SWISS ROLE

What the euro zone could learn from Switzerland

The EU has tried to impose fiscal discipline on euro zone members. However, this won't work – unless it's very clear that euro zone members getting into trouble won't be bailed out. The example of Switzerland demonstrates this, says CHARLES BEAT BLANKART

Tax competition among Swiss cantons and municipalities puts downward pressure on taxation.

But cantonal and municipal governments will not allow themselves to be steered towards a low-tax policy at any price.

Cantons will not incur debt to reduce taxes. Why is that? Why are Swiss cantons prudent while in other countries governments accumulate large debts?

Often the budgetary responsibility is attributed to "debt brakes" (or fiscal rules) that limit the annual and total indebtedness of central and many local governments.

But debt brakes have been adopted also by the European Union for its member states in the Stability and Growth Pact of 1997 and in the subsequent Fiscal Compact. Compliance is, however, far from complete in the EU.

Tables 1 and 2 summarise the fiscal performance of Swiss cantons and the Swiss federation and compare it with that of the larger euro member states.

In Switzerland, the annual deficits of federal, state and local governments were low, leading to a declining debt burden between 2002 and 2012 (Table 1).

In the euro average, debt has increased from 2002 to 2014 from 68.0 per cent of GDP to 95.9 per cent (see Table 2).

Debt breaks plus bailout in the euro zone

Why are debt brakes disregarded in the European Union and observed in Switzerland?

Overspending is a general problem of democracies as they have a tendency to spend too much and to postpone taxation into the future via government debt.

Before the euro, EU member states had very different public debt accounts. Some had balanced budgets, low public debts, were reliable borrowers, were unlikely to devalue their currencies and therefore had low interest rates.

However, others had large deficits, depended heavily on public borrowing, depreciating currencies and were less reliable borrowers facing higher interest rates.

Though the latter governments were unreliable as borrowers they did not tend to renege on debt – they tended to relax monetary policy and allow their exchange rate to fall.

The situation of these two groups of countries concerning interest rates is illustrated on the left hand side of Figure 1. Countries with good records such as Germany had low interest rates. Countries with lower ratings such as Greece had higher interest rates.

From the beginning of 1999, a number of EU member states irrevocably fixed their exchange rates and declared the euro as their common currency. Any exchange rate risk seemed to be eliminated and few expected a member state to default on its debt. Therefore all government bonds had low interest rates which were very close together, see the middle part of Figure 1.

As, however, the banking crisis appeared in the United States and spilled over to Europe, European investors began to ask: who is responsible if one of the large banks in the EU falls into bankruptcy?

The ecofin ministers wanted to calm the markets and decided on 5th October 2008 that each member state was responsible for its own banks.

Investors then correctly concluded that southern euro countries such as Greece, Italy, Spain, Portugal and, perhaps, France might be unable to carry the debt of their distressed banks in addition to their own government debt. Interest rates in these countries rose as can be seen on the right hand side of Figure 1.

After a series of meetings and initiatives, the ECB found a way of, in effect, guaranteeing the debts of the heavily indebted euro zone countries.

The joint bailout fund of the euro nations was too small to calm the market. However, eventually, the President of the ECB, Mario Draghi, proposed the "Outright Monetary Transaction Programme" in 2012 which effectively guaranteed a full bailout to each government in fiscal distress regardless of whether it complied with the debt rules. This calmed the government bond market.

As a consequence interest rates of the heavily indebted countries fell (see the far right of figure 1).

The conclusion for individual euro members was clear: why should they comply with the debt rules brakes when a bailout would be available from the deep pocket of the ECB spending, in effect, taxpayers' money?

IT IS NOT POSSIBLE TO SUBSTITUTE THE NO-BAILOUT POSITION BY A BETTER SET OF BUDGET CONSTRAINTS AND FISCAL RULES SUCH AS THE FISCAL COMPACT... BOTH ARE NECESSARY

Switzerland – the land of "no bailout"

The situation of Switzerland is different. While the ECB and some euro governments are large and have deep pockets to bailout smaller indebted members, Switzerland is a small country.

The Swiss National Bank (which is Switzerland's Central Bank) cannot afford to act as a lender of last resort. It cannot afford to finance credibly a programme to bailout distressed federal and cantonal governments: it would lose its credibility.

The external value of the Swiss Franc would decline on international markets and international investors would stop buying Swiss federal and cantonal bonds or want higher interest rates. The Federal and cantonal governments in Switzerland cannot count on the Swiss central bank bailing them out.

The no-bailout principle in Switzerland has the character of what can be called a "dynamically developing credence capital good". This means that the belief that the policy will be followed grows through its application over time, and debases itself when it is disregarded.

Each application of the no-bailout rule strengthens the expectation that it will continue to be applied in the future.

Therefore it is important that the no-bailout principle is continuously applied. Once a bailout takes place it takes time for the markets to believe that it will not happen again and borrowing costs rise.

When the cantons of Bern, Solothurn, Geneva, Waadt, Appenzell Ausserrhoden and Glarus ran into severe financial difficulties due to the losses of their cantonal banks in the 1990s, they were left to their own devices.

The question of whether the federal government would provide a financial injection was not even raised.

Instead, both the federal and cantonal governments acted on the assumption of the no bailout principle, according to which each canton is responsible for its own finances.

If a financially distressed cantonal government approaches the federal government with a petition for a bailout, the federal government would simply reply: "We have both to survive as borrowers on the international credit market. We both enjoy fiscal autonomy, you as a cantonal, and I as a federal borrower. We are free to choose, but we are responsible for our choices. If I fail as federal government, nobody will come to rescue me. If I bail you out, my creditworthiness is undermined and I would have to pay interest at higher rates."

FISCAL DISCIPLINE IS NOT POSSIBLE WITHOUT A STRONG NO-BAILOUT CONSTITUTIONAL PROVISION

Fiscal autonomy buttresses the no bailout regime. The cantons know that they take their own decisions and are responsible for the consequences.

The key to fiscal responsibility in Switzerland does not rest with balanced budget rules as such, but with a credible no-bailout position. The causality runs the other way. The fact that cantons will not be bailed out encourages them to have fiscal rules to stop the build-up of debt. This sends a signal to capital markets and allows them to borrow on more favourable terms.

Debt brakes have no value for their own. They are only helpful if they are linked to a credible no bailout position. In the euro area the no-bailout clause of the Lisbon Treaty has gone. Therefore debt brakes cannot be credible and they contribute little to budget stability.

It is not possible to substitute the no-bailout position by a better set of budget constraints and fiscal rules such as the Fiscal Compact.

Both are necessary.

The problem that euro zone faces now is that once expectations of "no-bailout" have disappeared it is difficult to convince markets that the principle will be followed again.

Credit markets in systems with bailouts do not differentiate between good and bad borrowers.

As such, the good borrowers, such as Germany, will suffer because of the weakening of the no-bailout position. Investors have no incentive to discover which jurisdiction is more and which is less reliable.

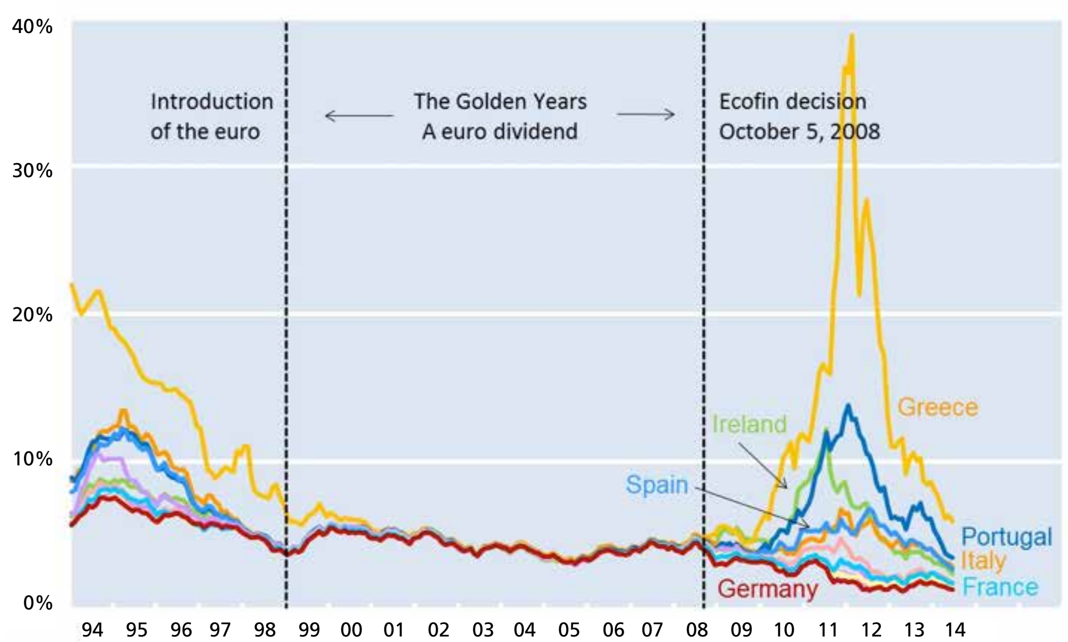
Governments also have little interest in building up a good reputation. Disinterest on both sides of the market drove interest rates towards convergence at a low level as represented on the right hand side of Figure 1.

No-bailout in practice

The significance of the no-bailout principle can hardly be illustrated more clearly than with the example of the bankruptcy of Leukerbad in 1998, a 1,400-inhabitant municipality in the Wallis canton.

After a series of expensive investment projects mainly in the tourism industry, for which it ran up high debts, Leukerbad's municipal council declared that it had run out of money: it could no longer service its debt.

Figure 1: Ten years' government bond interest rates in euro member states.



Source: Ifo Institute for Economic Research, Thomas Reuters Datastream and author's own additions

Just as cantons in Switzerland cannot count on federal support, local government cannot count on bailouts by cantons. Otherwise the Wallis canton would have had an incentive and an obligation to keep an eye on Leukerbad.

Instead, it is the role of creditors – not higher levels of government to exert due diligence and monitor the loans.

Given the unusually large volume of the debt (346 million Swiss francs) and the layered nature of the credit relationships (eight to ten creditors), the control problem turned into a public-good problem.

None of the creditors wanted to bear alone the costs of monitoring, so each creditor left the task to the next. Leukerbad's financial situation deteriorated and led in 1998 to its insolvency.

What should the creditors do in such a situation? They could not break up the municipality as in a private bankruptcy procedure: only a few assets could be sold. Thus, they tried to have the Wallis canton assume the debt. The cantonal government, however, rejected any responsibility.

The federal court in Lausanne, which was called upon to hear the matter, upheld the position of the Wallis canton and dismissed the case filed by Credit Suisse First Boston and other creditors. The no bailout principle was applied unambiguously.

With this ruling, the court sent a clear signal. It is the responsibility of the creditors to perform due diligence regarding their prospective borrowers' actual creditworthiness.

But how could the creditors access information regarding the borrower? This gap has been filled by the establishment of private rating agencies which developed as a consequence of the Leukerbad judgement.

The agencies assess the creditworthiness of municipalities on the basis of the state of their finances and possible bailout or no-bailout expectations as inferred from the constitution of the cantons.

Ratings are also prepared regularly to give information on the cantons' fiscal state. This reduces the information asymmetry between creditors and borrowers, which in turn contributes – and this is the key aspect – to overcoming the previous market failure and improving the efficiency of the credit market.

The cantons have an incentive to improve their ratings so that they can borrow at lower interest rates and, indeed, this has happened. Out of 26 cantons, seven have an AAA rating and fifteen an AA rating.

If the court had forced the Wallis canton to assume the Leukerbad debt, the ability of the market to allocate capital efficiently would have been eroded, and the incentive to balance budgets would have been eliminated.

Table 1: Deficits and surpluses in Switzerland according to the Maastricht definition

	2002	2007	2012
Debt (% of GDP)	52.9	41.8	36.4
Deficits and surpluses (% of GDP)			
Total government	-0.1	1.3	0.0
Federal government	-0.7	-0.5	0.1
Cantons	0.2	0.4	-0.1
Local government	0.5	1.0	0.5
Social security	0.5	1.0	0.5

Table 1: Deficits and surpluses in Switzerland according to the Maastricht definition
Source: OECD Economic Outlook November 2013

Table 2: Deficits and surpluses in the EU according to the Maastricht definition in larger euro countries

	Government Debt		Annual Financial Balances	
Year	2002	2014	2002	2014
France	59.0	96.7	-3.3	-3.7
Germany	60.6	76.1	-3.8	+0.2
Greece	101.7	181.3	-4.8	-2.2
Ireland	31.8	118.5	-0.3	-5.0
Italy	105.4	133.2	0.5	-2.8
Netherlands	50.5	77.0	-2.1	-3.0
Portugal	56.8	127.4	-3.4	-4.6
Spain	52.6	98.0	-0.3	-6.1
Euro area	68.0	95.9	..	..

Table 2: Deficits and surpluses in the EU according to Maastricht definition in larger euro countries
Source: OECD Economic Outlook November 2013

Lessons for the euro zone

The lessons for the euro zone are clear. Fiscal discipline is not possible without a strong no-bailout constitutional provision which is observed and upheld.

Creditors must know that when they lend to particular EU governments they bear the risk which is determined by the credit-worthiness of that government.

It is from this starting point that fiscal discipline will follow. There is no point directly imposing fiscal discipline from above through limits on debt and borrowing. Apart from the resentment this creates, it has not been and will not be effective in promoting sound fiscal policies•

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