The macroeconomic impact of the Swiss Corporate Tax Reform III

Macroeconomic impact analysis
on behalf of economiesuisse

Executive Summary

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Status quo

In Switzerland, companies with cantonal tax status play a significant fiscal role. In 2013, the federal government's revenue from companies with cantonal tax status accounted for around half of all taxes on earnings; the estimated average proportion for cantons and municipalities is 20 per cent (including the cantonal share in direct federal taxes). At over 50 per cent, the percentage is, however, much higher in individual cantons.

For years now, the current practice of granting tax privileges to the foreign revenue of special status companies in Switzerland has come under criticism. In response, Corporate Tax Reform III (CTR III) is intended to restore international acceptance. On top of this, CTR III is to ensure that Switzerland's corporate tax regime remains competitive and the federation, cantons and municipalities can continue to rely on the financial income from taxes on earnings.

While the fiscal impact of CTR III, or its failure, has been researched in most of the cantons and respective studies have been carried out at the national level, information regarding the overall macroeconomic impact of CTR III is still incomplete. This study aims to close the current information gap.

CTR III safeguards Switzerland's fiscal competitiveness

Today, thanks to their exceptional fiscal regulations for special status companies, not only low-tax cantons but also those whose regular taxation is merely average in international comparison are considered highly competitive by internationally active companies. CTR III will abolish the cantonal tax status as well as two federal tax models. In the absence of any further fiscal measures, companies which have been subject to special taxation will face a substantial increase in tax charges. The cantons, in turn, may lose their fiscal competitiveness.

To mitigate the tax shock triggered by the abolition of the current special tax status, CTR III will create a series of fiscal instruments which cantons can employ at their own discretion. At the heart of these measures are fiscal instruments whose main objective is the fiscal subsidisation of innovation activities in Switzerland (patent box, higher deduction for R&D expenditure). A third core element of CTR III is the introduction of a notional interest deduction (NID) on surplus equity capital.

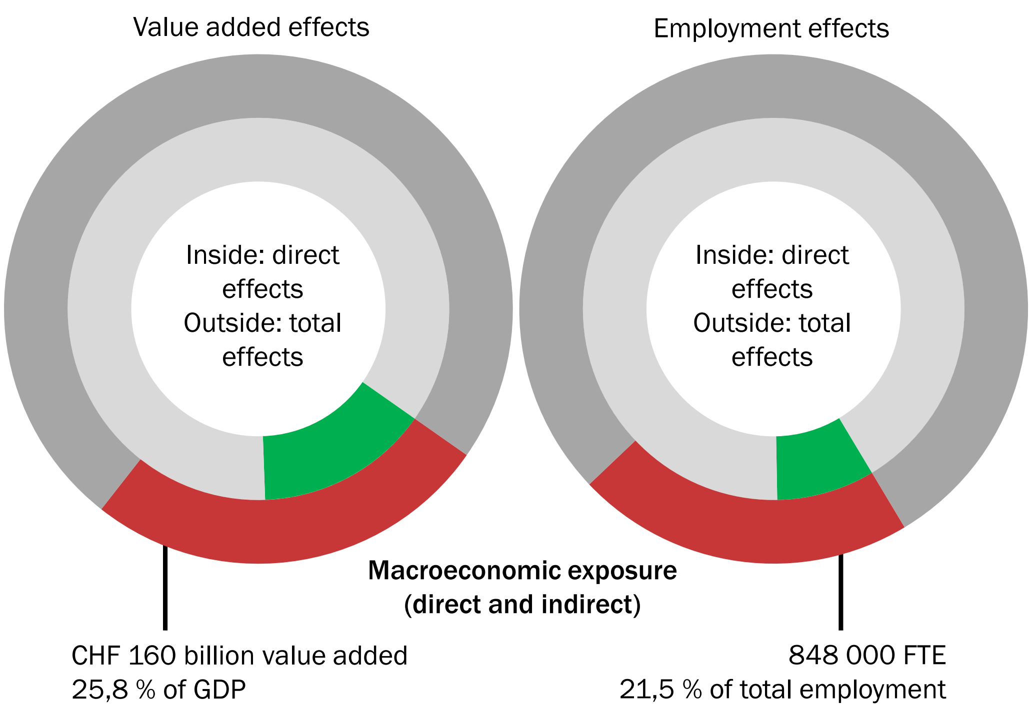
With the introduction of the new fiscal measures, only part of the mobile revenue will still be tax-privileged. Cantons may therefore also lower their regular tax on earnings and capital tax rates to prevent possible departures of highly mobile companies which do not qualify for CTR III instruments. The federation's financial support (vertical compensation measures) and the adjustment of the resource balancing system will contribute towards a possible relief of the cantons in respect of the revenue deficits arising from the reduction of the regular taxes on earnings rates.

Importance of maintaining fiscal competitiveness

Thanks to CTR III, fiscal competitiveness can be maintained and the departure of the majority of the companies which currently enjoy special tax status can be averted. This safeguards added value and employment, benefiting not only the population but also the social insurance system in the form of contributions and the public sector in the form of further tax revenue. Hence CTR III is not only compensating special status companies for their loss of special taxation but is also associated with macroeconomic benefits.

As a first step, we have investigated the extent of the macroeconomic benefits. The result is impressive: All in all, successful implementation of CTR III directly will safeguard an estimated CHF 91 billion with respect to around 7,000 companies included in the analysis. These companies consist either of highly mobile enterprises or big companies active in the high-tech and cutting edge technology segments of Swiss industry.

Chart: Benefits of retaining fiscal competitiveness



Source: BAKBASEL

Including the macroeconomic multiplier effects on other domestic companies, the model calculations result in a total gross added value of around CHF 160 billion and 848,000 jobs. In other words: The conversion of the Swiss fiscal system places around one quarter of Swiss GDP and every fifth job at stake.

Effects if CTR III fails

If CTR III is rejected in the referendum on 12 February 2017, it is uncertain whether and when an alternative solution can be found that retains the central elements of CTR III (e.g. fiscal incentives for innovation activities). Hence, instead of showing the difference to any alternative reform, the impact of CTR III as quantified in the first step represents the maximum potential loss (exposure) in the case of its failure.

It is difficult to predict, a priori, how quickly an alternative reform could be put to a new vote if CTR III fails, and what the specifics of such a solution may be. However, due to

- pressure from the EU and the OECD, several facts are unassailable: there is no alternative to abolishing the special tax status,
- a delay would result in an extended absence of reliable planning and legal conditions,
- in the case of an alternative reform, Switzerland would become less fiscally attractive to a number of big, internationally active companies, and
- competition in the field of corporate taxes will not stop at other locations, some of which would improve relative to Switzerland in the interim.

Scenario analysis

If CTR III fails, it is, a priori, not foreseeable what exact form an alternative solution would take and when an agreement would be reached, nor can such a solution be properly modelled through macroeconomic analysis. Hence this scenario analysis will refrain from simulating a detailed and inter-temporally differentiated but highly speculative scenario for an alternative tax reform.

Instead, the scenario analysis aims to estimate the extent of the macroeconomic impact that may arise under certain assumptions. For this purpose, to show the potential short-term losses as well as the medium and long-term losses, we have intentionally assumed two scenarios which are unlikely to occur exactly as imputed.

Potential short-term losses if CTR III fails

All in all, certain losses will also arise in the short-term if CTR III fails.

- Firstly, the lack of reliable planning and legal conditions will force Swiss companies to expand their sites abroad rather than those in Switzerland.
- Secondly, the arrival rate of new companies from abroad will decline in this scenario.
- Thirdly, there will be certain departures or partial relocations. The reactions will be strongest among the internationally integrated companies that are classified as highly mobile.

According to the model simulations, the departure of the highly mobile companies alone might result in a GDP deficit of around CHF 34 billion or 5.6 per cent, accompanied by a loss of around 190,000 jobs (-4.9%). Employers' income would decline by 5.5 per cent. As a result, the federation, cantons and municipalities would lose CHF 2.7 billion in income tax alone, while social insurance contributions (CHF -5.1 billion) would also decline substantially compared to a CTR III scenario

Table: Potential short-term losses if CTR III fails

	Unit	Absolute	In % of overall economy
Gross value added	[million CHF]	-34'324	-5.6
Employment (Full Time Equivalent)	[thousand FTE]	-193'914	-4.9
Gross wages and salaries	[million CHF]	-20'037	-5.5
Insurance systems (retirement, disability, income supplement and unemployment insurance, BVG)	[million CHF]	-5'114	-5.6
Taxes on income (federation, cantons, municipalities)]	[million CHF]	-2'680	-4.8

Source: BAKBASEL

If CTR III fails, it must be assumed that at least some of these effects will arise. Even given the prospect of an alternative tax reform that preserves fiscal attractiveness, only some of the highly mobile companies will be prepared to wait for such a reform. This applies in particular to enterprises which cannot be certain that they will actually benefit from the prospective alternative reform. On top of this, a rejection of the reform may also send a negative message: stability, security and reliability are central location factors that have distinguished Switzerland from many competing locations. Should the reform be rejected and the associated legal insecurity arise, Switzerland risks losing this location advantage.

Medium to long-term effects

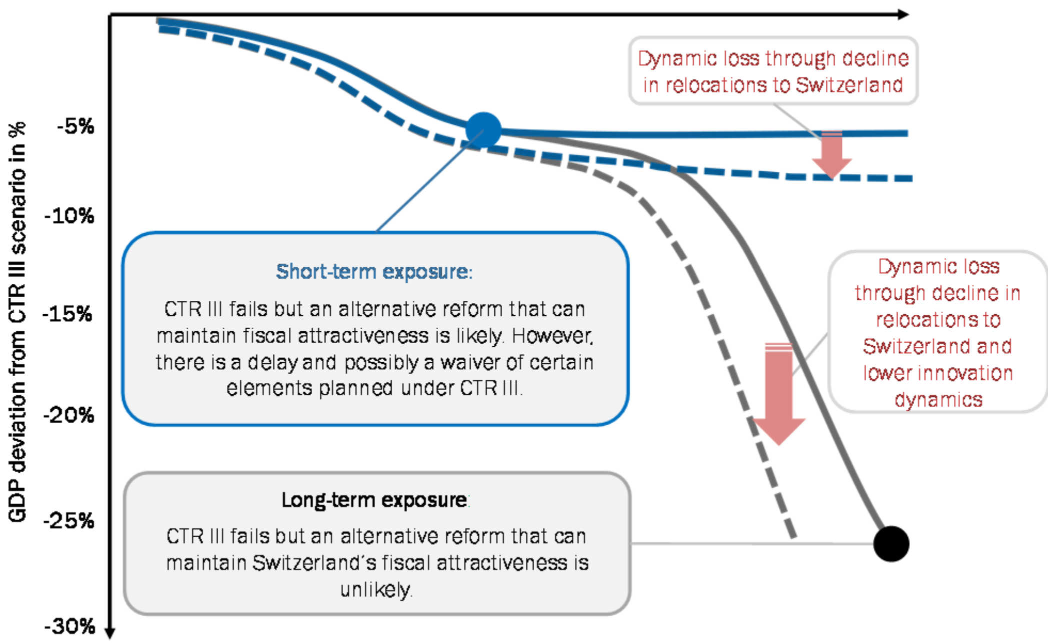
The extent of possible further relocation effects depends, on the one hand, on the concrete elements of the alternative reform and, on the other, on the speed with which an agreement on the alternative reform will be reached. Without doubt, however, neither the EU not the OECD would accept a postponement of the reform. In the worst case, Switzerland would be placed on the EU's and OECD's blacklist, which would have serious consequences for numerous companies.

Time also plays an important role since even company domiciles which appear to be less mobile are certainly movable in the medium to long-term. Departures and (partial) relocations become all the more likely the longer the absence of reliable planning conditions lasts and the more companies could benefit from similar fiscal incentive systems in other countries.

Classification

Statistical analysis shows that, depending on the chronological development, reaction by the EU and medium-term relocation trends, a potential short-term loss of 5.6 per cent of GDP arises, while a loss of up to 26 per cent is possible in the long-term if CTR III fails and no alternative reform is agreed upon. In reality, the medium to long-term exposure will lie somewhere between the two percentages.

Chart: Scenario analysis: GDP loss if CTR III fails



Source: BAKBASEL

Dynamic effects

The calculated long-term potential loss of CHF 160 billion and around 848,000 jobs appears very high and reflects the central role that international companies play in Switzerland. Although one may argue that, even in a scenario in which no adequate alternative reform is achieved, big enterprises in the cutting edge technology segment may not relocate their entire company in the medium run, an initial relocation of parts of the value added chain may still occur instead.

However, decisions by the companies concerned to increasingly invest in expansion abroad would have an even more significant long-term effect. If analysed on a dynamic basis, the dimensions involved are put into perspective: High-Tech companies are capable of doubling their value added within just 15 years. This requires growth of approx. 5 per cent per annum, which is more or less consistent with the average (nominal) growth of the high-tech industry in the period 1996 to 2016. If this growth predominantly happens abroad instead of at home, Switzerland will suffer substantial losses of value added and jobs.

The dynamics of relocation to Switzerland are also likely to lose a lot of momentum if CTR III fails. The past shows the substantial long-term impact which foreign companies' relocations to Switzerland have had on economic growth. Between 2004 and 2015, multinational companies accounted for around one-fifth of economic growth in Switzerland. In 2015, these companies provided one in eleven jobs and represented around 12 per cent of Swiss GDP. Including multiplier effects, the model calculations are resulting in 20 per cent of GDP and 19 per cent of all jobs.

Due to complex interdependencies, most analyses of CTR III are of a static nature and disregard the fact that new fiscal instruments will lead to adjustments within the economy in the long term. In the case of CTR III, such dynamic effects may also take the form of an innovation dividend since the introduction of the patent box and the optional input subsidy in the form of D&E deductions should give a boost to the innovation activities of Swiss companies that will have a positive impact on productivity, growth and prosperity.

Conclusion

- In the last 20 years, Switzerland's fiscal attractiveness for international enterprises has bolstered the country as a business location and has contributed substantially to growth and prosperity. The entire economy, from special status companies and regular taxation companies to the government and the population, has benefited.
- According to estimates, in the last decade, multinational companies have been directly responsible for around one-fifth of economic growth, provided one in eleven jobs and accounted for around 12 per cent of Switzerland's economic strength. If the extent to which domestic companies benefit from these enterprises is included, a total effect of 20 per cent of GDP and 19 per cent of employment results.
- Due to international pressure, a conversion of the Swiss tax system is unavoidable. In the long-term (excluding substitute measures), such conversion places around one quarter of Swiss GDP and every fifth job at stake. This is the total value of maintaining fiscal competitiveness via CTR III according to the model calculations.
- Analyses of fiscal sustainability show that, in contrast to the majority of the EU countries, the Swiss cantons have sustainable fiscal policies and hence the leeway required to operate internationally attractive tax regimes in the longer term.
- CTR III will introduce internationally acceptable corporate taxation that maintains the cantons' fiscal competitiveness and secures their fiscal base.
- While current special status companies are likely to pay slightly higher average taxes after a successful implementation of CTR III, many companies that have been subject to regular taxation will pay substantially lower taxes. This would apply to numerous Swiss companies which will then invest (at least part of) their fiscal savings locally and thus bolster Switzerland as a business location.
- SMEs, which often act as suppliers within the economic cycle, will also benefit from these effects. All in all, the positive impact of CTR III implementation is likely to outweigh partial additional charges (e.g. partial taxation on dividends) for SMEs.
- If CTR III fails, ten-thousands of jobs would be at risk. In the case of departures of highly mobile companies, the short-term potential loss alone amounts to194 thousand jobs. This would be associated with a decline in GDP of 5.6 per cent (CHF 34 billion). In the absence of an adequate alternative reform, the medium to long-term losses will be much more significant.
- The government would suffer substantial income deficits, the brunt of which would have to be borne by the population. Again, the longer-term consequences will be far more significant that the losses imminent in the short-term. On top of this, in a contractive scenario, the government would be subject to a double bur-

den since declining income would be accompanied by a trend towards rising expenses.

- According to the model calculations, a short-term contribution deficit of CHF 2.5 billion would arise in the mandatory social insurance system alone (retirement, disability, income supplement and unemployment insurance). The imminent losses in the second pension insurance pillar (BVG) would amount to CHF 2.6 billion. The federation, cantons and municipalities would face short-term deficits in revenue of CHF 2.7 billion.
- Aside from representing a key element in the sustainability of Switzerland's international competitiveness as a business location, the abolition of the special tax status and the introduction of fiscal incentives for innovation under CTR III will shift the fiscal focus towards major companies that play a central role in the Swiss economy. Even today, Swiss industry would be hardly competitive without the companies active in the high-tech and cutting edge technology segment.
- Previous analyses have usually been limited to static considerations and do not include dynamic adjustment reactions. In the case of CTR III, such dynamic effects may, for instance, take the form of an innovation dividend since the introduction of the patent box and the optional input subsidy in the form of D&E deductions should give a boost to the innovation activities of Swiss companies that will have a positive impact on productivity, growth and prosperity.

BAKBASEL is an independent economic research institute focussing on the combination of scientifically sound empirical analysis and its practical implementation since 1980.

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