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Enhancing the Effectiveness
of Public Spending
in Switzerland

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ENHANCING THE EFFECTIVENESS OF PUBLIC SPENDING IN SWITZERLAND

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by
Isabelle Joumard and Claude Giorno

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ABSTRACT/RÉSUMÉ**Enhancing the effectiveness of public spending in Switzerland**

Switzerland is a highly decentralised country with large spending and revenue-raising powers devolved to cantons and municipalities. The federal system, in combination with an extensive use of direct democracy, has contributed to keep public spending at a relatively low level in international comparison. It has also made it possible to tailor the provision of public services to citizens' needs and willingness to pay and to experiment with a variety of policies. At the same time, several tensions have emerged and effective control of spending deteriorated during the 1990s. After identifying these tensions, this paper reviews recent policy initiatives and proposes options for further enhancing public spending effectiveness. These entail implementing a new fiscal rule which will allow the free play of the automatic stabilisers at the federal level and ensuring its consistency with other government levels' behaviour; increasing transparency in public spending costs and benefits; improving management practices in the public sector; and modernising fiscal relations across government levels.

JEL codes: E61, E62, H1, H23, H4, H5, H6, H7

Key words: Fiscal equalisation, fiscal federalism, fiscal rules, intergovernmental grants, new public management, public spending, Switzerland.

Améliorer l'efficacité des dépenses publiques en Suisse

En Suisse, pays très décentralisé, d'importants pouvoirs sont dévolus aux cantons et aux communes en matière de dépenses et de recettes. Le système fédéral conjugué à un large usage de la démocratie directe a permis de maintenir des dépenses publiques à un niveau relativement faible comparativement aux autres pays. Il a également permis d'adapter la fourniture des services publics en fonction des besoins et de la disposition des citoyens à payer, et d'expérimenter diverses politiques. Dans le même temps, un certain nombre de tensions sont apparues et le contrôle effectif des dépenses s'est détérioré au cours des années 90. Après avoir identifié ces tensions, cet article passe en revue les initiatives récentes de politiques économiques et propose des options visant à améliorer l'efficacité des dépenses publiques. Celles-ci comprennent la mise en œuvre d'une nouvelle règle budgétaire permettant de laisser librement jouer les stabilisateurs automatiques au niveau fédéral tout en assurant sa cohérence avec les comportements des autres niveaux d'administration, le renforcement de la transparence des dépenses publiques du point de vue de leurs coûts et bénéfices, l'amélioration du système de gestion dans le secteur public et la modernisation des relations budgétaires entre les différents niveaux d'administration.

Classification JEL : E61, E62, H1, H23, H4, H5, H6, H7

Mots-clés : Péréquation financière, fédéralisme fiscal, règles budgétaires, transferts intergouvernementaux, nouvelle gestion publique, dépenses publiques, Suisse.

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ENHANCING THE EFFECTIVENESS OF PUBLIC SPENDING IN SWITZERLAND¹

1. Switzerland is a highly decentralised country with large spending and revenue-raising powers devolved to cantons and municipalities. The federal system, in combination with an extensive use of direct democracy, has contributed to keep public spending at a relatively low level in international comparison. It has also made it possible to tailor the provision of public services to citizens' needs and willingness to pay, and to experiment with a variety of policies. At the same time, several tensions have emerged. *First*, it has been difficult to ensure a sustainable fiscal policy during the low-growth period of the 1990s, while allowing a role for the automatic stabilisers. *Second*, the financing of several public spending programmes, in particular those funded by intergovernmental transfers, has largely relied on mechanisms that provide little incentive to contain costs and demand. This has been reflected in a high cost and/or excess demand for some public services. *Third*, despite an important role of the private sector in some key social policy domains, competitive pressures on public service providers have been rather low, further contributing to poor cost-restraint. *Fourth*, the provision and financing of public goods at the local level has sometimes made it difficult to take into account spillover effects or to reap scale economies, leading to low cost-effectiveness. Moreover, a sub-optimal provision of key public services can raise equity concerns.

2. After outlining the forces shaping public spending, this paper presents the policy issues relating to the tensions identified above. It also reviews recent policy initiatives to improve public spending effectiveness. These include: the debt containment rule, new public management methods, and a wide-ranging draft law to reform spending assignments and funding principles across government levels. The last section outlines pending issues and proposes options for further enhancing public spending effectiveness.

Main forces shaping public spending

Several factors have contributed to keeping public spending low

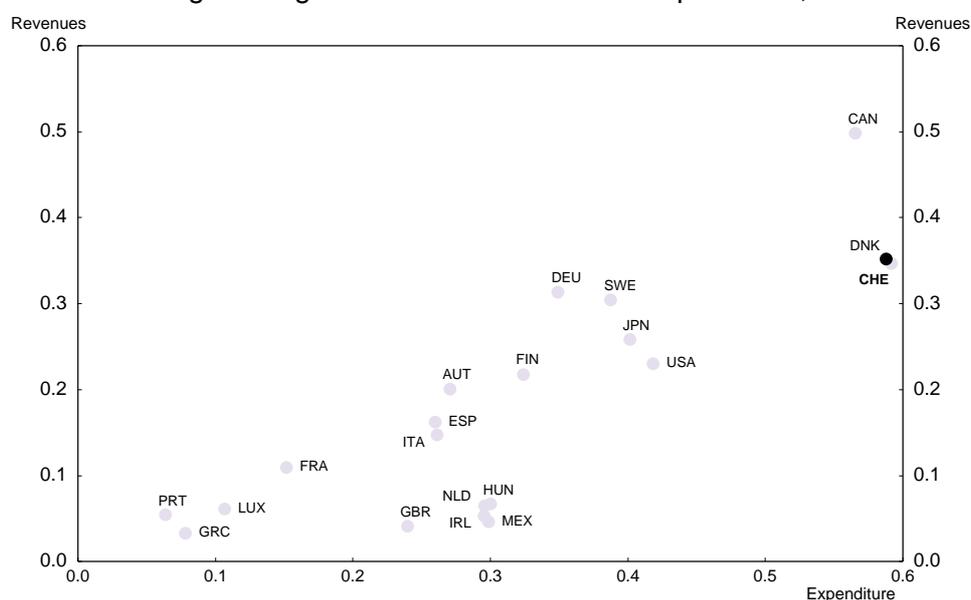
Being close to the citizen has contained spending

3. The Swiss institutional system combines direct democracy elements with a high degree of fiscal federalism. Both contribute to restrain spending. Spending by sub-national governments (municipalities and cantons) accounts for a much larger share of total public spending than in most other OECD countries (Figure 1). In most areas sub-national governments are responsible for setting the level and quality of local public services, though in some cases the federal government sets standards (*e.g.* for the environment). Local governments also have significant revenue raising powers, which enable them to fund additional local spending. However, a large share of expenditure controlled locally is financed through

1. This paper was originally produced for the OECD Economic Survey of Switzerland, which was published in May 2002 under the authority of the Economic and Development Review Committee. The authors, who are members of the Economics Department, would like to thank the Swiss authorities for the information and assistance provided; and are indebted to Hansjörg Blöchliger, Andrew Dean, Jorgen Elmeskov, Mike Feiner, Peter Hoeller, Val Koromzay and Emanuel Mönch for valuable comments and drafting suggestions; to Isabelle Duong for statistical assistance and Nathalie Macle for secretarial skills.

intergovernmental transfers, contributing to “fiscal illusion” — whereby residents in a jurisdiction do not bear the full costs of their spending decisions since it is partly financed by other jurisdictions. Nevertheless, the decentralised system setting introduces competitive pressures among local governments. By allowing each jurisdiction to provide its own combination of taxation and public goods, it enlarges the citizens’ choice. Citizens can thus “vote with their feet” (Tiebout model). This puts pressure on local governments to improve public services and/or to cut the tax burden, though several factors (such as transaction costs, including linguistic barriers) may limit the mobility of voters across jurisdictions.

Figure 1. Revenues and expenditure by regional and local governments
Share in general government revenues and expenditure,¹ 1999²



1. Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments and are expressed as a share of revenues received by the general government. Expenditure correspond to total expenditure by regional and local governments expressed as a share of general government expenditure. Transfers between governments are netted out. The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of sub-national governments.
2. For Finland, Luxembourg and United Kingdom: 2000. For Portugal and Mexico: 1998. For Canada, France and the United States: 1997. For Ireland: 1996. For Greece: 1995.

Source: OECD, *National Accounts*; Administration fédérale des finances of Switzerland; Hungarian Ministry of Finance.

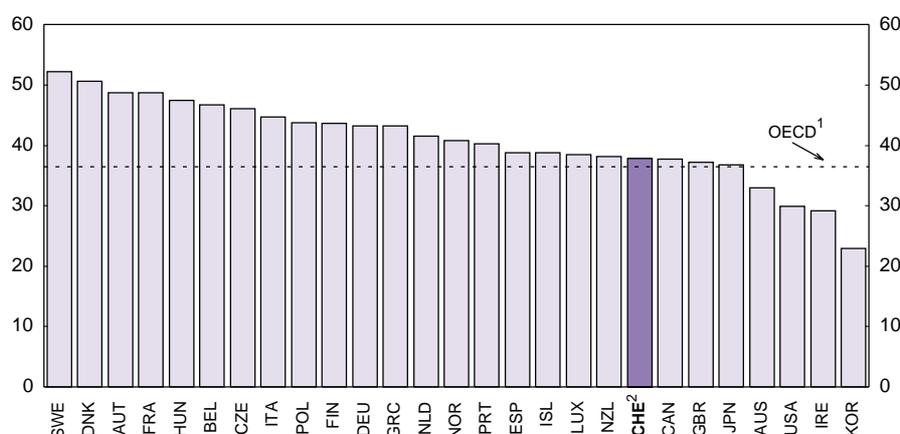
4. Direct democracy offers citizens another channel to influence public finances. Switzerland provides a good example of an extensive and functioning direct democracy, with taxation, spending and public management proposals regularly submitted to voters' scrutiny. Voting options vary across both cantons and municipalities. The strongest electoral control probably lies in the requirement that a new spending project must be approved by a mandatory referendum, which is in place in 17 of the 26 cantons. Feld and Matsusaka (2001), for instance, estimate that cantons with mandatory referenda indeed spend significantly less than others. However, optional referenda and voters' initiatives (the latter being embodied in the constitution of the Confederation and of all cantons) also provide powerful instruments to control and sanction local governments.² By reinforcing popular control of the fiscal process, direct democracy reduces the ability of local administrations and political parties to follow their own interests (as emphasised in public choice theory). In fact, a study by Kirchgässner and Pommerehne (1996) reveals that a demand-based model of public expenditure performs much better for Switzerland than for Germany, a country with a similar federal and economic structure, except that it is a representative democracy.³ On the other hand, extensive reliance on direct democracy may slow down the reform process (Saurer and Kungler, 2001).

A large "mandatory contribution" by the private sector to social spending

5. A large part of the social insurance system is managed by private insurance companies, thus keeping public spending low in international comparison (Figure 2). However, contributions to these insurance companies are largely mandatory.⁴ In particular, private mandatory insurance covered almost 40 per cent of health care costs in 1999. Likewise, the compulsory privately-funded pension system (second pillar) reduces public spending on pensions. Overall, social spending financed through private mandatory insurance companies amounted to CHF 44 billion in 1999 (11.6 per cent of GDP) which, in accordance with the OECD definition, is not included in the general government accounts.⁵

-
2. Feld and Matsusaka (2001) have investigated these institutional settings at the cantonal level. Where mandatory referenda are provided for by the constitution, new spending projects are initially approved by Parliament. If the cost of the project exceeds a predetermined amount — the spending threshold — the project must be approved by majority vote in a referendum. In the 17 cantons where mandatory referenda exist, thresholds ranged from CHF 150 000 to CHF 25 million in 1996. Optional referenda also existed in 20 cantons in 1996. After collecting signatures from a certain number of citizens, voters can also call for an optional referendum in all cantons. It allows citizens to propose an entirely new spending law that comes into effect if approved by a vote of the electorate.
 3. Feld and Kirchgässner (forthcoming) also show that government expenditure is, *ceteris paribus*, lower in a direct than in a representative democracy and that approval of budget deficits by mandatory or optional referenda keeps debt-to-income ratios in Swiss municipalities lower.
 4. For a description of the health and pension systems, see the special chapter "Ageing: the Swiss case" in OECD (2000).
 5. Mandatory private social expenditure schemes also exist in other OECD countries (*e.g.* Australia, Belgium, Germany, the United Kingdom and the United States), though their size typically ranges from 0.5 to 1 per cent of GDP, with the notable exception of Korea where they account for more than 5 per cent of GDP (OECD Social expenditure database).

Figure 2. Public expenditure in OECD countries
As a percentage of GDP, 2000



1. Weighted average.

2. "Statistique financière révisée" basis, including social security.

Source: Administration fédérale des finances and OECD, *National Accounts*.

Upward pressures have intensified since the early 1990s...

6. Despite all the safeguards in place that worked well in the past, spending growth was rapid during the 1990s, reflecting sharp increases in social insurance and social transfers. Switzerland's fiscal position worsened sharply. This resulted in a hike in the debt-to-GDP ratio by nearly 20 percentage points, two thirds of which was due to the rise in the Confederation's debt (Figure 3). At the same time, the tax-to-GDP ratio increased more rapidly than in the rest of the OECD, despite the authorities' aim of maintaining the competitiveness of the Swiss economy.

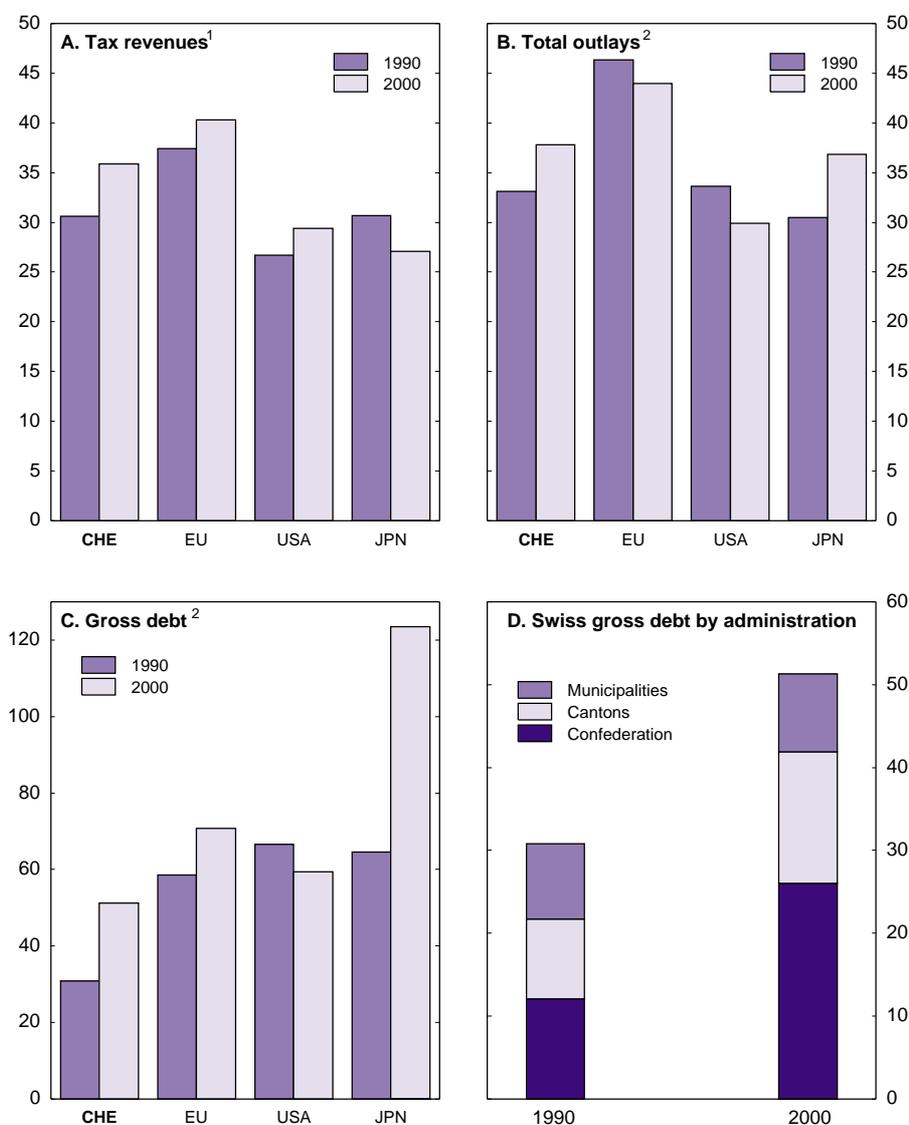
7. Following the long recession of the 1990s, increasing demands were placed on the welfare system. Social expenditure rose by 4¼ percentage points of GDP from 1990 to 1999, representing almost 80 per cent of the rise in consolidated government expenditure (Table 1). Unemployment expenditure, which had accounted for only a minor share of government expenditure prior to the 1990s, rose steeply for cyclical but also structural reasons, especially due to the more generous unemployment compensation system.⁶ Invalidity, social assistance and health benefits also increased sharply while the share of public pension expenditure in GDP continued to grow.⁷ Since the Confederation, and to a lesser extent the cantons, finance a significant part of these schemes, the rise in spending was less pronounced for the municipalities (Figure 4).⁸ Discretionary policies to boost demand implemented by the federal government at the beginning of the 1990s and again in 1996-97 also widened deficits and increased interest payments.

6. The maximum duration of unemployment benefits was increased from 250 to 520 days between 1993 and 1997. Furthermore, it is estimated that structural unemployment rose from 0.8 per cent in the mid-1980s to 1.8 per cent in 2000.

7. The strong rise in social benefits could partly reflect abuses. Invalidity pensions provide an illustration. Although the share of invalidity pensions is relatively small compared with the rest of the OECD, the number of recipients has risen by an average of 4.3 per cent per year between 1993 and 1999, whereas it fell in other countries (Message to parliament concerning the unemployment insurance law, LACI 2001).

8. Unlike the municipalities, the Confederation and the cantons were directly affected by the increase in unemployment expenditure. Between 1993 and 1998, their loans to the unemployment insurance system totalled 2¼ per cent of GDP.

Figure 3. The public finances in international perspective
As a percentage of GDP, 1990-2000



1. Based on OECD tax revenue statistics. Provisional data for 2000.
2. "Statistique financière révisée" basis for Switzerland and national accounts basis for the others.

Source: Administration fédérale des finances; OECD, *Revenue Statistics, 1965-2000* and OECD.

Table 1. **Changes in public expenditure over the 1990s**

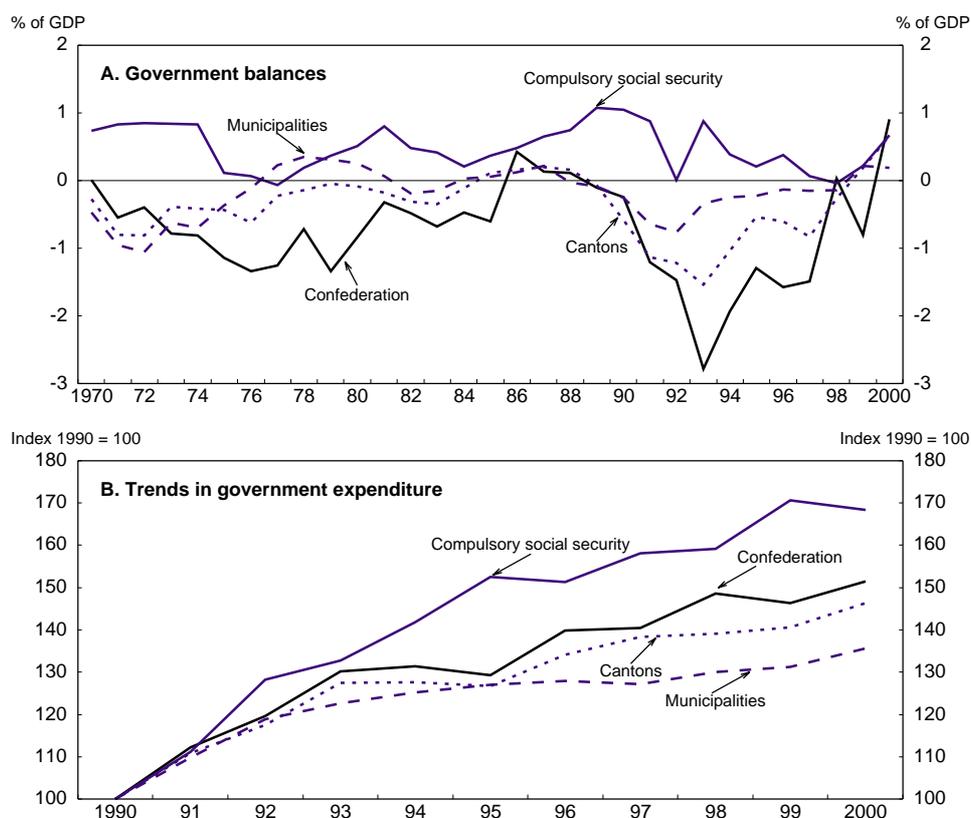
In per cent of GDP

	Level 1999	Change over period			
		1990-93	1993-97	1997-99	1990-99
Total public expenditure¹	38.6	5.6	0.7	-0.9	5.5
Social expenditure	17.7	3.8	1.3	-0.8	4.3
Health	4.5	0.6	0.1	0.0	0.7
Old age and survivors	6.4	0.8	0.3	-0.2	1.0
Invalidity	2.1	0.4	0.3	0.1	0.8
Social assistance	1.4	0.4	0.3	0.1	0.7
Unemployment	1.2	1.5	0.5	-0.9	1.1
Other	2.1	0.1	-0.2	0.0	-0.1
Other expenditure	20.9	1.8	-0.6	-0.1	1.2
Education	5.6	0.6	-0.1	-0.1	0.4
Primary and secondary schools	3.4	0.4	0.0	-0.1	0.3
Universities	1.0	0.1	0.0	0.0	0.0
Transport	3.1	0.2	0.1	-0.1	0.2
Administration	2.0	0.1	-0.1	0.0	0.1
Justice, police	1.7	0.2	-0.2	0.1	0.1
National defence	1.4	-0.3	-0.2	-0.2	-0.7
Environment	1.2	0.1	-0.1	0.0	0.1
Public economy	1.7	0.2	-0.2	0.1	0.1
Agriculture	1.2	0.1	0.1	0.0	0.2
Other	4.1	0.6	0.2	0.2	0.9
<i>Memorandum item</i>					
Investment expenditure ²	3.7	0.2	-0.6	0.2	-0.2
Current expenditure ²	34.9	5.4	1.3	-1.1	5.7

1. Consolidated data.

2. The Swiss definition of investment expenditure includes amounts lent by government to the social security system for the unemployment insurance scheme. However, these loans are included here as current expenditure.

Source: 'Statistique financière révisée' basis, Administration fédérale des finances and data directly provided by the authorities.

Figure 4. Expenditure and budget balances by level of government

Source: "Statistique financière révisée", Administration fédérale des finances.

... and are likely to gain further momentum

8. Upward pressures on social transfers are likely to gain further momentum due to population ageing. The expected increase in the elderly dependency ratio from 23.5 to 43.5 per cent by 2035 is broadly similar to that in other countries. According to official estimates, public retirement pension expenditure as a share of GDP could increase by 2¼ percentage points between 2000 and 2025 while total social expenditure, including health spending and expenditure on care for the elderly, could grow by about 4½ percentage points. These pressures should be more moderate than in most other OECD countries, largely reflecting the widespread recourse to privately-funded pension schemes and health insurance companies.⁹ Those pressures that Switzerland does face will largely be felt by the central government since it finances nearly 20 per cent of social insurance and assistance expenditure.¹⁰

9. Ageing-related expenditure could increase on average from 6 to 7 per cent of GDP in the OECD countries by 2035-40 (OECD, 2001a). The Swiss projections, which stop in 2025, *i.e.* before the projected peak in the dependency ratio towards 2035, understate the expected increase in ageing-related expenditure. However, these projections seem a little pessimistic since they are based on prudent growth projections (Dang *et al.*, 2001).

10. Federal subsidies finance 17 per cent of the expenditure of the first pillar of the old-age insurance system (the cantons' share is 3 per cent) and 37.5 per cent of invalidity pension expenditure. Social protection outlays account for a quarter of the Confederation's total expenditure. However, the bulk of public health care spending is financed by the cantons and municipalities.

Assessing public expenditure policies

Maintaining fiscal discipline has become a key objective since the mid-1990s

Spending has been better controlled in recent years...

9. In response to the worsening fiscal position in the early 1990s, the authorities focused on fiscal consolidation. This resulted in a balanced budget in 2000. From 1993, all levels of government implemented a restrictive fiscal policy, which placed an emphasis on cutting or delaying investment relative to current expenditure, especially in the cantons and municipalities. However, only since 1998 has the overall public spending to GDP ratio edged down, thanks — in part — to cyclical developments. Another important factor that reinforced spending control from 1998 was the constitutional mandate (*Budget Objective 2001*) to balance the Confederation's budget. This mandate, which set a timetable for balancing the budget, led to the adoption and implementation of the 1998 stabilisation plan, the main aim of which was to control expenditure (Kungler and Saurer, 2000).¹¹

... and has hardly played a role in macroeconomic stabilisation

10. The efforts to control expenditure since 1993 had a pro-cyclical impact on activity, which probably delayed the recovery. This destabilising trend of fiscal policy, which was more marked than in other OECD countries (Table 2), stems from three main factors. First, although the Constitution requires all levels of government to take account of the economic cycle when drawing up their budgets, most of the cantons and municipalities apply balanced budget rules which have tended to neutralise the effect of automatic stabilisers (Spahn, 1997).¹² Second, the financing of the unemployment insurance system reduced the role of automatic stabilisers of the Confederation's budget in the 1990s since contribution rates had to be adjusted when the fund exceeded or fell below a certain threshold.¹³ In addition, a growing share of the Confederation's expenditure consists of earmarked funds (12 per cent in early 2000).¹⁴ Third, the federal government, whose spending represents only a third of the total budget (10 per cent of GDP), does not have much leeway to implement an effective discretionary stabilisation policy. Its expenditure is dominated by transfers, whose changes have only a limited effect on activity in the short term compared with public investment or consumption.¹⁵ Moreover, there is little co-ordination of fiscal policy between

11. The 1998 stabilisation plan contained a raft of expenditure cuts equivalent to 0.5 per cent of GDP and affecting public transport, defence, social protection and transfers to the cantons.

12. Almost all the cantons have constitutional constraints that require them to balance their budgets, which sometimes take the form of constitutional obligations. While these constraints are not always binding, in five cantons, taxes must be raised if the deficit exceeds a certain level.

13. The Federal Council is required to raise (or to lower) the rate of contribution if at the end of two years running the fund's reserves are below (or above) 2.5 per cent of wages subject to contribution. In 1990, the contribution rate was cut to 0.4 per cent of the wage, and then raised to 2.0 per cent in 1993 and 3.0 per cent in 1995.

14. On the revenue side, the biennial system of direct taxation in force up to 2001 was also frequently criticised for its destabilising effect, especially during cyclical downturns (Amman, 1995).

15. Whereas changes in government consumption or investment have a direct impact on GDP, variations of government transfers might be partly saved by the beneficiaries rather than spent completely, which will dampen their effect on activity. This is particularly the case of transfers to households. In the short term, fiscal multipliers of public investment or consumption are significantly higher than those of transfers.

the various levels of government.¹⁶ Plans to boost investment have been adopted in the past by the federal government, for instance, the introduction of subsidies to cantons in 1997 to promote infrastructure maintenance projects. This policy might encourage strategic behaviour by the cantons, since they have an incentive during an economic slowdown to delay expenditure in the hope of obtaining a higher federal subsidy later.

Table 2. **Correlation between the fiscal stance and the output gap**¹

	1970-79	1980-90	1991-00
Austria	0.57	0.12	-0.05
Belgium	0.12	-0.40	-0.63*
Canada	0.85*	0.58*	0.02
Denmark	0.43	0.70*	0.10
Finland	..	0.13	0.62
France	0.20	-0.26	-0.51
Germany	0.55	-0.57*	-0.05
Greece	0.16	-0.32	0.05
Italy	0.30	-0.09	-0.09
Japan	0.28	-0.59*	0.48
Netherlands	-0.30	-0.57*	0.07
Portugal	0.19	-0.11	0.24
Spain	..	-0.03	-0.17
Sweden	0.17	0.15	0.03
United States	0.64*	0.62*	0.47
Switzerland	-0.68*	-0.71*	-0.54*
Confederation and social security	-0.52	-0.35	-0.34
Cantons and municipalities	-0.54	-0.65	-0.45
Number of countries applying counter-cyclical discretionary fiscal policy	12	6	9
Number of countries applying pro-cyclical discretionary fiscal policy	2	10	7

1. Counter-cyclical policies lead to a positive correlation between output gaps and the fiscal stance. Pro-cyclical policies lead to a negative correlation between output gaps and the fiscal stance. The fiscal stance measures the yearly change in the cyclically adjusted balance as a percentage of potential output. It is only indicative for discretionary fiscal policy changes. Cyclically-adjusted balance and output gap measures are based on official estimates in the case of Switzerland, and on OECD estimates for the other countries. The two methods of estimations of the structural balances are similar. See Van den Noord (2000) and Ammann (1995). Starred coefficients are significant at 95 per cent confidence interval.

Source: OECD calculation.

Reforms aim at a steady and sustainable spending path...

11. With the Confederation's finances balanced in 2000, the federal authorities' major aim is to prevent debt from increasing again. A new constitutional provision — the “debt containment rule” (“*frein à l'endettement*”) — was adopted by the Parliament in June 2001. Ratified by referendum on 2 December 2001, it will be implemented as from 2003. This mechanism will replace the rule laid down in

16. Informal co-ordination takes place between the Confederation and the cantons for the preparation of the budget since part of the cantons' revenue consists of federal transfers. The macroeconomic assumptions used by the various levels of government are also broadly consistent.

the Budget Objective 2001, which required a federal budget deficit of under ¼ per cent of GDP,¹⁷ and leads to an expansionary stance of spending during upswings and a restrictive stance during downturns.

12. The debt containment rule will cap public expenditure with a view to maintaining a balanced structural budget (Box 1).¹⁸ It allows deficits during recessions but requires that surpluses be achieved during upswings. It will thus stabilise the federal public debt in nominal terms. The law provides for a correcting mechanism in the event of non-compliance via a system of intertemporal compensation, which should ensure its effectiveness.¹⁹ It also reduces the institutional asymmetry that currently affects federal expenditure and revenue. Whereas changes in revenue must be submitted to referendum, since tax rates are written into the constitution, changes in spending depend only on parliament. The new spending control mechanism will not impinge directly on tax decisions, but tax cuts will have to be matched by similar cuts in spending to maintain the structural budget in balance.²⁰ This should prevent excessive tax cuts from being unmatched by equivalent spending cuts, while the mandatory control of spending will reduce the risks of tax increases for consolidation purposes.

13. With this reform, the role of the automatic stabilisers will be enhanced, while the recent direct tax reform will eliminate the destabilising effect of the previous system.²¹ Also, as from 2002 federal loans to the unemployment insurance system and their reimbursement will be managed outside the federal budget, so that the debt containment rule will not impede the stabilising effect of the unemployment compensation system.²² However, the continuing poor co-ordination and lack of harmonisation between the budgetary rules of the various levels of government are liable to reduce the effect of the overall budget stabilisers to those of the Confederation, which would amount to about ¼ per cent of GDP, *i.e.* half the OECD average.²³ On the other hand, though the debt containment rule restricts the use of discretionary fiscal policy by the federal government, this should not jeopardise macroeconomic management. The rule, however, allows for higher spending in the case of severe recessions. It will enable the National Bank to

-
17. The rule provides that the federal deficit must not exceed 2 per cent of revenue, equivalent to ¼ per cent of GDP.
18. The new constitutional articles only indicate that expenditure cannot exceed a ceiling determined on the basis of projected revenues and taking account of the cycle. Besides the constitutional revision, parliament approved an amendment to the Confederation's Finance Law. This law deals with the practical implementation of the debt reduction mechanism.
19. Experience shows that in the absence of correcting mechanisms or penalties, budget rules tend to be circumvented. Dafflon (1995) provides an example for the Swiss municipalities and Atkinson and Van den Noord (2001) discuss rules in various OECD countries. In addition, the risk of a built-in electoral cycle (with the overspending of the outgoing government being compensated by the new one) is low as the Swiss political system is consensus driven.
20. In practice, a tax cut will reduce future expected revenues and, therefore, the expenditure ceiling, which will have to be met by the budget prepared by the Federal Council and approved by the Parliament, except in exceptional circumstances.
21. The biennial system of direct taxation, which entailed a three year gap between the moment incomes were received and the actual payment of the tax, has been replaced since 2001 by an annual system similar to that in place in most other OECD countries.
22. A reform of the unemployment insurance system is under consideration. It would remove the obligation to adjust contribution rates when the surplus, or deficit, of the unemployment fund exceeds 2.5 per cent of the wages subject to contribution.
23. As federal tax revenue represents 11½ per cent of GDP, a change of 1 per cent in the output gap will have a stabilising effect of around 0.12 per cent of GDP on the assumption of a unitary tax elasticity with respect to production. The stabilising effect of unemployment expenditure also amounts to nearly 0.1 per cent of GDP (on the assumption of an Okun coefficient of 4).

assess the thrust of the federal government's policy more easily. Moreover, in such a small and open economy operating with a flexible exchange rate regime, macroeconomic stabilisation should primarily be ensured by monetary policy, operating against the background of a clearly defined fiscal policy.²⁴

Box 1. Main features of the debt containment rule

The purpose of the debt containment rule is to maintain a balanced structural budget at the federal level while allowing for cyclical developments. It sets a ceiling for expenditure, which can not surpass cyclically-adjusted revenue. While federal revenues fluctuate with the cycle, the debt containment rule prevents these fluctuations from being transmitted to expenditure. The rule can be summarised by the following formula:

$$\text{Expenditure cap}_{t+1} = E^t(\text{total revenue}_{t+1}) * E^t(\text{trend GDP}_{t+1}/\text{actual GDP}_{t+1}) + A_{t+1}$$

where $E^t(\text{total revenue}_{t+1})$ represents the revenue estimate at period t for year $t+1$, $E^t(\text{trend GDP}_{t+1}/\text{actual GDP}_{t+1})$ is the factor that denotes the estimate at period t for the cyclical position of the economy at $t+1$ and A_{t+1} is an adjustment factor that takes account of past deviations of budget out-turns from the norm laid down by the rule.

Trend GDP is estimated by smoothing historical and projected GDP data via the Hodrick-Prescott filter. If trend GDP is higher than actual GDP, the cyclical factor will be more than 1 so that expenditure can exceed projected revenues, resulting in a deficit. Conversely, close to a cyclical peak, the cyclical factor will be less than 1, making it necessary to keep expenditure below total revenue, resulting in a budget surplus. Over the entire cycle, the budget will be balanced.

This rule is binding both for the preparation of the budget and its implementation.¹ Thus, the Federal Council is required to present a budget that meets the debt containment rule and parliamentary amendments can derogate from that rule only in exceptional cases.² However, even if the budget complies with the rule, it cannot be ruled out that actual expenditure will exceed the cap because of errors in revenue estimates or in assessing the business cycle. For this reason, the law provides for an adjustment mechanism denoted by the term A_{t+1} in the formula. Under this mechanism, discrepancies between actual expenditure and the cap are booked in an equalisation account. In the event of an excessive deficit on this account, *i.e.* exceeding 6 per cent of expenditure (0.6 per cent of GDP), the authorities have to reduce the balance to below 6 per cent within three years. In the event of a surplus, it will be kept in the account to cope with eventual future spending overruns unless Parliament decides to use it to reduce federal debt, as in the case of revenue windfalls, for instance, from asset sales.

1. If the budget voted by Parliament does not comply with the debt containment rule, the initial budget proposed by the Federal Council is adopted unless a qualified majority (an absolute majority in both houses of Parliament) decides otherwise for exceptional reasons (deep recession, natural disaster or other one-off events).

2. Decisions to vote supplementary appropriations, for example at the end of the year, do not derogate from the debt containment rule. The *ex post* evaluation of compliance with the rule and the position of the equalisation account will be conducted during the first quarter after the fiscal year, when the central government accounts are closed.

14. The difficulties in implementing the debt containment rule should not be underestimated. The rule for controlling expenditure is fairly complex and will profoundly reshape the budget process, which will have to take into account the *ex ante* setting of an overall package. Spending decisions will henceforth depend on estimates of future revenue and the economy's position in the cycle. The rule implies a unitary elasticity between revenue and output, which has been found to be somewhat on the conservative side by a number of observers, with the associated risk of a slight bias towards a pro-cyclical fiscal stance.²⁵ In

24. The Mundell-Fleming model suggests that fiscal multipliers under a flexible exchange rate regime are smaller than under a fixed exchange rate regime.

25. Several studies, including KOF (2001), Chouraqui *et al.* (1990) and IMF (1998) noted that the elasticity between taxes and output might exceed unity by a small margin. With an elasticity slightly underestimated relative to its "true" value, structural revenues as calculated by the rule (in the right-hand side of the

addition, past revenue estimates have sometimes shown large errors, for instance, the 2000 budget (OECD 2002a). These errors, which will have to be corrected during subsequent budgets, will induce fluctuations in the structural deficit, with a risk of conducting at times a pro-cyclical policy in the event of a major forecasting error (IMF, 2001 and Danninger, 2002). However, this risk appears limited, as the phasing in of corrective actions should prevent sharp changes in the structural deficit.²⁶ Another, more technical, difficulty concerns the estimate of the economy's cyclical position. Using a Hodrick-Prescott filter to estimate trend output and the output gap has the advantage of transparency and simplicity but it also involves an appreciable risk of bias, especially at the end of the estimation period, which could impair the implementation of fiscal policy. The result of this method could also be inconsistent with the National Bank's estimate, which is based on the economy's potential growth derived from a production function (Stalder, 2001).

15. Perhaps more importantly, in a budget as inflexible as that of the Confederation, changes in expenditure as a result of revised revenue estimates are also likely to be difficult to implement on an annual basis. The federal budget is essentially a "transfer" budget and the share of "mandatory" expenditure (from a short-term perspective) was over 80 per cent in 2001.²⁷ Also, a growing proportion of expenditure is in the form of multi-year appropriations, such as those for agriculture, which restricts short-term flexibility still further. The Confederation's fiscal policy is actually shaped to a large extent outside the budget process, as the decisions of the Federal Council and Parliament often have a direct impact on federal finances.

16. The Confederation has already implemented medium-term budget planning before the recent reform. Four-year horizon financial plans are prepared every year at the same time and including the same amount of detail as the budget. In the past few years, new laws have also been accompanied by estimates of their medium-term financial consequences. The financial plan thus provides a solid base for the continuity of the budget process by making it possible to identify the underlying spending pressures. However, unlike the budget, the plan does not have to be approved by Parliament, and thus does not give rise to discussion and approval of strategic choices within a coherent and forward-looking framework. In the current framework, the risk remains that certain expenditure categories will be crowded out due to the annual application of the debt containment rule, especially as capital and current spending are subject to the same overall cap (KOF, 2001).

formula in Box 1), would also be underestimated during cyclical troughs, which would lead to a small surplus of the structural balance. The reverse would happen during cyclical peaks inducing a procyclical policy. This critique however does not apply if the actual tax revenue calculation is also biased due to the elasticity estimation error.

26. Revenue forecasting errors have averaged 3½ per cent since 1970, with the maximum errors exceeding 10 per cent, happening generally during downturns, as in 2000. In such cases, up to 6 per cent of the expenditure will be booked in the equalisation account. The residual, 4 per cent of federal expenditure, or ½ per cent of GDP, has to be eliminated within three years, corresponding to a change in the structural balance of less than 0.2 per cent per year (Mönch, 2001).

27. The following are considered as "mandatory" expenditure: personnel expenditure, interest payments and transfers arising from commitments. A third of these transfers, which represented 62 per cent of federal expenditure, go to cantons, another third to social insurance, and a sixth to federal enterprises and entities (railways, universities). The "mandatory" nature of personnel expenditure, which amounts to less than 12 per cent of federal spending, should however not be exaggerated, especially in a medium-term perspective.

... but the lack of transparency entails some risks to the public finances

17. While the federal government had increased the amount and quality of publicly-available information, transparency could be significantly improved in several areas to support the soundness of the public finances. *First*, aggregate information on general government finances (including social security) remains piecemeal. *Second*, while several OECD countries and some Swiss local governments have moved to accrual accounting, the federal budget is still based on a modified cash accounting. This can lead to a misleading picture of commitments, since payments can be accelerated or deferred. *Third*, public enterprises have an important weight in some sectors and perform social objectives without direct budgetary appropriations,²⁸ and these enterprises' unfunded contingent liabilities have often made it necessary for the government to take over debt. In the 1990s, about one third of the net increase in the Confederation's debt stemmed from the under-provision of the pension funds of public enterprises or autonomous authorities.²⁹ *Fourth*, financial auditing carried out by the Contrôle fédéral reportedly takes prominence over performance assessment. Most of these reports are submitted only to a limited number of parliamentarians and some are confidential. *Fifth*, little information exists on the fiscal costs of tax relief in terms of foregone revenues.³⁰ Tax expenditures are not reported on an annual basis and *a fortiori* are not evaluated during the budget process.

More flexible and outcome-oriented public management approaches are being introduced

18. Maintaining fiscal discipline has long relied on strict enforcement mechanisms to ensure that budgets were implemented along intended lines. However, these mechanisms have been too rigid to promote public spending efficiency and have even created incentives to overspend. Strict rules on the number of public employees implemented from the mid-1970s up to the late 1990s have failed to reverse the rising trend in personnel costs, partly due to the replacement of low-paid by higher-paid employees. The civil servant status and the associated rigid salary scales and job classifications have also made it difficult to attract specific groups of workers (*e.g.* software or financial specialists) since wages failed to reflect the degree of labour market tightness and wage levels in the private service sector for similar responsibilities.³¹ In addition, most public bodies have been operating under an annual line-by-line budget, whereby spending is itemised and unspent funds lapse at the end of the fiscal year. This approach has severely limited the flexibility to find the most efficient combination of inputs. It has also created strong incentives to spend the authorised amount so as to reduce the probability of a cut in resources the following year.

28. For instance, the local electricity monopolies reportedly offer some price rebates to public hospitals and schools which *de facto* result in lower public spending, at the cost however of higher prices for other users. Similarly, postal services serve regional policy objectives and postal offices with very few customers have been maintained.

29. The net federal debt rose by more than 13 per cent of GDP between 1990 and 2000. However, the cumulative impact of the Confederation's deficit explains only about 8 percentage points of this increase.

30. Switzerland grants generous tax privileges to capital income in general, and for savings with pension funds and insurance companies in particular (Carey *et al.*, 1999). The last tax expenditure review was published in 1997, as an annex to the review of the Confederation's transfer system. This review contains estimates for only two thirds of the tax expenditure items, dating back from the early 1990s in most cases. Information on the beneficiaries of these tax relieves does not appear in this review.

31. International comparisons highlight the large share of personnel outlays in total public expenditure, which seems to reflect a high average wage in the civil service rather than a large number of civil servants. According to census data, employment in general government accounts for 12.6 per cent of total employment in Switzerland compared with an average of 16.2 per cent in the euro area and 14.3 per cent in the United States.

A more flexible management of resources...

19. Several changes have recently been introduced to improve the quality and cost-efficiency of public services. A majority of cantons (sixteen) and municipalities have abolished the long-standing public servant status and the associated rigid pay arrangements. A new personnel law (Lpers) is also being implemented at the federal level and by some large public enterprises, covering 110 000 employees.³² Such reforms in personnel management should not only give these public entities more flexibility in setting the appropriate level and composition of their labour force, but also provide better work incentives by making part of compensation dependent upon performance.³³

20. New public management principles have been introduced in some public entities, although other OECD countries have gone much further than Switzerland in several respects. Moving away from a rigid input approach by more clearly defining the expected outputs has been a key objective. Some public entities are now responsible for deciding about how to best deliver these outputs within a given budget constraint (the so-called *Gestion par Mandat et Enveloppe Budgétaire*, GMEB). Concomitantly, employees are required to be more accountable for outputs, through performance-related compensation schemes. These new management principles are expected to improve cost-efficiency but also to allow public bodies to better respond to the clients' needs. Public entities managed through the GMEB are allowed to exceed their budgets if additional services can be financed out of additional revenues (over and above those specified in the contract with the administration). They also have considerable freedom to use their efficiency gains (*e.g.* to raise employees' wages or to develop new activities). First introduced at the municipal and cantonal levels, this approach is also being implemented at the federal level.³⁴ Adopted on a voluntary basis by 11 federal agencies since 1997, the move has been associated with a commitment to cut costs by 10 per cent over a four-year horizon.³⁵ Savings are mostly expected to derive from enhanced flexibility in resource management, and by the move to a global budget. There are several constraints to the development of the new management approaches. First, cost-accounting is still too little developed in the public sector. Second, defining and measuring outputs and outcomes is difficult. Third, the requirement to cut costs may have reduced the attractiveness of the new management approach. Overall, offices managed under the new regime accounted for 1.3 per cent of the Confederation's total spending in 2001, and 7.9 per cent of its labour force.

32. The new personnel law was implemented in 2001 by the railway company (CFF) and the postal services (La Poste). It is due to come into force in 2002 for the Confederation. Overall, 111 000 persons will be affected by the law, of which 23 000 and 24 000 at La Poste and the CFF, respectively.

33. In the previous system, seniority bonuses were granted almost automatically, irrespective of the employee's performance and in 2000, only 0.5 per cent of the Confederation's wage bill was available to reward good performance.

34. One fifth of the municipalities (mostly the largest ones and those that are part of German-speaking Switzerland) have introduced new public management methods, including product definitions, performance agreements, and global budgets (Steiner, 2000).

35. The 11 agencies managed under the "GMEB" model are: Institut suisse de météorologie, Office fédéral de topographie, Centre sportif de Tereno, Swissmint, Office fédéral de communication, Office fédéral de météorologie, Centrale de compensation, Organe d'exécution de la confédération pour le service civil, Stations de recherches agronomiques, Haras fédéral d'Avenche, Institut de virologie et d'immunophylaxie.

... with greater emphasis on outcomes

21. The ambition to increase public spending effectiveness is enhanced when relying on outcome-oriented public management, since the ultimate objective is no longer the supply of public services but its impact on the (targeted) population. All levels of the Swiss administration have taken interesting initiatives in this direction. At the cantonal level, one example is the introduction of a global budget for secondary schools in the canton of Zürich, accompanied by outcome indicators (Reichard, 2001).³⁶ At the municipal level, the use of outcome-oriented public management is largely correlated with the municipalities' size, partly reflecting the stronger need in large municipalities to bridge the gap between the administration and the general public (Steiner, 2000). At the federal level, the recent reform of the public employment services is also ambitious and places Switzerland (along with Australia) at the forefront of implementing new management models geared to outcomes. While the Australian approach involves considerable market testing and outsourcing, Swiss regional placement offices (RPOs) have been assigned clearly measurable outcome objectives and considerable flexibility on how to reach them (Box 2).³⁷ However, contrasting with agencies which have been granted greater freedom in achieving outputs within a budget constraint (the GMEB), RPOs are funded by the federal government mainly on the basis of their actual expenses. There is a ceiling — defined as a function of the number of registered job seekers in the canton — on federal reimbursement of ALMP costs. However, all cantons operate below this limit suggesting that it may be too high. As a result, while outcomes may improve, the current financing framework of RPOs creates incentives to overspend and may not guarantee “value for money”.

Table 3. **Agreement 2000 on regional placement offices: objectives and indicators**

Objective	Indicator	Weight in the synthetic indicator
Rapid return to the labour market of the unemployed	Average number of compensation days	50%
Reduction in long-term unemployment	Ratio of long-term unemployed to total unemployed	20%
Reduction in the number of people reaching the end of unemployment benefit entitlements	Ratio of benefit terminations to the total number of benefit recipients	20%
Reduction in the incidence of re-registrations after exit from unemployment	Ratio of re-registrations within four months after leaving the unemployment register to the total number of benefit recipients	10%

Source: National authorities.

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36. The objective set for secondary schools in the canton of Zürich is that at least 90 per cent of pupils should qualify for university studies or a professional occupation and more than 60 per cent of university students are expected to finish successfully their graduate studies within 7 years after leaving secondary school.
37. Some remaining detailed rules on the structure of cantonal spending (*e.g.* no more than one office manager for eight personnel counsellor in the RPOs) were abolished in June 2001.

Box 2. Moving towards an outcome-focused management approach for public employment services

Increasing financial resources for public employment services...

Although the unemployment rate is low by international standards, it has risen steadily in the early to mid-1990s, from below one per cent to more than 5 per cent in 1997. As a result, public spending on unemployment programmes rose from less than ½ per cent of GDP to 2 per cent in 1997. This has led to a fundamental reform of labour market policies, with a shift in emphasis from passive to active labour market policies. The 1995 reform of the unemployment law aimed at a rapid and durable return of the unemployed to the labour market. Key to the new approach was the replacement of numerous municipal labour offices (over 3 000), whose role was perceived as marginal by the municipalities, by 150 professional regional placement offices (RPOs) managed by the cantons but financed by the federal government. RPOs have been made responsible for: *i*) counselling; *ii*) job placement; *iii*) organising active labour market programmes, which are partly outsourced to the private sector; and *iv*) sanctioning those who refuse an “acceptable” job.

... but failure to deliver the expected outcome, partly reflecting a too rigid management approach

Despite the labour market reform and the rise in financial resources, several surveys show that RPOs have failed to deliver the expected outcome (*i.e.* the rapid and durable return of the unemployed to the labour market). Strict and detailed rules on RPOs’ inputs and outputs in place up to 1997 (such as the annual minimum supply of ALMP slots, the number of counsellors per unemployed, or the number of counselling interviews) have in some cases contributed to poor labour market outcomes, in particular the duration of unemployment spells (Sheldon, 2000). For instance, RPOs reportedly kept the unemployed in active labour market programmes longer than needed to meet annual targets for programme slots. In addition, the funding of public and private providers of training and education programmes according to the number of participants created incentives to retain the unemployed in these programmes instead of facilitating their return to the labour market.

The 2000 Agreement has enhanced flexibility and incentives to reach targeted outcomes

The 2000 Agreement between the federal government and the cantons aims at improving the RPOs’ performance. To this end, rules on RPOs’ inputs and outputs have been replaced by four clearly defined objectives, with an indicator attached to each of them (Table 3). Using a weighting scheme, these indicators measure RPOs’ overall performance. The federal government ranks RPOs — after controlling for other influences, notably local labour market characteristics such as the economic situation and the composition of the unemployed population. Performance rankings, as measured by the multivariate indicator, also serve as a base for rewarding, and possibly sanctioning the cantons on the basis of the outcomes achieved by the RPOs under their management (sanctions can be imposed for RPOs below the national average during three consecutive years). The maximum level of the federal bonus is however relatively small (equivalent to about 1 000 euros per counsellor) and is not paid directly to the counsellors nor to the RPOs but to the cantons, thus potentially reducing the RPOs’ incentives to perform well. Nevertheless, the publication of the performance ranking every six months seems to work as a strong incentive to achieve a good performance. Also, in 2000 financial incentives for training providers have been introduced by granting them a bonus when a participant finds a job during the training programme.

Funding principles do not always promote allocative and cost efficiency

An extensive reliance on earmarked tax revenues obscures allocation decisions

22. Earmarking tax revenues for specific spending programmes could hinder an efficient allocation of public resources. As a share of the Confederation’s total spending, earmarked appropriations amounted to 11.9 per cent in 2000, up from 7.7 per cent a decade before, largely reflecting the one percentage point increase in the VAT rate to finance public pension and invalidity transfers (AVS/AI) in 1999. However, the financing of road infrastructure — through excise taxes on fuel, cantonal taxes and custom duties on motor vehicles and road taxes — accounts for the largest component of earmarked appropriations

(CHF 3.7 billion in 2000).³⁸ This form of financing creates the risk of spending too much on projects with a low social value but whose funding is “guaranteed”. In addition, building new roads thanks to taxes on the use of the most polluting vehicles may contribute to reducing traffic congestion but it could also give rise to an increase in car use, and in pollution, thus reducing the environmental impact of such green taxes.

Extensive vertical transfers create poor spending incentives and little redistribution

Table 4. Public expenditure by function and government level¹
1999, in percentage

	Share in total spending	Share by level of government ²			Total
		Confederation	Cantons	Municipalities	
Administration	6.5	22.4	35.9	41.7	100
Justice, police	5.5	7.7	68.2	24.2	100
National defence	4.5	92.3	3.5	4.1	100
Foreign relations	1.8	100.0	0.0	0.0	100
Education	18.4	14.9	51.0	34.2	100
Primary and secondary schools	11.1	0.2	46.7	53.0	100
Universities	3.2	50.8	49.1	0.1	100
Culture and entertainment	3.1	13.2	31.7	55.1	100
Health	12.6	1.3	60.0	38.7	100
Hospital	11.6	0.1	60.7	39.3	100
Social insurance	19.4	51.9	27.4	20.7	100
Old age	4.7	80.6	16.1	3.3	100
Invalidity	3.5	75.3	20.8	3.9	100
Sickness	2.2	63.9	28.6	7.5	100
Other (including social assistance)	9.0	24.6	35.7	39.7	100
Transport	10.1	57.2	20.2	22.6	100
National roads	2.0	82.2	17.8	0.0	100
Cantonal roads	1.6	43.1	52.0	4.9	100
Municipal roads	1.8	0.3	5.4	94.3	100
Railroads	2.3	99.3	0.7	0.0	100
Environment	4.0	15.9	21.7	62.5	100
Public economy	5.6	73.2	18.9	7.8	100
Agriculture	3.9	89.4	9.1	1.5	100
Interest payments and others	8.4	82.4	0.1	17.4	100
Total	100.0	38.7	33.5	27.8	100

1. Excluding social security.

2. Spending by each government level, net of the transfers paid to another government.

Source: Office fédéral de la statistique, *Finances publiques en Suisse, 1999*.

23. While managerial approaches within each government level have improved, fiscal relations across them are still characterised by some overlap of responsibilities, poorly defined strategic objectives and weak incentives to reach them. The provision of many public services involves different government

38. Road taxes consist of an annual fixed-rate charge on heavy goods vehicles levied by the Confederation on vehicles weighing over 3.5 tonnes and a motorway tax. Special major infrastructure projects in the rail sector — including the construction of two main tunnels through the Alps, one in the west (Lötschberg) and one in central Switzerland (St. Gotthard) — are also largely funded through earmarked appropriations. The “Fund for Public Transport Infrastructure” is financed by a part of the gasoline tax, a part of the heavy vehicle tax, and 0.1 percentage point of the value added tax. However, contrasting with the financing of road infrastructure, this earmarking will stop once these specific projects are completed.

levels (Table 4). Clear definitions of each actor's responsibilities, as well as appropriate incentives to achieve them, are of paramount importance. In many cases, the public layer responsible for setting strategic policy objectives — the “buyer” — has retained the power to decide on details on how these objectives are to be achieved by operational layers and agents — the providers — without imposing a binding budget constraint or competitive pressures. While there are rules and regulations to control spending, overruns occur and lead to a high cost for some public services.

24. The current transfer system across government levels — aimed both at providing incentives to invest in some specific programmes and at ensuring some fiscal equalisation — is not well geared toward achieving allocative and cost-efficiency. It relies largely on conditional (vertical) grants. In 1999, conditional grants accounted for 75 and 81 per cent of the transfers received by the cantons and municipalities, respectively. However, these conditional grants are often designed for too narrowly defined objectives, while key strategic objectives are not clearly specified. In the case of forestry for instance, Jeanrenaud (1994) mentions the existence of 12 federal grants to the cantons. Such a fragmentation of the grant system mimics the “line-by-line” budgeting approach and may thus hinder an efficient allocation of resources. Furthermore, combined with a complex procedure to approve the transfer, it generates high administrative costs, for both the recipient and the grantee.³⁹

25. The current grant system mixes allocative and redistribution objectives, making it difficult to achieve each of them in a cost-effective manner. Aiming at redistributing the ability to spend from the rich to poorer cantons, conditional grants are adjusted and contain an element of fiscal equalisation — known as “equalisation supplements”. The Confederation's participation rate in the cantons' spending thus varies from one canton to another to reflect their fiscal capacity (Table 5). However, in some cases, the remaining part, which the poorer cantons have to pay, is still high. This may *de facto* exclude them from receiving the federal grants and undermines the objective of fiscal equalisation (Dafflon, 1994). Examples include forestry and civil defence.

26. To provide strong incentives for sub-national governments to deliver specific public services (the allocation objective), the Confederation's financial contribution is very high in some cases, weakening the incentives for cantons to contain costs. Such conditional matching grants may also lead to an over-supply of some services or a biased allocation between expenses with different subsidy rates. In particular, as grants usually support mostly capital investment and less current expenditure, the cantons may prefer to invest in a new project while neglecting maintenance of existing facilities. Local tax implications of a project largely financed by the Confederation also create an incentive for local authorities to inflate spending. If a local company is responsible for the project, the tax revenues for the local authority may be higher than its contribution to the project. In addition, conditional grants create incentives for cost padding, *e.g.* by inflating the costs of some spending programmes to take on tasks outside their formal remit. These drawbacks, also at work at the municipal level, are presumably higher for spending programmes where vertical conditional matching grants account for a large share of the grantees' effective spending (Table 6). And the most affected cantons are the poorest ones: while conditional grants amounted to about 17 per cent of the cantons' financial resources in 1999 on average, this share reached more than 40 per cent in some of the poorest.

39. Jeanrenaud (1994) provides an estimate of administrative costs for both the cantons and the Confederation for 4 grant programmes. Administrative costs ranged from 1.6 to almost 10 per cent of the grant, with the most important part of the cost being borne by the cantons.

Table 5. Grants from the Confederation to the cantons: fiscal equalisation supplements

Key cantonal programmes ¹	Grants from the Confederation to the cantons (CHF Million)			<i>Memorandum items</i>		
	Total	Basic grants	Fiscal equalisation supplements	Fiscal equalisation supplements as a share of total grants	Confederation's participation rate into the cantons' expenses	
					Minimum	Maximum
Preservation of monuments	25.3	14.2	11.1	44	10	35
Preservation of cultural assets	12.0	7.6	4.4	36	10	35
Forest maintenance	82.8	69.8	13.0	16	20	50
Waste water treatment	143.5	70.2	73.3	51	15	45
Old-age supplementary benefits	310.5	143.9	166.6	54	10	35
Supplementary invalidity benefits	167.4	79.8	87.6	52	10	35
Grants to students	104.0	53.2	50.8	49	20	60
On-the-job training programmes	286.6	210.7	75.9	26	27	47
Cantonal roads	235.0	197.5	37.5	16	20	60
Current subsidies to universities	370.9	340.3	30.6	8	--	--
Investment transfers to universities	91.7	75.8	15.9	17	35	60
Compensation for regional transport	1 214.0	1 117.7	96.3	8	50	95
Technical improvements for regional transport	126.1	81.6	44.4	35	5	50
Total conditional grants with a fiscal equalisation supplement	3 507.1	2 721.8	785.3	22	--	--

1. Only large grant categories are presented, and in most cases each category reflects the aggregation of several grants.

Source: National authorities.

Table 6. Intergovernmental transfers: conditional grants

As a share of subnational governments' spending, 1999

	Cantons	Municipalities
Education	21.5	16.8
Primary and secondary schools	23.9	14.0
Universities	19.8	5.5
Health	4.0	19.5
Hospitals	3.7	25.0
Social insurance and assistance	39.1	18.4
Health insurance	70.5	38.1
Social assistance	34.2	26.3
Transport	57.5	6.5
National roads	82.5	0.0
Agriculture	84.3	34.8
<i>Memorandum item</i>		
Total spending	25.4	17.3

Source: Office fédéral de la statistique, *Finances publiques en Suisse, 1999*.

The lack of competitive pressures further undermines cost-efficiency

Limited competition in public procurement markets...

27. Despite commendable steps towards the liberalisation of public procurement markets since the mid-1990s, there are still some barriers to effective competition.⁴⁰ Government procurement amounts to almost one fourth of total public spending (CHF 30 billion), and efforts to reduce costs could potentially result in important savings. The recent bid for the National Library provides an example. Reflecting collusion among the bidding companies, the “best offer” was a price that was about twice the estimated “reasonable value”.⁴¹ The complexities of regulations on public procurement markets as well as their fragmentation raise entry barriers. Regulations and procedures vary not only between the Confederation and the cantons but also from one canton to another (including thresholds for public tendering). In addition, government procurement policies, essentially at the lower levels of government, have been used to protect local enterprises and employment, subsidising small and medium-sized enterprises and favouring regional development. Among the devices used to exclude non-local competitors from public contracts are the proximity criteria or conditions related to domicile.⁴² In addition, some diplomas obtained in one canton may not be fully recognised in another canton (*e.g.* in the health sector), thus limiting the ability of the professionals to bid in jurisdictions in which they are not resident. Combined with funding principles largely based on *ex post* actual spending, the lack of competition is conducive to low cost-effectiveness.

40. Switzerland has adopted the WTO government procurement framework and is implementing the bilateral agreement with the European Union (accepted by referendum in May 2000). These agreements oblige the Confederation, cantons and municipalities to implement open competitive bidding for contracts above a threshold value. In addition, an intercantonal agreement on public procurement has been adopted in 1994 and is currently under revision.

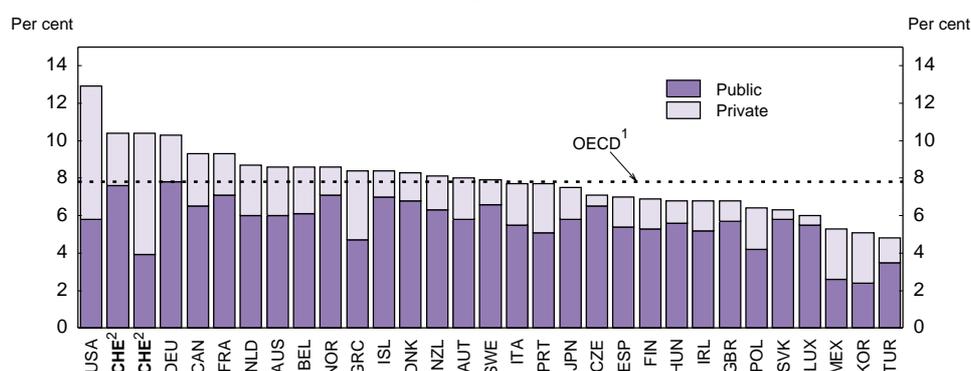
41. The competition authority concluded in December 2001 that the companies acted as a bidding cartel. <http://www.wettbewerbskommission.ch/site/f/medien/Medienmitteilungen.Par.0026.Pic0.pdf>

42. To participate in a bid in the canton of Geneva, architects and engineers need to have their headquarters in the canton. However, under certain conditions, a temporary registration can be obtained.

... and in the health care sector

28. In the health care sector, pricing and funding arrangements limit competition and boost the demand for and the supply of health care services (OECD, 2002a). While health outcomes are rather good, the Swiss health care system is the second most expensive in the world, surpassed only by the United States (Figure 5), with total spending reaching 10.4 per cent of GDP in 1998. The private sector accounts for a large share of both the financing and supply of health care services. However, pressures on public spending arise from the fact that about half of the treatment cost in public and subsidised hospitals is paid for by the cantons (only for services charged to the compulsory insurance). In addition, the Confederation and the cantons grant subsidies to low-income households to help them pay for insurance.⁴³ This component could increasingly burden public budgets since insurance premiums have risen steadily and are expected to rise by a further 10 per cent in 2002. A draft law which aims at ensuring that the insurance premiums paid by a household do not exceed 8 per cent of its income, the remainder being paid for by the Confederation and the cantons, will reinforce budgetary pressures.⁴⁴

Figure 5. Health care expenditure in international perspective
As a percentage of GDP, 1998



1. Unweighted average.

2. The first bar relies on OECD health data which classifies private insurance premiums under LAMal in the public component of health care expenditure even though the majority of this is paid for by households (a small part is government subsidies to the poor for health insurance). The second bar attributes private premiums to private spending.

Source: OFS; OECD Health Data 2001.

43. Health insurance premia are defined on a per capita basis and vary by a factor of one to two across cantons. About two thirds of the subsidies to the insured who cannot afford to pay the premia are paid by the Confederation, with the remainder being paid by the cantons. The health insurance law (LAMal) implemented in 1996 sets the maximum contribution by the Confederation allocated to health care subsidies at CHF 1 830 million (*i.e.* about 0.6 per cent of the confederation total spending). As a consequence, the cantons maximum contribution was set at CHF 640 million. However, many cantons took advantage of the possibility provided by the law of reducing their contribution by half, which also induces a halving of the Confederation's subsidy. Overall, subsidies from the Confederation and the cantons amounted to CHF 1 813 million in 1996.

44. This proposal will be presented to the Parliament in January 2002. If approved, it is expected to come into force in 2004 and is estimated to cost an additional CHF 280 million to the Confederation. Each canton will be required to complement the Confederation's subsidy. This would further increase public spending by an estimated CHF 135 million.

29. The lack of competition among health care suppliers has been considered as an important factor behind cost and supply-driven pressures on the system (OECD, 2000). Several forces are at play. *First*, payments for public hospitals and private practitioners create incentives for increasing the quantity of medical care. Prices are negotiated between the insurer and provider associations in each canton — all insurers are then charged the same price. Although the law allows some exception to this principle, in practice only very few purchasers (the insurance companies) put downward pressures on the prices of providers. In addition, the providers' remuneration is largely based on the number of medical interventions (fee-for-service) in the ambulatory sector or days of hospitalisation rather than on diagnosed medical conditions (*i.e.* outcomes) though several cantons have introduced case mix systems. Since costs tend to be relatively higher in the early days of a stay in hospital than towards the end, there is a financial incentive for hospitals to lengthen the hospitalisation period. This may partly explain the long length of hospital stays by international standards (Table 7). In addition, hospitalisation prices paid by insurers for the population with a compulsory basic health insurance are, by law, less than full cost, with the remainder being at the charge of the cantons. This creates an incentive to use hospital facilities rather than ambulatory care, which might be more cost-effective.⁴⁵ For those with a complementary insurance, cantons have refused to finance part of the hospital costs until recently, but several decisions by the federal insurance tribunal now oblige them to do so, adding a further cost for the cantons estimated at CHF 500 million. *Second*, all insurers must accept bills from all certified physicians, thus further reducing their incentives to put pressure on suppliers to reduce costs. *Third*, on the demand side, low co-payments by the patient (10 per cent) fail to contain demand while insurers have little incentive to curtail it. On the other hand, higher co-payments would raise serious equity issues.

45. The 1996 law on health insurances (LaMal) requires that health insurance does not cover more than 50 per cent of the operating costs of public hospitals for an insured person with a basic health insurance coverage. The rest of the cost should be paid by tax-financed cantonal contributions.

Table 7. **Health care resources and utilisation**¹
1999²

	Health employment		Acute-care hospitals	
	Practising physicians per 1000 population	Total hospital employment per 1000 population	Beds per 1000 population	Average length of stay
Australia	2.5 ³	19.4	3.9 ³	6.2 ³
Austria	3.0	15.6	6.2	6.5
Canada	2.1	11.5 ³	3.2 ³	7.0 ³
Czech Republic	3.0	12.3	6.6	8.6
Denmark	3.4	16.0	3.3 ³	5.3 ³
France	3.0 ³	18.6 ⁵	4.3 ³	5.5
Germany	3.5	10.3	6.4	10.4
Italy	5.9	11.0	4.9 ³	7.2 ³
Japan	1.9 ³	12.8		
Netherlands	3.1	9.1 ⁴	3.6	9.5 ³
Norway	2.8	16.4	3.2	6.1
Switzerland	3.4	29.7⁶	5.6³	11.4³
United Kingdom	1.8	22.2	2.4 ³	5.0 ⁵
United States	2.7 ³	16.3 ³	3.0	5.9
Unweighted average of OECD countries	2.9	13.9	4.2	7.1

1. Cross-country comparisons need to be interpreted with caution. See OECD *Health Data 2001*, Sources and Methods for details of methodology variations across countries. For Switzerland, it should be noted that *i*) "practising physicians" refers to all physicians; *ii*) the "length of stay" refers to the average for all hospitals excluding psychiatry and day cases, and is defined as the period between admission and discharge including short absences and disregarding transfers within the same hospital.

2. Unless otherwise indicated.

3. 1998.

4. 1997.

5. 1996.

6. 1995.

Source: OECD *Health Data 2001*.

Spending assignments across government layers raise efficiency issues

The local supply of public goods may raise citizens' satisfaction and promote competition...

30. Devolving spending responsibilities to local governments may raise economic welfare when the supply of public goods and services can be tailored to local citizens' preferences and willingness to pay. In addition, the adoption of new practices and policies by a canton or a municipality can generate valuable information for others, thus promoting innovations and creating an "information externality" at the national level (Oates, 1999). In this respect, the setting up of a health observatory to collect information on cantonal experiences in the health care sector is promising. In addition, many policy changes have first been introduced at the local level and then replicated at the federal level. For instance, the current system for public employment services (discussed above) was based on a model first introduced in one canton.⁴⁶ Likewise, several cantons and municipalities reconsidered their civil servant status and the management of

46. RPOs were introduced in 1994 in the canton of Vaud.

public entities before the Confederation. The differentiation in public services across jurisdictions also allows for some competition, thus reinforcing pressures on local officials to improve the efficiency of public services.

... but makes it difficult to reap scale economies and to internalise spillovers

31. A too locally-oriented supply of public services may hamper economic efficiency by making it difficult to take advantage of scale economies and to internalise the benefits received by residents from other jurisdictions. Education provides an illustration. The relatively small size of Swiss educational institutions — which limits their ability to realise scale economies — has been recognised as a factor contributing to the high cost of tertiary education, which is a cantonal responsibility (OECD, 1997). Some issues also arise on primary and secondary education programmes, which are set under the responsibility of the cantons. The proximity of managers to the communities which they serve facilitates feedback and adaptation of the system to clients' preferences. This has allowed the cantons to tailor programmes to local citizens' preferences, thus providing more choices overall. However, local managers' responsiveness and effective competitive pressures are limited by strict zoning regulations and the fact that the "money follows the student" principle does not apply (in particular, the level of subsidies for private schools is generally low). In addition, the absence of a nation-wide school curriculum may contribute to reducing the geographic mobility of the parents once they have made a choice of the school for their children, thus hampering labour mobility.⁴⁷

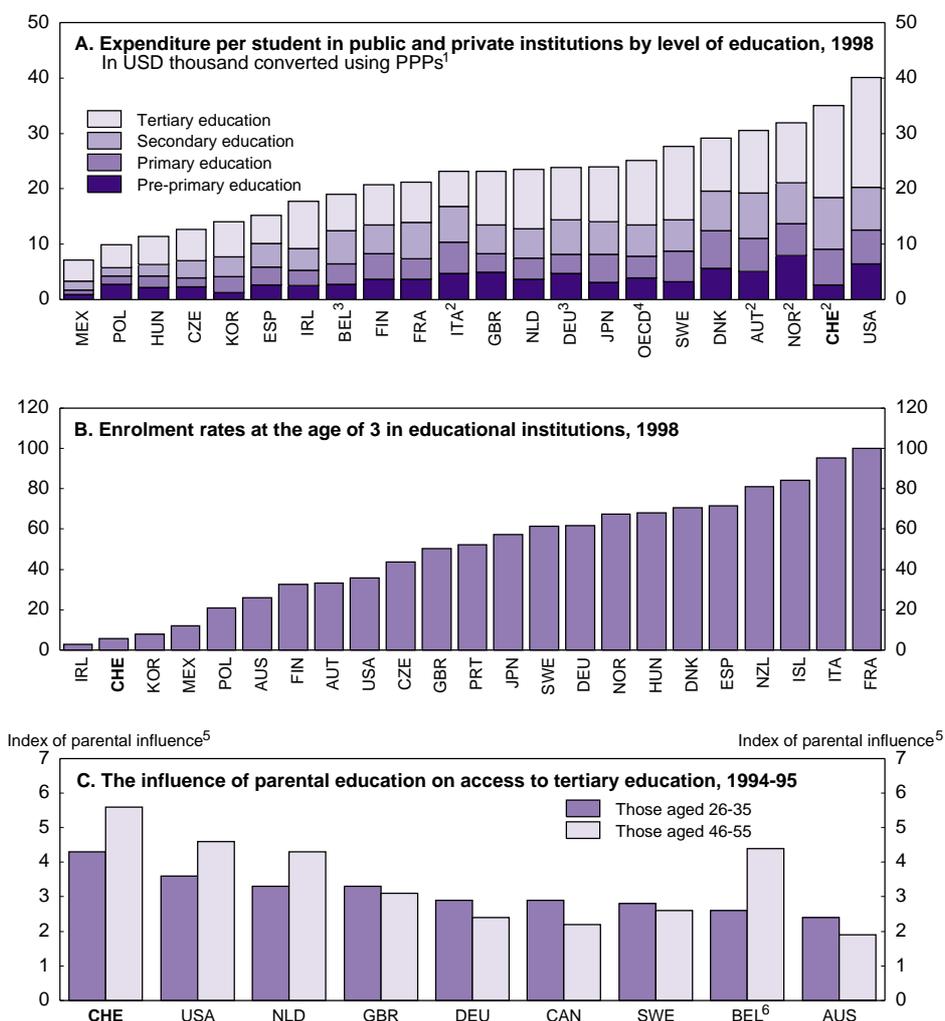
Spillover effects and the under-provision of public services: the case of childcare facilities

32. An under-provision of public services may also result from the existence of spillover effects. This arises when the benefits from local public spending extend to residents of other jurisdictions while the provider does not receive an adequate compensation. The lack of early childhood and educational care services provides an illustration. While public expenditure on education per student is very high by OECD standards, reflecting the high priority given to human capital in Switzerland, expenditure on "pre-primary" education is well below the OECD average (Figure 6, panel A). Participation rates in pre-primary education for young children are the lowest in the OECD area after Turkey and Ireland (Figure 6, panel B). Social and cultural factors play a role. However, long waiting lists suggest that private demand for childcare facilities is largely unsatisfied (National Council, 2002). While the initial effects are on the parents and children directly involved, it has been suggested that social rates of return of investing in childcare facilities are high (Heckman, 1999). This is postulated to reflect an increase in labour force participation; a higher ability later on to learn for those enrolled and; a lower recourse to welfare programmes.⁴⁸ For a country like Switzerland where foreigners account for a large share of the population, the US experience that early childhood educational care is an important factor to facilitate social integration of foreign-born children may be particularly relevant. Indeed, a recent cost-benefit analysis (Müller-Kucera and Bauer, 2001) estimates the impact of childcare on gross public spending and its returns. Overall, the net return ranges from CHF 3 to 4 for every franc spent.

47. The only exception concerns some of the secondary schools, whose programmes are co-ordinated nation-wide through an inter-cantonal agreement (Maturitätsanerkennungsverordnung).

48. The overall female participation rate is relatively high by OECD standard but, corrected for working hours, participation rates are much lower, especially for 25-40 year olds.

Figure 6. Education indicators



1. Based on full-time equivalents.
2. Public institutions only.
3. Public and government-dependent private institutions only.
4. Weighted average.
5. The index shows the multiplicative effect of tertiary education by the parent on the probability of tertiary education by the individual in this age bracket.
6. Flemish region.

Source: OECD, Education at a Glance: OECD Indicators, 2001; International Adult Literacy Survey, Statistics Canada.

33. Among the factors which impede public investment with high social rates of returns is the institutional and geographic fragmentation of the Swiss territory, combined with a lack of congruence between the costs and benefits for some public services across government layers. In the case of public childcare facilities, costs associated with their construction and maintenance are borne by the municipalities while benefits also accrue to the cantons (higher income tax revenues), firms (availability of qualified labour), parents and children (higher future income) and social insurance (lower welfare payments). Recognising the sub-optimal provision of childcare facilities, some cantons are increasingly

urging the municipalities to increase their efforts in this area, while contributing to some of the costs.⁴⁹ Financial incentives to improve childcare facilities are also debated by the Swiss Parliament and a decision is expected during the next summer session.⁵⁰

Merging jurisdictions and conditional grants have rarely been used to internalise spillovers...

34. Several institutional arrangements could be designed to internalise spillovers, including the merging of local jurisdictions and instituting or at least encouraging co-operation across government levels. Though the dispersion in the size of the cantons and municipalities is very high — suggesting potential spillover effects — few territorial modifications have taken place since the foundation of the Swiss federation in 1848. While the fusion of local authorities would improve spending efficiency by internalising spillovers and permit scale economies, it would also reduce the competitive pressures across them. In particular, it would entail a harmonisation of tax rates within the new jurisdiction and thus a higher tax burden for the residents of the former low-tax jurisdiction.⁵¹ In theory, conditional grants from a higher government level, in the form of “matching” grants, could be an alternative in cases where the provision of local services generates benefits for residents of other jurisdictions.⁵² In practice, however, as externalities extend both between and within layers of government, such an approach would probably lead to a too complicated transfer system.

... but horizontal co-operation agreements have developed

35. Horizontal co-operation agreements are another solution. The inter-cantonal agreement on university financing (Box 3) and municipalities’ co-operation on many local public services are promising examples. They make it possible to reap scale economies and to internalise spillovers by concentrating the supply of these services in some cantons/municipalities and by requiring other beneficiaries to pay for the benefits in exchange for participation in the management of these public services. Similar arrangements across cantons and municipalities have also contributed to the development of a coherent local public transport network able to meet the needs of commuters and to reduce the environmental impact of an excessive use of private cars (OECD, 2002b).

36. The lack of such horizontal arrangements is still hampering efficiency in some key public spending areas. There is evidence that frail elderly have to wait before receiving a place in old age and nursing homes in certain cantons while unused capacity has been available in neighbouring cantons. Thus, extending horizontal agreements has been considered as an option to achieve a better utilisation of existing capacities in old age and nursing homes at the cantonal level (OECD, 2000).⁵³ A similar issue arises in the

49. Four cantons (Tessin, Fribourg, Valais and Neuchâtel) have introduced a new law on childcare facilities. These cantons’ contributions to the municipalities’ costs vary however significantly (Berset, 2001).

50. An initiative launched in 2000 by a Parliamentarian (J. Fehr) proposes that the Confederation devotes CHF 100 million a year to fund childcare facilities over a 10-year period.

51. This was the main argument for the rejection (through a referendum) of a merger of municipalities in the canton of Thurgau in the late 1990s.

52. In a few cases, including the building and maintenance of national roads, participation rates by the Confederation to the cantons’ expenses do partly reflect the cantons’ benefit from a specific spending programme. However, in most cases, participation reflects first and foremost the Confederation’s fiscal position when the grant was given and the fiscal equalisation components (Blöchlinger *et al.*, 1999). They thus largely fail to incorporate spillover benefits.

53. In principle, each canton organises and regulates the provision of long-term care for the elderly. However, some cantons have devolved this responsibility to municipalities.

hospital sector. Though a number of smaller cantons already purchase a good part of their health services elsewhere, extending this practice through inter-cantonal agreements has been considered as a key factor to increase cost-effectiveness. However, the *ad-hoc* nature of these agreements has contributed to raise administrative costs while their voluntary nature may lead to free-riding (*i.e.* residents from one jurisdiction benefiting from public services provided by another jurisdiction in the absence of a fair compensation being paid to the providers).

Box 3. University financing arrangements

Accounting for spillover effects through a fair compensation of the provider's costs. Since 1981, inter-cantonal agreements have provided payments from cantons without a university in proportion to the number of students they send to cantonal universities. Up to 1998 however, the per capita compensation provided for by the agreements were uniform across study fields and did not cover costs. In 1997, the per capita compensation stood at about one fifth of the true average cost per student (OECD, 1997). In 1998, a new agreement was implemented, introducing a differentiation in compensation among three groups of subjects. In 2002, contributions per student amount to CHF 46 000 for medical sciences (clinical training), CHF 23 000 for natural sciences, and CHF 10 000 for human and social sciences. Per capita compensation was also raised substantially, though not up to the cost borne by universities (net of the Confederation's contribution). Setting inter-cantonal compensation below tuition costs is a recognition that host cantons do benefit from having a university in their territory: they retain highly qualified labour to the detriment of other cantons as a result of attracting students, who tend to stay and work in the host canton after finishing their studies.

Applying new public management principles to university funding. Up to 1997, the Confederation's financial contribution was based on universities' actual expenses. For current spending, the participation rate was set at about 10 per cent for rich cantons and higher for the poorer. The Confederation's participation rate was higher for investment and also differentiated according to the cantons' financial situation. A 1999 law induced a shift in university management towards defining outputs and giving universities greater autonomy in deciding how to produce them within a global budget. The Confederation's subsidies now finance services (*prestations*) rather than expenditure. Basic subsidies are proportional to the number of students and take the normal length of study for each field into consideration. As part of this process, a new body (*Conférence universitaire Suisse*) has been created to assess and promote the quality of services.

Equity considerations. Substantial public support for tertiary education raises equity issues. The private participation in tuition costs at the university level is low while public expenditure per student is very high by international standards. The greatest beneficiaries are those who participate most intensively and more than in most other OECD countries, the influence of parental education on young people's access to tertiary education is high in Switzerland (Blondal *et al.*, 2002). Though this influence has declined over the past decades, children of tertiary-educated parents are still more than four times more likely to enter tertiary education than children with parents that have only lower-secondary education (Figure 6, panel C). Social equity may also be undermined because individuals with high lifetime earnings receive large subsidies.

Poverty issues have also come to the fore⁵⁴

37. The responsibilities for and financing of social assistance programmes are largely in the municipalities' hands, creating two main risks: a low level of support for the poor and unsustainable public finances at the local level. As in many other OECD countries, Switzerland has witnessed migration of middle and upper income groups from inner cities to suburban areas. As a result, large city centres tend to have a higher proportion of low-income households, who are more dependent on welfare programmes. They also have a large share of immigrants, which on average depend more on social welfare than Swiss nationals. Although there is a unified framework covering core social benefits at the cantonal level, municipalities still have discretion to accept or reject social claims in most cantons and can grant social

54. This section largely draws on OECD (1999) and on the Territorial Review of Switzerland (OECD, 2002b).

benefits over and above the minimum standards.⁵⁵ Thus, unequal standards prevail, giving rise to some “social tourism” (claimants looking for the most generous assistance benefits and better social services — such as greater professionalism among staff and less stigma in large than in small rural communities).⁵⁶ Overall, the share of spending on social assistance programmes amounted to about 12 and 15 per cent of total spending for the two large cities Zürich and Bern, respectively, compared with a national average of 7 per cent in 1999. On the revenue side, the migration of middle and upper income groups to suburban areas have put further strains on large cities’ fiscal positions while further hikes in taxes have reinforced incentives for those groups to migrate.⁵⁷ Eventually, this situation could result in severely curtailing social assistance programmes and/or a further deterioration in the financial position of large cities.

The proposed reform of spending assignments and fiscal equalisation schemes

38. An ambitious draft law to revamp spending assignments and financial transfers between the cantons and the Confederation could entail, if consistently implemented, significant gains in terms of cost and allocative efficiency for key spending programmes (Box 4). The project was designed at the outset to be without financial losses or gains to the Cantons on aggregate and to the Confederation.⁵⁸ However, if implemented, this project should influence spending behaviour and efficiency gains would stem from three main channels.⁵⁹ *First*, the project aims at reducing the existing overlaps in cantonal and federal spending responsibilities by applying more consistently the subsidiarity and fiscal equivalence principles. This would contribute to streamlining administrative costs, allow the cantons to better tailor the supply of “pure local goods” to their residents’ needs and willingness to pay and improve the accountability of public administrations. *Second*, for those spending programmes which would still be co-financed by the cantons and the Confederation, management principles would move from an input (*ex post* actual expenses) to an output approach. Conditional grants would target broader strategic objectives, with more flexibility for the cantons on how to reach them (within a global and multi-year budget envelope). *Third*, the draft law foresees binding inter-cantonal agreements if the majority of cantons so decide in some key spending domains (including universities and specialised hospital care). This would make it easier to cope with spillover effects.

39. Moreover, the proposed reform would contribute to reducing the long-standing financial disparities across cantons, to reinforcing the cohesion of regions and to improving the functioning of federalism. In fact, the allocation of substantial fiscal equalisation transfers (CHF 2.1 billion in 1999) has not been accompanied by a reduction in the income distribution across cantons.⁶⁰ To improve the

55. Some cantons (*e.g.* Fribourg and Neuchâtel) have passed the responsibility for accepting or rejecting a demand for social assistance from the municipalities to a cantonal commission.

56. If an individual moves from one municipality to another, the municipality of destination can recoup the costs of the recipient’s benefits from the municipality of origin for a two-year period. This system is, however, administratively cumbersome.

57. The personal and income wealth taxes account for about 75 per cent of municipal tax revenues and are paid in the jurisdiction of residence.

58. The project would introduce a new transitional compensation scheme for poorer cantons (“*compensation des cas de rigueur*”). Associated spending would amount to CHF 280 million, *i.e.* less than 0.2 per cent of total public spending in 1999. Spending would not be adjusted for inflation and could be phased out after 4 years.

59. A previous version of the reform project estimated that these gains could reach CHF 2 to 2.5 billion (1.7 per cent of total public spending).

60. Zürcher (1998) shows that the dispersion of income across cantons was broadly similar in 1994 to the 1965 situation. However, these disparities are low compared to many other OECD countries (OECD, 2002*b*).

effectiveness of fiscal equalisation policies, the reform envisages abolishing the fiscal equalisation supplements to the remaining conditional grants, thus disentangling the allocative and distributional objectives which have often proved to be inconsistent. Redistribution across cantons would instead result from higher block grants (not earmarked for any specific activity) from the Confederation. These block grants would leave the cantons with discretion as to how to organise local provision in the best way while avoiding micro-management by the central government. In addition, the fiscal equalisation scheme from the rich to the poor cantons would also be broadened, with a shift in emphasis from actual taxes collected to their capacity to raise taxes. Incentives to adjust local tax rates to citizens/taxpayers preferences would thus be reinforced.

Box 4. Reforming the assignment of spending responsibilities and fiscal equalisation scheme

Drawbacks resulting from the current assignment of spending responsibilities and financial transfers across government layers (see above) have long been recognised by the Swiss authorities. *First*, the overlap in the cantons' and the Confederation's financing responsibilities for an increasing number of spending programmes has contributed to dilute each actor's responsibilities in achieving objectives. *Second*, high contributions by the Confederation to the cantons' actual expenses for too narrowly-defined objectives has provided poor incentives to improve cost and allocative efficiency. *Third*, the existing fiscal equalisation scheme has been disappointing in reducing financial disparities across cantons, largely reflecting the mixing of redistributive and allocative objectives embodied in the vertical transfer system. *Fourth*, cantons have failed to internalise spillovers for some spending programmes, resulting in a sub-optimal provision of public services and/or in a difficulty to seize scale economies.

To remedy these shortcomings, a wide-ranging discussion and negotiating process involving the cantons, the Confederation and experts was launched in the early 1990s. This forms the basis for the ambitious draft law to reform spending assignments and financial transfers across the Confederation and the cantons (*Réforme de la péréquation et de la répartition des tâches entre la Confédération et les cantons*, RPT). If approved by the cantons and by the Swiss population, it is expected to enter into force in 2006. This reform has four main objectives:

Disentangling cantonal and federal spending responsibilities. The reallocation of tasks has been mainly driven by greater emphasis on the subsidiarity and "fiscal equivalence" (or user-decider pay) principles. The RPT reform would change spending assignments in twenty-nine areas. In particular, the Confederation would be competent for national roads, old age and survivors' pensions (first pillar) and invalidity pensions. The cantons would be responsible in other areas, including specialised care institutions for handicapped persons and housing policies in mountain areas. As a result, the responsibility for over 40 per cent of the spending programmes which are currently co-financed by the cantons and the Confederation would be transferred to only one administration level.

Improving the co-operation on spending programmes whose responsibility would still be shared by the cantons and the Confederation. Conditional grants would no longer be based on *ex post* actual expenses but on an estimation of standard costs (defined *ex ante*). In addition, many of the existing small conditional matching grants would be merged and folded into a broader envelope. The Confederation would set the strategic objectives (output) for these broader spending programmes while the cantons would be fully responsible on how to reach them. The main spending areas to which these new management principles would apply include: universities, regional public transport systems, airports, agriculture and forestry.

Reinforcing co-operation across cantons. To avoid that spillovers give rise to a sub-optimal provision of public services, the providing cantons would be entitled to claim a financial compensation from the other cantons whose residents are using its services. Such a compensation scheme has already been introduced for universities and local transport networks through voluntary inter-cantonal agreements. This new institutional setting would also reduce the opportunities to free-ride on these forms of co-operation. Nine areas are concerned by this compensation scheme, including: universities, local transport systems, waste water management facilities and hospitals.

Reducing financial disparities across cantons. Fiscal equalisation supplements to the conditional matching grant system would be replaced by a financial equalisation scheme based mainly on the cantons' ability to raise taxes and by new block grants from the Confederation (reflecting geographic or social and demographic factors). In addition, two new grants from the Confederation to the cantons would be introduced to help the cantons meet an extra financial burden under specific circumstances, taking into account: *a*) geo and topographic factors (for mountain areas and/or those with a highly dispersed population); *b*) and socio-demographic factors (for those cantons where the old, poor, low-qualified and unemployed account for a large proportion of their population).

Agenda for further reform

40. The Swiss authorities have recently implemented and are planning several reforms to contain public spending and improve its cost and allocative efficiency. While these are clearly steps in the right direction, a rapid implementation of the reforms would be advisable and should be accompanied by other initiatives to deliver their full benefits. Recommendations for further reform are discussed below and Box 5 provides a synopsis.

Box 5. Recommendations for enhancing public spending efficiency

Increase the efficiency of automatic stabilisers

- Implement the debt containment rule rapidly, as from 2003. Avoid a too mechanical approach to the estimation of the output gap that is necessary for the implementation of the rule.
- Promote the implementation of a similar rule at the other levels of government to make the automatic stabilisers work better. The reform of the unemployment insurance system, which could be challenged in a referendum would also reinforce the stabilisers.

Enhance the medium-term focus of fiscal policies

- Apply the debt containment rule in a process that is centred on multi-year planning, with a formal adoption of the financial plans by Parliament.

Improve transparency

- Assess on a yearly and more systematic basis the fiscal costs and the main beneficiaries of tax expenditure and include the tax expenditure report in the budget process.
- Accelerate the move from a cash to an accrual basis.
- Improve the transparency of social mandates carried out by public enterprises and assign direct budgetary appropriations.
- Phase out earmarked funds.
- Give more emphasis to performance assessment so as to ensure value for money in the *Contrôle Fédéral*'s reports and make these reports publicly available.

Focus more on public spending outcomes

- Extend the use of outcome-oriented management methods by defining appropriate performance-oriented compensation schemes and performance management tools.
- Develop appropriate instruments to evaluate outcomes and establish an independent body for this purpose.
- In the hospital sector, replace the existing per-diem reimbursement scheme by a system based on case mix while abolishing the financial contribution from the cantons.

Intensify competitive pressures and the use of price signals

- Simplify and harmonise rules on public procurement and intensify competition in this market.
- Introduce contractual arrangements in the health care sector, which allow insurers to place pressures on the suppliers of services to increase efficiency and quality of care.
- Introduce road-pricing mechanisms.
- Raise tuition fees for universities and reduce public funding of tertiary education. To mitigate the potential adverse distributional impact, some means-testing could be introduced (either grants, tuition fees or subsidised loans).
- At primary and secondary education levels, apply a “money follows the student” approach and remove strict zoning regulations to enhance competition across jurisdictions and between public and privately-managed schools.

Re-assign functions and change the funding principles across government layers

- Implement rapidly the proposed reform of spending assignments and fiscal equalisation schemes, while lifting the constraint on the cantons to spend the full conditional grant in a specific area once strategic objectives have been met.
- Develop appropriate instruments to evaluate to what extent the cantons comply with the objectives and establish an independent body for this purpose.
- Adjust conditional grants to better reflect spillover effects across jurisdictions or further reconsider the spending assignment (*e.g.* for early childhood care and educational facilities).
- Improve cost accounting to facilitate horizontal co-operation across jurisdictions through a fair compensation of the providers' costs.
- Harmonise sub-national governments' practices in deciding over the granting and level of social benefits and introduce a funding scheme, which avoids a disproportionate financial burden on large cities.

Control the federal budget better and allow the automatic stabilisers to work fully

41. The adoption of the debt containment rule will improve the role of spending policy in macroeconomic management. In particular, federal spending should be under better control than during the past decade. The gradual reduction of federal debt as a proportion of GDP required by this rule appears to be broadly adapted to the needs of the economy in the light of the long-term budgetary outlook and the goals of fiscal policy. It is traditionally difficult to identify an optimal level of debt.⁶¹ The current level of gross general government debt is not high compared with other countries. A more rapid reduction in federal debt that would be possible with a more restrictive rule requiring a structural budget surplus hardly seems warranted on grounds of inadequate saving, as the comfortable current balance shows. A gradual reduction in debt is compatible with the objective of maintaining or even reducing taxes to foster the economy's competitiveness. The reduction, which will give some leeway to cope with future increases in transfer expenditure, also seems justified on grounds of intergenerational equity (OECD, 2002a). On the other hand, while the functioning of the automatic stabilisers will be enhanced at the federal level, their overall effect is likely to remain weak, unless a better harmonisation of fiscal rules between the various levels of government is achieved. The balanced budget rules followed by a majority of cantons and municipalities will not be affected by the new debt containment rule and hence will likely continue to have a pro-cyclical influence on activity, as in the past decade.

Give a greater role to the financial plan in the management of expenditure

42. After the approval of the debt containment rule, it is important not to underestimate the difficulties involved in implementing the law. It would be desirable, for instance that the estimate of the output gap not be based on too mechanical an approach but rather rely on a broad assessment of trend output and that the tax elasticity be carefully assessed in order to limit the risk of a bias in revenue estimates. It would also be useful to apply the debt containment rule in a budget process centred on a multi-annual planning strategy. Given the rigidity of the federal budget, care should be taken to ensure that the rule does not jeopardise the efficient allocation of resources. In particular, there is a risk that capital expenditure could become excessively volatile relative to current expenditure, especially as the control of some social expenditure items is difficult. The formal adoption of the financial plans by the two Chambers

61. With a debt stable in nominal terms, the debt-to-GDP ratio should fall by 25 per cent over a decade (*i.e.* by 13 percentage points), assuming a nominal output growth of 3 per cent a year — 1.5 per cent real and 1.5 per cent of inflation.

as proposed by the National Council and rejected by the Council of States would reduce this risk. It would also increase Parliament's scrutiny of the budget, which at present is very limited given the importance of "mandatory" outlays. In so far as the spending trend will need to be in line with structural revenues, which do not fluctuate much, it seems more natural to conduct budgetary discussions within a medium-term framework, so as to reconcile the objectives of controlling and allocating expenditure efficiently.

Enhance the transparency of public spending costs and benefits

43. Improving the transparency of public spending is desirable as it would support fiscal discipline and a better allocation of public funds. The systematic assessment of the medium-term fiscal costs of the main policy changes is an important step in this direction. However, further progress is desirable in several areas. The current accounting framework does not allow future liabilities and the contingent debt of some public entities to be properly taken into account and part of the Confederation's expenditure is recorded off budget — part of the rail infrastructure and, from 2003, the federal contribution to unemployment insurance. A working party has been set up to devise a new accounting framework which would encompass, on the liability side, all the Confederation's accounts, including implicit debts. This reform should be implemented rapidly.⁶² In addition, the authorities should make all the necessary efforts to provide national account data consistent with international norms and on a timely basis. Efforts to move to accrual accounting should be reinvigorated. Improving the transparency of public enterprises' social mandates would also be desirable. This would force governments to identify clearly the social objectives they want to pursue, to find the most efficient way of achieving them and to judge whether they merit the cost. These mandates could be more efficiently and transparently performed through direct budgetary appropriations.

44. Better prioritisation in public spending programmes would also require assessing the fiscal costs of tax reliefs on a more systematic basis, to reconsider the use of earmarked funds and to enhance the role of the *Contrôle fédéral*. Reports on tax expenditures are not frequent and comprehensive enough to identify their fiscal costs and their impact on efficiency and income distribution. A more systematic assessment would not only lead to a clearer identification of costs and objectives but could also point to better ways of achieving them. Tax expenditure reports should be produced annually and linked explicitly to the budget process, as is already done in several OECD countries (including Belgium, Finland, France, Portugal and Spain). Earmarking budgetary resources reduces uncertainty in the financing of key spending projects such as infrastructure investment. However, this also reduces the scope for reallocating public resources to the most effective use. Redefining the role of the *Contrôle fédéral* to include a more systematic assessment of public spending outcomes, and making its report available to the public, would further help in this respect.

Shift the focus to public spending outcomes

45. The recent moves towards better management methods have reduced incentives to overspend while allowing a better response to clients' needs. However, the coverage of the expenditure involved is still too limited. The extension of this approach to other parts of the administration is slowed by the requirement to implement a 10 per cent cut in budgetary resources. To make the voluntary shift to the new management model more attractive, the size of the budget cut should reflect conditions facing each particular agency. In addition, while the GMEB approach clearly reduces the most blatant incentives to overspend, it partly fails to address the effectiveness of such spending programmes. The quality of the output produced by these entities as well as their impact on the population (*i.e.* the outcome) should be

62. See AFF, 2001. On the current timetable, the new framework will not be adopted before 2004-05.

assessed regularly by independent auditors. This would help to guarantee the effectiveness of spending programmes and to avoid the risk of crowding out private providers.⁶³

46. Some public services have clearly-defined outcome objectives but the lack of appropriate compensation schemes may still create incentives to spend too much. The recent reform of public employment services (“Objective 2000”) aims to redress the drawbacks resulting from a management approach focused on outputs (*e.g.* the supply of action labour market programme slots) by introducing a clearly measurable outcome objective which serves to assess the performance of regional placement offices (RPOs). However, since RPOs are mainly financed on the basis of their actual expenses, with no hard budget constraint, no mechanism ensures that marginal benefits of public spending do not exceed social marginal costs. Though it is difficult to say *a priori* from which level a cut in RPOs’ spending would result in a net saving, existing data on RPOs’ costs could be used to define a benchmark and assess best practice.⁶⁴ Another solution would be to follow the Australian experience (OECD, 2001*b*). This would argue for defining the “optimal” RPO’s fee from the budgetary balance in terms of unemployment benefits saved, taxes received and a valuation of other externalities that result from lower unemployment. Employment service providers should then bear the cost of inputs and be free to choose the level of spending on inputs which maximises their “profitability”.

47. In the health care sector, funding principles have also encouraged providers to increase the volume of services, probably beyond the level required to ensure satisfactory health outcomes for the population. The very long average length of stay in public hospitals provides an illustration. It largely reflects the incentive to prolong the duration of hospitalisation inherent in the *per diem* reimbursement scheme. Moving, as envisaged in a draft law, towards a payment-per-case system whereby fees are set according to diagnosed medical conditions and standardised treatment costs would serve to redress suppliers’ incentives.⁶⁵ In Austria, for instance, the introduction of a performance-oriented reimbursement system for hospitals has resulted in a decline in the average duration of hospital stays (OECD, 2001*c*).

Raise the contestability of public service provision and use price signals more often

48. Reaping the full benefits of a market-oriented management approach partly depends on the strength of competitive pressures. While Switzerland relies heavily on the private sector for providing and financing key public services, weak competitive pressures have failed to keep costs low. In the health care sector, this has been reflected in the steady rise in insurance premiums paid by individuals to private companies. To relieve the pressures on low-income households, the authorities are considering a draft law to grant subsidies to the insured for whom the basic premium amounts to more than 8 per cent of the family income. Raising competitive pressures in the system could serve to reduce the budgetary impact of

63. Most public offices managed under the GMEB model deliver some services to private clients, which partly serves to assess their ability to respond to the market. However, in some cases they may hinder the development of private companies. Claims of unfair competition between GMEB offices and private competitors have already surfaced. A private company brought a case against the federal topography agency. The government, after consulting the competition authority, has denied the unfair competition claim.

64. RPOs contribute to a rapid and durable return to work for the unemployed, and thus to reduce the overall amount of unemployment benefits. Cutting too much spending on RPOs may result in an increase in unemployment benefits. Net savings could even turn negative. In 2000, unemployment benefits cost 0.57 per cent of GDP. RPOs’ administration cost amounted to 0.11 per cent of GDP while other labour market measures cost 0.36 per cent of GDP.

65. Pilot experiences have recently been introduced in several cantons (Valais, Geneva, Tessino, Vaud) and could provide useful lessons. A wider reform is currently under discussion within the Parliament.

the draft law. This would require allowing insurers to negotiate with the suppliers of services through contractual arrangements. The cantons' contributions to public hospitals (at least 50 per cent of their costs) also reduce incentives for insurers to rely more on less expensive health care suppliers (ambulatory care and Health Care Maintenance Organisations). Effective competition at the provider level is hindered by the requirement for insurers to accept bills from all certified practitioners combined with a uniform price negotiated at the cantonal level between insurers and health care providers. In this context, the implementation of the proposed introduction of a refusal right for insurers would be desirable but should be extended to hospital care. However, to be fully effective, it would also require changes to the pricing of health care services (OECD, 2002a) and to eliminate the canton's contributions to public hospitals.

49. The complexity and fragmentation of rules for public procurement markets also reduce competitive pressures. Cantons still apply different thresholds, procedures and criteria on public procurement markets, which often result in excluding non-local competitors. A revision to the existing inter-cantonal agreement on public procurement is under consideration and should improve the situation. However, efforts to speed up the revision and the implementation of this agreement would be desirable since its implementation is expected to take from two to four years. The competition authority's role to monitor non-competitive behaviour by government agencies should also be extended, and its resources increased accordingly. Meanwhile, transparency should be enhanced. Intensifying the use of e-procurement as in the European Union is an option, and the initiative to create an Internet site to publish cantonal public tenders, already implemented by the canton of Vaud, could be extended to all cantons.⁶⁶ In some cases however, costs of writing contracts and bidding for tenders could reduce the attractiveness of turning to competitive bidding. This, combined with significant differences in financing conditions between private and public borrowers, also contribute to explain the rather limited scope of public-private partnerships in Switzerland. Efforts to reduce these costs — *e.g.* by providing guidance and technical assistance to the cantons and by standardising the contracts — should thus be implemented to foster competitive pressures from the private sector.

50. In some domains, raising market pressures would also entail the more frequent use of price signals. Relying more on user charges could in fact prompt demand-side pressures for better-quality and lower-priced services. Little information is available on the use and level of user charges, largely reflecting the very decentralised institutional setting. But there are at least two domains where user charges could be increased: tertiary education and roads. Road pricing is virtually non-existent, despite its potential contribution to lower public spending on roads and to urban traffic management.⁶⁷ Increased reliance on road pricing would however require a change in the constitution, which forbids tolls on all roads. For tertiary education, private co-payments are quite low by international standards (about 1½ per cent of total university revenues in the mid-1990s, OECD 1997) while they would increase incentives to study faster and to demand a better quality of services. Raising tuition fees could raise distributional issues. However, several studies have concluded that the impact of public support for tertiary education on equity is ambiguous (Atkinson and van den Noord, 2001; OECD, 2001d). In any case, the adverse impact on low-income students could be cushioned by means-tested tuition fees, grants or subsidised loans.

66. The internet site on public procurement markets for the canton of Vaud can be accessed at the following address: <http://www.marches-publics.vd.ch/>.

67. Any driver using the motorway has to pay an annual sticker. However, this fee does not reflect road use nor the contribution to traffic congestion. Set at CHF 40 per car in 2001, it is also low for the average user.

Reform spending assignments and funding principles across government layers

51. The draft law to reform spending assignments across government layers and the fiscal equalisation scheme is ambitious and lays the ground for enhancing public spending effectiveness significantly in many domains. However, it could be further improved in a few areas. For some tasks, the cantons would retain the operational responsibilities and receive conditional grants from the Confederation. These grants would no longer be based on *ex post* actual expenses but on an *ex ante* estimation of standard costs and many narrowly-defined grants would be merged into a broader envelope with key strategic objectives. This would give more flexibility to cantons on how to achieve them. However, the draft law would not allow the cantons to retain any financial surplus on a conditional grant once the strategic objective has been met as efficiency gains will have to be spent in the same area (*e.g.* forestry). This constraint may not provide the right incentives to improve efficiency and should thus be reconsidered. In addition, conditional grants should better reflect the externalities associated with the provision of public goods. One option is to rely more on a cost-benefit analysis to define the appropriate contribution from each level of government. This would suggest, for instance, raising public spending on childcare and educational facilities — with a financial participation from both the cantons and the Confederation — and lowering contribution rates for cantonal road investment. Increased public funds for childcare and educational facilities could be given to the providers. They could also be given to the parents, either as cash or vouchers so as to give more choice to the users and invigorate competition across providers.

52. The proposed measures to reinforce inter-cantonal co-operation should enhance cost-efficiency while avoiding a sub-optimal provision of public services. To maximise their benefits, these efforts should be complemented by several measures. The draft law's provisions should undercut free-riding behaviour by making it mandatory for cantons to co-operate in nine key areas and by prescribing that a canton using the public facilities of another one pays for the costs. However, defining a fair compensation for the providers' costs will require improving cost accounting and transparency at all levels of the Swiss administration. To extend the scope of this form of horizontal co-operation, which has often proved costly to design and monitor, the Confederation could consider providing technical and legal support.

53. Such co-ordination efforts should be broadened to encompass municipalities and social assistance programmes so as to avoid putting the fiscal sustainability of some large cities and poverty alleviation objectives at risk. As in other OECD countries, spatial mobility of households has limited the scope for local governments to redistribute income — as greater ambition in this field encourages an exodus of wealthy citizens and an influx of poorer ones — and has created important fiscal imbalances at the local level. Recent policy initiatives could contribute to lessen these adverse effects. In some cantons, municipalities already co-operate on social assistance programmes (*e.g.* Bern and Grisons), with a financial participation from the cantons. In addition, the draft law on spending assignments embodies a new equalisation fund, based on social and demographic variables, which could help those cantons with a disproportionate share of their population dependent on welfare programmes to fund assistance benefits. However, since this new fund would not be tied to a specific use and would be allocated to the cantons, tensions between the cantonal governments and the most affected cities could persist. There could thus be a case for harmonizing sub-national governments' practices in deciding over the granting and the level of social assistance benefits, while a funding scheme could be introduced that would avoid that a disproportionate financial burden falls on large cities.

GLOSSARY OF ACRONYMS

ALMPs	Active labour market programmes
AVS/AI	First pillar of old age and disability insurance
CFF	Federal railway company
GDP	Gross domestic product
GMEB	Public expenditure management based on output targets and block appropriations
KOF	Federal Polytechnic School of Zurich
LACI	Unemployment insurance law
LAMal	Health insurance law
LPERS	Federal personnel law
RPOs	Regional Placement Offices
RPT	Réforme de la péréquation et de la répartition des tâches entre la confédération et des cantons
VAT	Value added tax
WTO	World Trade Organisation

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