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ECONOMIC ANALYSIS

Reforming Corporate Income Taxation in Switzerland

by Martin D. Dietz and Christian Keuschnigg

Switzerland currently uses a classical system of corporate income taxation, resulting in double taxation of dividends. Unlike in the United States and many other countries with a classical corporate tax system, capital gains remain largely untaxed in Switzerland.[1] Dividends are taxed twice, first at the corporate level and then at the personal level. Capital gains from retained earnings, however, are taxed only once at the corporate level. The principle of equal taxation of personal income irrespective of its form is obviously violated. The inequality in the taxation of dividends and capital gains was pointed out in 1998 by a government Commissioned expert group (*Expertenkommission Steuerlücken*), which classified the untaxed capital gains as a tax loophole.

The issue subsequently has received much attention. The boom in stock prices in the late 1990s created some extraordinarily high capital gains that rather wealthy individuals realized tax-free. The labor unions argued for more fairness in taxation and initiated a referendum, which requested the introduction of a general capital gains tax. Because the referendum failed to propose an offsetting tax cut on other forms of business taxation, voters perceived it as yet another tax and rejected it in the November 2001 ballot. The topic has stayed on the political agenda as the government announced it would reconsider the issue in the context of a broader company income tax reform. It commissioned another study by tax experts, lawyers, and academics (*Expertenkommission rechtsformunabhängige Besteuerung* — ERU) and asked them to particularly investigate whether, and by how much, the double taxation of dividends discriminates between corporate and noncorporate businesses. The ERU expert commission developed a specific reform proposal, which the government is considering introducing into the political decision process. The authors were asked to evaluate the proposal from a quantitative economic perspective.[2]

The Current System

With that tax initiative, the government aims to achieve not only more equitable taxation, but also efficiency gains. Experts believe that the different tax treatment of dividends and capital gains is responsible for the traditionally low dividend payout ratio of Swiss companies. When companies largely retain profits, rather than distribute them, they deny shareholders the opportunity to decide how to reinvest their resources. Instead, companies often retain earnings and invest available cash flow in the firms' own projects. The problem is that those internally financed investments often yield a lower rate of return than investors could earn elsewhere. That is

typically a problem of large and mature firms with available cash flow. Economic theory predicts that the internal allocation of funds is, on average, less efficient than the external allocation of capital via financial markets. It is an indication of inefficiency when companies finance investments predominantly with internal funds, rather than using financial markets — not a sign of strength. Taxation that favors retained earnings and, thereby, discriminates against external investment finance does not foster strong corporate governance and efficient investment. The tax bias for retained earnings also discriminates against young and fast-growing companies. Those firms might have investment opportunities that offer a high yield but do not have sufficient cash flow to finance them internally. They cannot take full advantage of the light taxation of retained earnings but must resort to tax-discriminated external equity. More tax neutrality toward retained and distributed profits is preferable and clearly would promise efficiency gains, as compared to the current tax practice.

The discrimination against corporate dividend payments is not the only distortion created by the Swiss company taxation system. Switzerland still maintains rather low effective tax rates on investments, as compared to other neighboring countries; however, the Swiss economy's recent growth performance has been disappointing. That has spurred a debate about the competitiveness of the Swiss economy in general, and the tax system in particular.[3] In that context, commentators expect a reduction of the double taxation of dividends to strengthen growth. The tax system tends to distort firms' financing decisions toward an overly strong reliance on debt finance because the double taxation adds to the cost of equity capital, as compared to the cost of debt. That makes the business sector more vulnerable to adverse economic shocks. Last, but not least, the double taxation of dividends raises the tax burden on corporations, while noncorporate firms only are subject to the owner's personal income tax. The noncorporate form seems appropriate mostly for small firms. Big firms are corporations, almost without exception. Therefore, the double dividends' taxation selectively discriminates against investment by corporate firms. It also distorts firms' choice of organizational form by preventing some firms from incorporating, even when the corporate form might be more advantageous economically. On the other hand, the Swiss tax system requires the owners of personal businesses to report as part of their taxable personal income any realized capital gains from transferring ownership of a business but the capital gains from selling shares in corporate firms are largely tax-free. That increases the incentive to incorporate and offsets the disadvantage of dividends taxation.

Switzerland is a federal country consisting of 26 highly autonomous cantons. The decentralized structure is reflected also in the tax system. To a large extent, the cantons are free to levy additional taxes and use different tax rates, which has led to a rather pronounced variety of tax regimes. That tax autonomy induces quite intensive tax competition among cantons, which many believe is responsible for the comparatively low tax rates in Switzerland. The effective corporate tax rate across cantons ranges from only 15 to 27 percent, with an average of about 23 percent.[4] Top rates of personal taxes range between 22 and 41 percent, with an average of 38 percent.

A recent comparative study using the concept of marginal effective tax rates estimated a marginal tax for qualified stakes (investments) of only 39 percent for Switzerland, while the United States (56 percent), neighboring Germany (56 percent), and France (68 percent) have much higher tax burdens.[5] Switzerland's favorable tax position comes from the low corporate income tax rates, despite the double taxation of dividends. Looking at the different sources of financing reveals, however, that the Swiss system is far from tax-neutral. According to the authors' calculations, the deductibility of interest on debt from corporate income results in a low effective tax burden of 42 percent for debt financed investment. The cheapest financing source is retained earnings (35 percent), which reflects the low corporate tax rates combined with the tax exemption for capital gains at the personal level. New equity is by far the most expensive method of financing investment and results in an effective tax burden as high as 60 percent.

Mature firms are able to generate more available cash and, therefore, finance new investments using lightly taxed retained earnings. Younger and fast-growing companies typically are short of internal financing and must finance investments, at least partly, with highly taxed new equity. New firms are an important driving force of innovation and play an important role in the development of new industries. The discrimination against young firms is a further tax impediment to economic growth.

All in all, the Swiss system of business taxation is not neutral in several important dimensions. An economic assessment of any specific reform proposal should capture the effect on the most important margins of business decisionmaking. The authors' study considers the effect of tax reform on (i) investment and international competitiveness, (ii) debt policy, that is, the relative use of debt and equity financing, (iii) dividend pay-out policy, which implies a choice between retained earnings and external equity financing of investment, and (iv) choice of organizational form. Given the distortions in place, any tax

reform should make a positive step toward more neutrality in business decisionmaking and keep the overall tax charge at a low level.

The Reform Proposal

Although the introduction of effective capital gains taxation might seem the simplest way to close the tax loophole and restore more neutrality in the firm's dividend policy, there are mainly two reasons against that initiative. First, it would raise the overall tax burden on business income and, thereby, impair growth. Second, some commentators argued that a capital gains tax is difficult to enforce, partly because it conflicts with the Swiss bank secrecy law, but also because it requires high administrative efforts. ERU therefore proposed to differentiate the taxation of corporate income at the personal level according to qualified and nonqualified stakes (investments).[6] ERU created that differentiation to avoid compliance costs for small holdings. For nonqualified stakes, the current system would be kept — leaving in place the double taxation of dividends and the tax exemption on privately realized capital gains. The reform proposal, however, considerably changes the tax treatment of qualified stakes. A stake is qualified and subject to the new treatment if an investor holds more than 5 percent of the outstanding shares of a corporation or if its value exceeds 1 million Swiss francs. Tax evasion on qualified stakes is unlikely, and compliance costs are small relative to tax revenues. Furthermore, qualified stakes usually are related to an active involvement in corporate management so those equality considerations are most relevant here. An empirical assessment of the Swiss treasury indicates that qualified stakes subsume about 65.11 percent of all dividends, and 53.55 percent of all property values held in corporate stakes.

Table 1: Tax Rates Pre- and Post-Reform

		Reform		
Tax rate on[a]	**Status Quo**	**Non-qualified Stakes**	**Qualified Stakes**	**Average**
Corporate profits[b]	23.20	23.20	23.20	23.20
Dividends	37.32	37.32	**22.39**	**27.60**
Capital gains	4.46	2.23	**13.39**	**9.50**
Property	0.70	0.70	**0.42**	**0.55**

Legend:

[a]Tax rates apply to corporations. Only bold numbers change as a result of the reform.

[b]In percent of taxable profit.

Average values are calculated using the relative weights of qualified and nonqualified stakes, 0.65 for dividends and capital gains and 0.54 for share holdings. The new average dividend tax rate is, thus, 0.65*22.39+0.35*37.32=27.60, and the new property tax rate is 0.54*0.42+0.46*0.7=0.55.

Aiming at a more equal taxation of dividends and capital gains, the reform introduces a capital gains tax on qualified stakes and compensates that new tax burden by a partial elimination of the double taxation of dividends. Under the new treatment, 60 percent of dividends (fully taxed until now) as well as 60 percent of capital gains (tax free until now) must be added to taxable personal income. The proposal also offers business-related property tax relief as individuals need to add only 60 percent of the value of their qualified share holdings to their taxable private property, instead of 100 percent as up to now. At first glance, the initiative seems to restore fully equal treatment of dividends and capital gains. However, because capital gains are taxed only on realization, taxpayers receive a tax deferral, which significantly decreases the effective capital gains tax burden. Using typical holding periods and discount rates, the effective capital gains tax is only about half the statutory rate. For that reason, the new effective tax rates reported in Table 1 show that the personal taxation of corporate income is far from neutral, even after the reform. However, the reform is a step in the right direction.

According to the authors' calculations, marginal tax rates between the two types of financing are much closer now than they were before. The authors estimate a 52 percent marginal effective tax rate on investments financed with new equity, and 38 percent if financed with retained earnings, as opposed to 60 and 35 percent, respectively, prior to the reform. Taxation will distort dividend policy, and the implied choice between internal and external equity financing, less after reform. The authors arrive at a 2

Table 2: Model Results

Variable Sector	Status Quo		Reform I		Reform II	
	C	P	C	P	C	P
Dividend tax	37.3%	0%	27.6%	0%	27.6%	0%
Capital gains tax	4.5%	15.9%	9.5%	15.9%	9.5%	15.9%
Property tax	0.7%	0.7%	0.6%	0.7%	0.6%	0.7%
Effective marginal tax rate	45.8%	47.0%	43.6%	47.0%	43.6%	47.0%
Value added tax		7.6%		7.6%		8.0%
Debt ratio	0.439	0.624	0.427	0.624	0.427	0.624
Pay-out ratio	0.400	1.000	0.479	1.000	0.479	1.000
Equity premium	0.040	0.040	0.038	0.040	0.038	0.040
Cost of equity	0.082	0.080	0.078	0.080	0.078	0.080
Capital stock*			1.563%	0.871%	1.387%	0.695%
Employment*			0.492%	-0.193%	0.317%	-0.367%
Outputs*			0.808%	0.121%	0.633%	-0.053%
Wages*				0.569%		0.569%
Labor supply*				0.284%		0.110%
Aggregate capital stock*				1.353%		1.177%
Gross domestic product*				0.470%		0.278%
Private consumption*				0.638%		0.463%
Tax revenue*				-0.479%		0.000%

Legend:

C: Corporation, P: Noncorporation (partnership). Reform I: Lump-sum tax used to balance budget. Reform II: VAT used to balance budget.

* Percentage change relative to the status quo.

percent reduction of the overall marginal effective tax rate on investment, considering the average mix of investment financing. The tax reform initiative, therefore, should provide a moderate stimulus to investment and growth because it yields a small net tax cut on corporate firms, while leaving the noncorporate businesses' tax treatment unchanged. It also should shift resources into the corporate sector.

An Economic Assessment

The incentive effects of the tax reform, in principle, are readily checked by using the measures of marginal effective tax rates, but a number of other issues — such as the expected effects on growth, distribution, and tax revenues — are more difficult to estimate. For policymakers, the overall losses or gains in tax revenues are a priority. It, however, is not easy to predict how tax revenues will change because the reform is intended to change taxpayers' behavior. The reform includes some components that increase the tax burden, and others that lower it. It is not clear which will dominate.

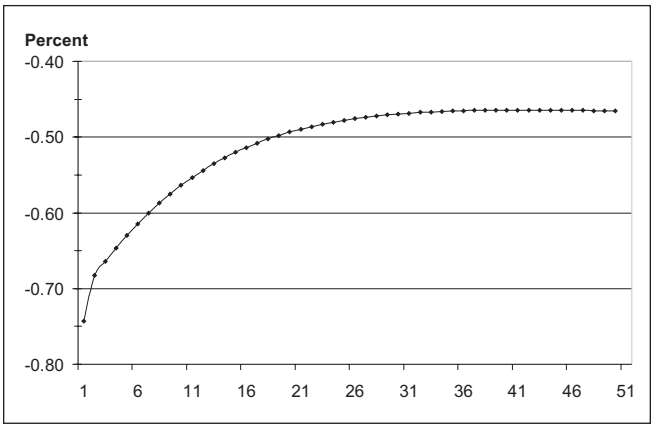
In addition, the reform is intended to spur additional economic growth, which presumably boosts revenues from other taxes. To capture those economy-wide repercussions, the authors used a computational growth model of the Swiss economy, which is particularly detailed in its modeling of the corporate and noncorporate business sector. It also includes a detailed representation of the tax system and the public sector.[7] To capture the main determinants of the tax reform, the model allows for behavioral responses of the margins: investment, debt, and payout policy, as well as choice of organizational form. The model was calibrated using economic data for Switzerland and the results of recent econometric studies on changes of financial behavior in response to tax changes.

Table 2 summarizes the study's simulation results. The first double column reports current effective tax rates, as well as other key aspects of the status quo equilibrium. The following columns turn to the tax reform scenario under two alternative budgetary assumptions for revenue neutrality. Reform I uses a neutral lump-sum tax to finance the revenue losses of the tax reform, and to keep the government budget balanced with constant real expenditure. Reform II endogenously adjusts the value added tax rate to obtain a balanced budget. Each pair of columns reports simulation results separately for the corporate and noncorporate sectors. The first three lines repeat the average tax rates from table 1 as they enter the model. Profits of noncorporate firms are taxed at the owner's personal income tax rate. Capital gains from the sale or other transfer of a business also are subject to the personal income tax on realization, yielding an effective tax rate of 15.9 percent when including the tax postponement over a typical holding period. The following lines report coefficients of firms' financial policy. The payout rate is 100 percent by definition because noncorporate firms are transparent for taxation. The model computes behavioral responses to changes in the relevant tax rates. The dividend tax relief and the more effective taxation of capital gains induces corporations to increase their pay-out ratio from an initial 40 percent to 47.9 percent. That remarkable increase is because the reform largely removes the tax penalty on dividend payments. A higher payout ratio reduces the risk to outside investors and, thereby, leads to a lower equity premium for corporations (the premium declines from 4 percent in the status quo case to about 3.8 percent in both reform scenarios). The slightly lower cost of equity relative to debt financing also results in a small reduction of the debt-equity ratio.

The lower effective tax rate on corporate investment, together with the reduction in the equity premium, spur additional investments and increase the long-term capital stock in the corporate sector by a noticeable 1.6 percent in Scenario I and 1.4 percent in scenario II. That investment-led expansion drives other macroeconomic results. Overall GDP is estimated to go up by 0.47 percent or 0.28 percent respectively. The weaker response in scenario II is due to the VAT increase eroding the real wage and, thereby, discouraging labor supply and employment. Private consumption, which serves as a rough welfare measure, increases by 0.64 percent (or 0.46 percent under VAT finance). Note that labor also benefits from the tax reform as wages increase by more than half a percentage point (0.57 percent). In Switzerland's small open economy, the real interest rate is largely fixed on international markets. A reduction in source-based capital income taxation results in a smaller pretax rate of return to capital and, thereby, raises capital intensity and wages.

Table 2 refers to long-term results. The short-term effects of the reform are much less beneficial because it takes an extended period of time until the increased capacity of induced investment is felt. Wages will increase only slowly in line with capital accumulation. For largely the same reason, the reform will be more expensive in the short-term than in the long run. Despite some extra revenue from more effective capital gains taxation, the reduction in dividend and property taxes instantaneously leads to a tax revenue loss of roughly 0.75 percent (see Figure 1). In subsequent periods, the investment-led expansion increasingly swells the tax bases of commodity and wage taxes, resulting in additional tax revenues. The short-term revenue losses from the policy initiative, mainly due to the loss in dividend and property tax revenues, are increasingly counterbalanced by other tax sources. The significant expansion of consumption in the long run is largely accompanied by higher VAT revenues, whereas higher wages and employment strengthen the payroll tax revenues. Considering those revenue effects in other parts of the tax system, the authors compute a much more moderate long-term revenue cost of 0.48 percent of overall tax revenues in scenario I (see the last line in Table 2). That could be counterbalanced, for example, by a slight VAT increase of only 0.4 percent, as in scenario II.

Figure 1: Tax Revenues



Summary

The tax reform proposal that Switzerland currently is considering reduces the double taxation of dividends and of the property tax on privately held corporate shares. It also aims to close an existing tax loophole by enforcing a more effective taxation of capital gains from corporate ownership. The government hopes to alleviate the tax discrimination

against dividend payments and achieve a more equitable taxation of dividends and capital gains from corporate ownership. At the same time, the reform should underline Switzerland's investment friendly position, from a tax viewpoint. The most important results from the quantitative economic assessment of that reform proposal are:

- The reform considerably eliminates the tax discrimination against dividend payments, although it fails to achieve full tax neutrality for internal and external equity financing.
- It slightly reduces the marginal effective tax rate on corporate investment, leaving the tax treatment of noncorporate firms unchanged. On average, it reinforces a minor tax preference for corporate over noncorporate investment.
- The reform yields a moderate growth stimulus and raises wages, employment, and consumption. The effects are felt only after an extended transitional period, leading to rather small short-term but more pronounced long-term gains.
- While the revenue losses from the reform proposal materialize immediately, induced growth strengthens revenues by swelling the tax bases of wage and commodity taxes. Therefore, it is more expensive in the short-term, but considerably less costly in the long run.

✦ *Martin D. Dietz and Christian Keuschnigg are with the University of St. Gallen (IFF-HSG) in Switzerland. (Web site: http://www.iff.unisg.ch)*

FOOTNOTES

[1]There are exceptions to the general rule that capital gains on privately held, movable property, such as shares in corporations, are tax-free. Companies that realize capital gains, for example, or private persons qualified as professional traders, must include capital gains in their taxable income.

[2]Christian Keuschnigg and Martin D. Dietz (2002), "Volkswirtschaftliche Auswirkungen der Unternehmenssteuerreform II," Report to the Government, EStV, Bern.

[3]*See* the recent growth report by the Swiss economics ministry: Seco (2002), Der Wachstumsbericht. Determinanten des Schweizer Wirtschaftswachstums und Ansatzpunkte für eine wachstumsorientierte Wirtschaftspolitik, Studienreihe des Staatssekretariats für Wirtschaft, Grundlagen der Wirtschaftspolitik Nr. 3D, Bern.

[4]Corporate taxation at the cantonal level is typically progressive. The effective tax rates relate to a typical firm and take account of those nonlinearities.

[5]*See* G. Gutekunst and R. Schwager (2001), Die Steuerbelastung von Unternehmen in ausgewählten Regionen des Alpenraumes, Mannheim: ZEW.

[6]ERU (2001), Bericht der Expertenkommission für rechtsformneutrale Unternehmensbesteuerung (ERU), Bern.

[7]*See* Christian Keuschnigg (2002), Analyzing Capital Income Tax Reform With a CGE Growth Model for Switzerland. Technical Report, University of St. Gallen, mimeo.