

Although a broad voluntary agreement to stop competing for investment via special deals would probably be unsustainable, a more limited agreement between two neighboring states exists and appears to be working. The agreement involves the states of Kansas and Missouri, each of which contains a portion of the Kansas City metro area. Through various deals, the two states over the years had attempted to attract firms from one side of the metro area to the other, a competition which the press described as a “corporate-welfare border war” (Brown, 2019) and that was formally analyzed by Kim (2023). In 2019, Kansas and Missouri agreed to stop this competitive process through legislation and executive orders, and the agreement appears to be stable. The approach would be applicable in other cases where a US metro area crosses state borders.

Although Switzerland’s alternate harmonization approach to outlawing special deals appears promising, there is in fact a loophole. Although the base is harmonized, corporate tax holidays as long as 10 years are allowed at the cantonal level for new industrial firms. These holidays resemble the various tax abatement schemes practiced in the US, and they leave the door open for special deals despite the efforts to close it.

References

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