Switzerland: Relic of the Past, Model for the Future?*

2.1 Introduction

Like every European country and Europe itself, Switzerland is a collection of diverse communities connected by a web of markets and policies. The socio-economic institutions that link people and land have always evolved through history, as communication technologies altered the cultural significance of existing borders, while trade and factor mobility altered local governments' ability to enforce taxes and regulations. This Chapter reviews the often quaint and always intriguing ways in which such phenomena operate in Switzerland, and discusses whether and how the Swiss Confederation's past history and current Swiss policy issues may help us to understand the parallel evolution and similar problems experienced by other European economies and societies. At a time of critical crisis for Europe's Economic and Monetary Union project, it is very useful to study the role of social and cultural factors in shaping the challenges and opportunities of economic union and diversity management. National and cultural identities currently play a prominent role in European economic policy debates. In July 2012, for example, positions on banking union were taken by groups of economists who identified themselves as "German speaking", rather than as taxpayers of specific countries, or members of some other economic interest group.

Swiss citizens feel that they belong to their country in a way that approximates national feelings, but differs from those that prevailed over the last couple of centuries in other parts of Europe. The Swiss are very much a nation in a sense, because they are very proud of their country and there is no discussion whatsoever of breaking it up. Part of the reason for the absence of break-up tensions is, however, that the Swiss Confederation does not rely on cultural homogeneity to build consensus around centralised institutions – an approach, typical of European nation-states, that is increasingly less effective within countries, and extremely unlikely to work at the European level. Instead, the Swiss are linked by a relatively loose (but tightening) institutional framework, held together by pragmatic awareness that common problems need common solutions.

Many who hope that Europe will develop a more cohesive political structure are fond of De Rougemont's (1965) picture of Swiss federalism. Observing the Swiss indeed offers the authors and readers of this chapter plentiful opportunities to rehearse all the relevant issues of market and policy integration, including tax competition, financial regulation, labour mobility, currency adoption, and monetary and fiscal policies. As we shall see, Switzerland has become more similar to its neighbour countries and more tightly integrated with their financial, fiscal, and market structure. And Europe may arguably, in turn, benefit from becoming more Swiss in its approach to solving the key issue it faces, namely that of defining and designing a new set of policies and political interactions that works consistently both at lower levels than that of legacy countries, and across the boundaries of historical nations.

2.2 The Swiss way

The Swiss Confederation includes 26 cantons: 4 French-speaking, 1 Italian-speaking, 3 French-German bilingual cantons, 1 German-Rhaetoromanic-Italian trilingual canton and 17 German-speaking ones. Its citizens' social and political rights and obligations are traditionally derived from their membership of a commune, which is generally based on ancestry ("ius sanguinis") rather than place of birth ("ius soli"). The notion of a "place of origin" was established in the 18th century, when a child was entered in the citizen registry of his or her father's commune. The commune is still reported, in passports and other documents, where other countries show their citizens' place of birth. These historical roots help us to understand why the Swiss socio-economic model is not as individualistic as that of more market-oriented countries, but does privilege local po-

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litical interactions and choices over broader and longer-range schemes and projects. In Switzerland a modern, urban, market-oriented view of the world coexists with rural traditionalist roots. The Swiss do not like to be controlled by a distant government and like their privacy to be strictly protected, especially in financial matters, but do control each other's individual behaviour. In small communes, in the neighbourhoods of larger towns, and in work places, rules are strictly enforced not only by formal policing, but also by less formal yet no less stringent monitoring by peers, who strongly feel that law and order should be preserved, and that it is their duty to defend common property and quiet against destructive and disruptive behaviour.

2.2.1 Institutional structure

Many of Switzerland's more than 2,500 communes are still small enough to allow all important decisions to be taken by annual (or more frequent) general assemblies. Most of the population lives in larger communes, where decisions are approved by more modern, but still very frequent and comprehensive voting procedures. A similarly broad spread of decision power is observed at the top federal level of the Swiss political system: Legislative power is perfectly shared by the National Council (where cantonal representation is roughly proportional to their population) and by the Council of States (where 20 cantons are represented by 2 councillors and the other 6 by 1); there are frequent referendums on popular legislative initiatives; executive power is exercised by a government in which all major parties are usually represented.

This direct democracy and consociational ("Konkordanzdemokratie") political model tends to imply a decentralised structure for economic policies and institutions (Kirchgaessner, 2013). Cantons' and communes' tax income, wealth, and specific goods and services: The Federal Act on the harmonisation of the direct taxes of cantons and municipalities of 2000 and 2001 regulates their types, bases, and assessment timing, but allows tax rates to differ widely. The Federation imposes an income tax that is steeply progressive, but only reaches 11.50 percent maximum average and 13.20 percent maximum marginal tax rates. Value added tax is levied by the Federation since 1995 at a current standard rate of 8 percent,[1] and at even lower rates on convenience goods and lodging. This is exceptionally low compared to other OECD countries. A value added tax (VAT) was introduced much later than income taxes, so it has not yet had much time to rise. In both cases, tax rate increases are constrained by the fact that Swiss voters and cantons care less (to date) about federal tax revenues than those of lower levels of government.

Social assistance used to be a responsibility of the commune of origin, which until late 2012 was still responsible for a share of the benefits drawn by any needy citizens: Such benefits are now the responsibility of the cantons for their residents, and have become less necessary as federal social schemes were introduced. These include a basic pay-as-you-go pension scheme (AHV, "Alters- und Hinterlassenenversicherung"), which together with the disability insurance scheme (IV, "Invalidenversicherung") constitutes the first pillar of Switzerland's social insurance. The federal government also establishes and enforces the rules of the mandatory unemployment insurance scheme (ALV, "Arbeitslosenversicherung") but lower-level regional offices are responsible for the implementation of counselling, monitoring, and activation policies. Switzerland's second welfare pillar consists of occupational funded pension plans, mandatory for employees and optional for the self-employed; health insurance is similarly compulsory, and privately run by competing schemes rather than by a national health service.

Many policies and institutions are decentralised in Switzerland. Only a few tertiary education and research institutes are federal; secondary and tertiary education is organised by the cantons; and primary schools are run by communes subject to cantonal legislation, which, in turn, is at least in principle, but in practice only slowly and partially, subject to federal rules and supervision. The Federal Constitution in Switzerland is renewed at irregular intervals, and the version that has been in force since 2001 provides for common primary education standards (Article 62). It also provides for freedom of establishment (Article 24) and of commerce (Article 27), and establishes a mandate "to create a unified Swiss economic area" (Article 95). Implementation of these principles requires legislation that is only being very slowly drafted and approved (or rejected) by the cantons. The "Accord inter-cantonal sur l'harmonisation de la scolarité obligatoire" ("HarmoS") was joined at its 2007 inception by 11 cantons and has been in force since August 2009. It now covers 76.2 percent of the population after another 7 cantons joined in 2010. The Accord has, however, been rejected by 7 cantons rep-

[1] In order to refinance the invalidity insurance system, this rate has been set at 8 percent until 2017. In 2018, it will revert back to 7.6 percent.

resenting 13.5 percent of the population, and the remaining cantons have not yet decided upon the issue. Cantons regulate professional qualifications, with a few exceptions (for example, the medical professions are regulated at the federal level). As a result, services markets remain less than fully integrated within Switzerland (Cottier and Oesch, 2012).

The "Accord inter-cantonal sur les marchés publics" of 1994 (revised in 2001) provides for only some competition-oriented regulation of public procurement. Two other key institutions are organised at the federal level of government. Article 99 of the Federal Constitution establishes that an independent central bank, the Swiss National Bank (SNB), should conduct monetary policy in the interests of the country as a whole, and maintain adequate foreign currency and gold reserves. Two thirds of its profits, net of dividends to shareholders at a rate of a maximum 6 percent, are paid to the cantons, and the other third is paid to the Confederation. The SNB's mandate is to balance price stability and business cycle considerations, with price stability as a priority.

The Constitution also envisions a federal army, organised into four regional commands that liaise with cantonal authorities, but obey only Federal Council decisions. All male Swiss citizens between 19 and 34 are subject to low-paid military service (around two thirds are deemed fit for it, the others perform civilian services, or pay 3 percentage points of additional income tax until the age of 30), and about 5 percent of the force is professional. The Swiss have supported this military structure in three referenda. The latest referendum rejected the proposal to abolish compulsory military service by a vast majority of 73 percent in September 2013. Of the previous two, the referendum held after the New York terrorist attacks more strongly supported Switzerland's military structure than its predecessor held in 1984.

2.2.2 Taxes

While other federal countries also decentralise many public expenditure decisions, a key specific feature of the Swiss institutional layout is the decentralised tax system. This provides a rich field for research into tax competition, which theoretically implies stronger pressure on the public sector's performance, but also lowers revenue-raising power, and hence reduces the ability to spend on public goods and redistribution (see Feld and Kirchgaessner, 2001; Feld et al., 2003, and their references).

To detect the pressure exercised by "yardstick" competition on service providers across jurisdictions, it is necessary to identify instances where taxpayers are unlikely to exert pressure by threatening to choose a different jurisdiction. An interesting illustration is offered by the fact that in most of Switzerland, church taxes are levied at the parish level, can differ across Catholic and Protestant confessions, and tend to be similar across churches of different denomination in nearby locations (Egger et al., 2012). Swiss parishes are more likely to set performance examples for each other than to be trying to steal members from each other, as they might in more individualistic societies (like the United States) where people are much freer than in Europe to change communities. Such yardstick competition must be much weaker in countries with more centralised arrangements (as in Germany, where church tax rates are set at the federal level for individuals who choose to declare a religion).

Theory predicts, and Swiss evidence confirms, that decentralisation of tax policies should lower tax revenue through tax competition, and shift its composition from taxes to user charges. Not surprisingly, high-income people are more likely to live in low-tax localities within Switzerland. The French-speaking cantons traditionally charge higher rates but, as predicted by tax competition pressure, cantonal income tax rates are lower when the tax rates of their neighbours are low, and the lowest tax rates can be seen in Zug, Schwyz and Nidwalden, which neighbour rich Zurich where the tax rate is higher.

Tax competition, however, is clearly not strong enough to make either taxation or high-tax areas disappear. This is partly for institutional reasons. In Switzerland, inter-cantonal redistribution takes place through a federal equalisation system that has slowly grown over time and, like redistribution across municipalities within cantons, takes into account the extent to which locally-raised revenues exploit the economy's fiscal potential. Like the expenditure co-financing mechanisms of such federal fiscal systems as those of the United States and Germany (Egger et al., 2010), this partially counteracts incentives to engage in tax competition (Smart, 1998; Koethenbuerger, 2002).

The intensity of competition is, however, also limited by the fact that agglomeration economies improve productivity and make it possible to afford better amenities. A large and well-located community like Zurich, or New York, can charge higher taxes than its smaller neighbours, and still offer an attractive after-tax income. In Switzerland, competition across jurisdictions may also be weakened by the fact that traditionally local institutions and socio-political interactions offer limited support to broader economic interactions. Locally administered social and pension rights are an obvious obstacle to mobility, and such institutional barriers used to be very strong in Switzerland. All employers have been required to participate in mandatory pension schemes since 1985, but these second pillar pension rights were not fully portable until 1995. However, additional contributions to local occupational pension schemes (of which there were over 17,000 in the early 1980s, and thousands still exist) may still not be fully portable.

More interestingly, cultural features also reduce the relevance of purely economic incentives to relocate in order to exploit tax differentials. Eugster and Parchet (2011) show that while there is competition in income taxes at the language border, its spatial reach is restricted to 20 km from Switzerland's language borders. Swiss data also offer many other indications that differences of language (and potato cooking recipes, work attitudes, and presumably more general cultural features) influence many important economic phenomena not only within Switzerland, but indeed within each Swiss canton. After taking into account relevant structural economic factors, no independent influence of local language and tax rates can be detected on entrepreneurship indicators (Bergmann, 2011), and financial capital mobility is presumably even less strongly, if at all, influenced by the cultural differences that restrain labour mobility. On the Latin-speaking side of the "Roestigraben" boundary of German-speaking Switzerland, which does not always coincide with cantonal boundaries, there is a tendency to make more intense use of similar or even identical unemployment benefit entitlements (Bruegger et al., 2009), and exports are more likely to be directed to France or Italy than to Germany or Austria (Egger and Lassmann, 2011).

2.2.3 International comparisons

If not language, culture and institutions do change across the boundaries of the Swiss Confederation. The cantons and communes of the Confederation do not only differ from each other, but are also on the whole different from the European Union (EU) countries that completely surround them. We briefly illustrate some key differences by comparing aggregate Swiss indicators to those of the country's neighbours and fellow language speakers (Austria, France, Germany, Italy) and, for reasons that will become clear if they are not already, to those of Belgium and the United States.

The first panel of Figure 2.1 shows that Switzerland's purchasing-power-adjusted GDP per capita, while comparable to that of the United States, is far higher than that of its immediate neighbours, chiefly because of the very high employment rate of Swiss residents (second panel of Figure 2.1): Hours per worker are in the middle of the group's range (third panel of Figure 2.1), and productivity per hour worked is actually lower in Switzerland than in all comparison countries except for Austria and Italy (fourth panel of Figure 2.1). That productivity difference partly reflects differences in capital intensity and in the employed labour force's educational qualifications. Over time, Figure 2.2 shows that after accounting for such observable factors, Switzerland's residual total factor productivity has not grown as fast as in some of its neighbouring countries: It slumped during the 1990s, recovered sharply before the Great Recession, and is currently stagnating.

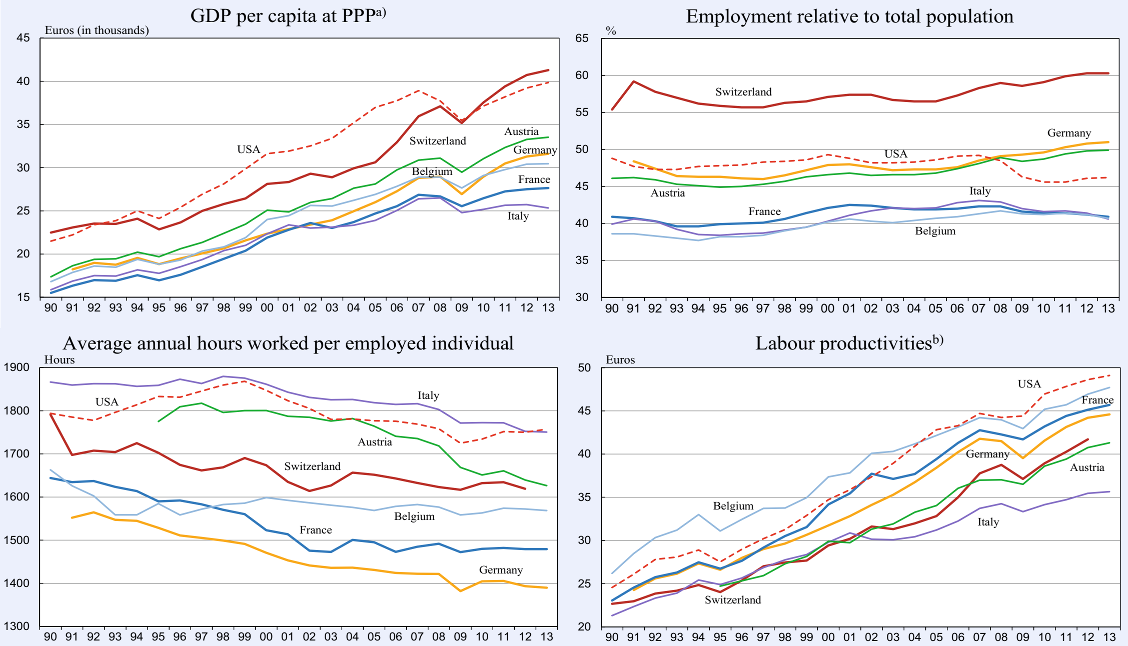
The data shown in Figure 2.3 highlights an interesting Swiss peculiarity: The country's income inequality is quite different from its European neighbours. In Switzerland, taxes and subsidies reduce inequality only a little, and even less – albeit from a much lower level – than in the United States. Such cross-country comparisons are possible only for one rather recent year in the OECD set of comparable data, where Switzerland's inequality is, at the same time, the lowest for gross incomes and one of the highest for disposable incomes. Tax competition makes it difficult to implement redistribution schemes, and a "race to the bottom" outcome may not be surprising in a country where a very large share of tax revenues is raised by sub-central levels of government, and three quarters of local taxes are on income (rather than on consumption, sales, and property, as is the case in the United States and other federal systems).

It is important, however, to note that there is nevertheless some redistribution.[2] Currently, roughly a third of

[2] See Swiss Federal Statistical Office, http://www.bfs.admin.ch/bfs/portal/de/index/news/publikationen.html?publicationID=5391.

Figure 2.1

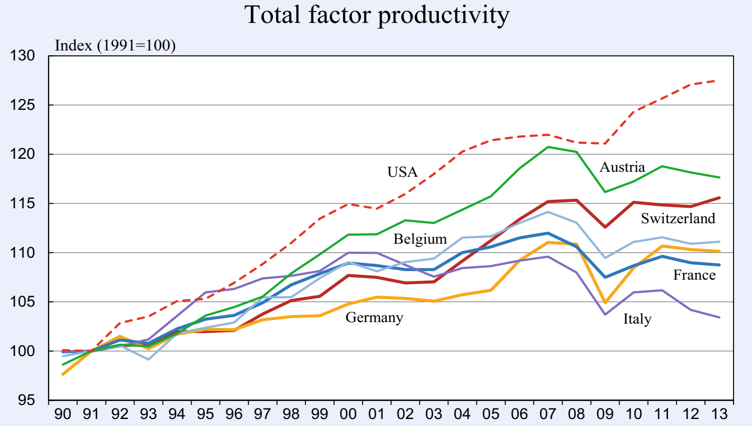
Productivity in the labour marktet



[a)] GDP is measured in PPP adjusted euros.
[b)] GDP is measured in PPP adjusted euros. Productivity is measured per hour worked.
Source: DG Ecfin / AMECO, Eurostat, last accessed 3 December 2013.

Figure 2.2

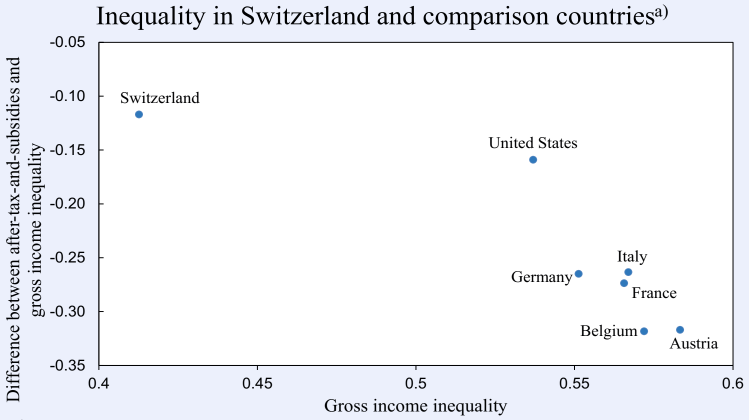
Total factor productivity



Source: DG Ecfin / AMECO, last accessed 3 December 2013.

Figure 2.3

Inequality in Switzerland and comparison countries[a)]



[a)] Gini coefficients of household income per equivalent member in 2009; average of 2008 and 2009 data for United States
Source: OECD Income distribution and poverty database and EEAG calculations.

the Swiss Confederation's budget, which only amounts to some 10 percent of GDP, is spent on social welfare; about a quarter of the basic AHV pay-as-you-go pension scheme, and about half of the other IV disability insurance scheme, are funded by federal VAT and income tax revenues, rather than by contributions of current workers and employers. In addition, as shown in Figure 2.4, the incidence of mandatory private social schemes is very high in Switzerland (the highest in the OECD database at some 7 percent of income). These schemes bring its overall publicly provided or regulated social expenditure to a level comparable to those of its European neighbours, and much higher than in the United States where, as in the United Kingdom and also in the Netherlands, private voluntary social expenditure largely fills the gap to total social expenditure, which largely reflects variation in income levels and demographic factors. In Switzerland, government entities pay 21 percent of total health expenditure, and the mandatory health insurance system 35 percent; the rest is covered by other schemes, and roughly a third of the total is paid directly by private households and other direct private funds.

2.3 The Swiss exception in history and in Europe

The facts briefly reviewed above indicate that Switzerland is richer, more employed, and less dynamic than its European neighbours. In that group, its policies stand out in three related respects: Its institutional and political structures are relatively loose and decentralised, its taxes and public social expenditure are relatively low, but its military is centralised. We have also noted, however, that during the last 20 years the Swiss Confederation has introduced and refined important changes in those and other fields.

The starting point of that relatively recent evolution was a configuration that, while peculiar in modern Europe, was quite common in earlier times. Like the cantons' colourful coats of arms, in fact, the Swiss socio-economic landscape was until recently, and in some respects remains, similar to that which prevailed in medieval times, when the range of economic interactions was limited by institutions, as well as by technology.

A thousand years ago, the Holy Roman Empire provided a basic legal and cultural framework for trade, but the European economic system was far from free. Peasants were tied to their lord's land, and tariffs were charged whenever people or goods crossed a bridge or city wall. In what is now central Switzerland, the Zahringer and Kybourg feudal dynasties became extinct in the 13th century (unlike their Augsburg and Savoy neighbours that later expanded to the East and West to play important roles in European history). The Holy Roman emperor then granted a special status to the rural valleys around the Gotthard pass: Like Imperial Free Cities, some of which were also established in the area, they would be subordinate only to his central authority, and were populated by free men rather than by serfs tied by feudal obligations to the land and to a religious or lay local lord.

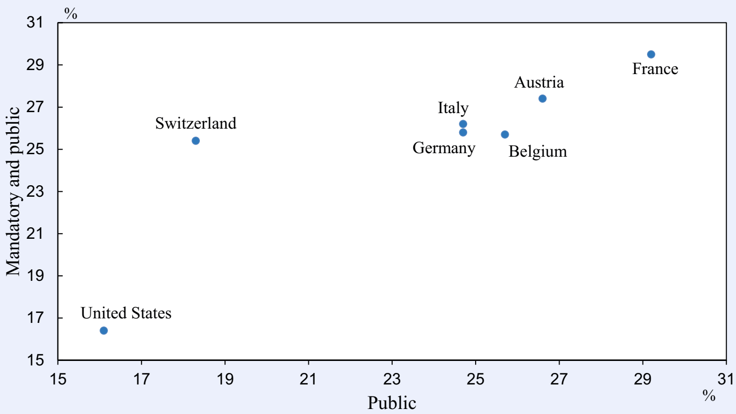
The first federation agreements across such entities were established sometime in the 13th century (1291, according to myth) between Uri, Schwyz and Unterwalden (later split into Obwalden and Nidwalden). A web of mutual support agreements later formed, with Lucerne in 1332, Zurich in 1351, Glarus and Zug in 1352, and Berne in 1353. A "Tagsatzung" central legislative and executive council had only very limited powers in this Old Confederacy of German-speaking free cities and rural communities that often fought each other. The Old Confederacy later expanded to include Fribourg and Solothurn in 1481, Basel and Schaffhausen in 1501, and Appenzell in 1513. Within it, economic activity was much freer than in the still medieval fiefdoms that surrounded it. While the rural areas provided mercenaries for European wars, city dwellers engaged in commerce and craft activities, heavily regulated by guilds, often dominated on a hereditary basis by successful families, and still subject to onerous taxes and tariffs.

2.3.1 Nation building (or not)

The events that progressively disrupted this socio-economic configuration of Europe are well known. On the cultural and political side, the authority of lay and religious sovereigns was challenged by increasingly widespread access to education and information. Even before the Enlightenment and the French revolution, the 1555 Peace of Augsburg established a "cuius region, eius religio" framework for the regulation of cultural diversity across areas of the Holy Roman Empire of the German Nation, as it was then called. The Peace of Westphalia established the principle that the rulers of each autonomous region, and the Emperor

Figure 2.4

Social expenditures$^{a)}$ in Switzerland and comparison countries



$^{a)}$ Old age, health, disability, unemployment subsidies of net national income, 2007.
Source: OECD Social Expenditure Database.

himself, should not interfere in the internal affairs of other regions. On the economic side, trade spread within and to some extent across the boundaries of these states, workers were freed of their ties to the countryside and specialised, and large-scale production could be organised in factories and cities. Between the seventeenth and nineteenth century, a process of nation formation and industrial revolutions swept Europe, and eventually reorganised its political and economic landscape around bureaucracies and constitutional democracies at the level of more or less well-defined national entities, along the borders of which trade was restricted and war, in the absence of imperial authority, was the normal way to resolve conflicts when diplomacy failed.

This process proceeded unevenly across Europe. Very small "pebble states" like San Marino, Monaco, the Channel Islands, Andorra, Liechtenstein, and Luxembourg have preserved their rather medieval character to this day; smaller states, such as Savoy and Bavaria, long served as buffers between increasingly militant European "powers". The Old Swiss Confederation briefly aspired to be a power in the decades around 1500, conquering large portions of Burgundy and Northern Italy. But the cantons did not unite against the French reaction to this move: Those that did not retreat were defeated in 1513, the Confederation pledged eternal neutrality, and Switzerland thereafter stayed on the sidelines of a nation-building phase of European history. The original cantons were content to rent mercenaries to European powers and to rule over the French, Italian, and German-speaking areas that remained under their joint control. Their landlord role there was similar to that of the English or Prussian landlords' domination of Irish or Slavic peasantry.

Nation-building interfered with such old-fashioned arrangements when the French invasion in 1798 and subsequent Austro-Russian attacks forced the cantons to tighten their ties. The Swiss all together negotiated Republican status with the French in 1803, and in 1815 the Council of Vienna implemented the Swiss sovereignty that had been recognised in 1648. It was at this stage that new cantons were formed (some French- and Italian-speaking, some German-speaking) and Switzerland reached its current configuration.[3] The new Confederation struggled for decades with the need to adopt a form of government that would, on the one hand, allow it to deal with its more modern nation-state neighbours, and reconcile its internal differences on the other.

The tension between progressive federalists and conservatives (who favoured the previous loose organisation of very independent cantons) was settled after the brief civil war of the cantons in 1848 by swift negotiation of a new constitution, closely patterned along the federalist lines of the United States of America, with a directorial rather than a presidential form of government. The Constitution established bottom-up commune-based citizenship, but endowed the Confederation with only very limited tax and regulatory powers, and did not aim at building national solidarity. It did transform the previous cantonal militias into a federal army, removing from the cantons the right to wage war with the very small military forces that remained under their control: The army draft, a powerful nation-building tool, remains to this day a key element of the Swiss socio-political infrastructure. It did not at all deploy the other main nation-building tool: To this day, as noted above, primary schooling is largely locally organised in Switzerland, and does not serve the identity-building purpose it has in traditional nations.

The year 1848 not only marks the beginning of modern Switzerland, but also a watershed for the spread, speed, and intensity of nation-building efforts in Europe. Unrest prodded France, Belgium, Germany, and Austria-Hungary to evolve towards constitutional and nationalistic governance, and the Savoy-ruled Kingdom of Sardinia to launch an Italian national project. Nations were glued together by military power, as well as by the cultural homogeneity generated by government-organised education, and by safety nets meant to prevent the social exclusion of and unrest in an urban working class that could no longer rely on village common properties and family networks for collective support. The employment-related old-age and sickness benefits introduced in unified Germany by Bismarck in the 1870s were largely motivated by the desire to build national cohesion and maintain internal peace (with obvious competitiveness implications. To control race-to-the-bottom tensions, Germany at the turn of the century tried, and failed, to achieve agreement with its trading partners on minimum welfare provision standards). The introduction and development of elaborate government redistribution systems and socio-political rights and obligation also required increasingly formal regulation of immi-

[3] Only the separation of Jura from Berne in 1979 altered it since then. The Vorarlberg region voted in 1919 by an 81 percent majority to join Switzerland, but this was opposed by Austria as well as by the winning side of World War I, and not supported by the Swiss government.

gration and citizenship, whether on the basis of ancestry, as until recently in Germany and Italy, and in Japan, or on the basis of birthplace and/or parents' residence, as in France and in the United States.

The nation-building phase of European history generated about two major wars per century, a source of technological and organisational progress, as well as of destruction, pain, and suffering. In other nations, organisational progress and industrialisation fostered economic growth and technological innovations. In Switzerland, by contrast, economic prosperity was achieved by managing to keep out of European wars after fierce initial battles with neighbouring regions. The Swiss mercenaries did fight for other countries until the 18th century, but since the formation of the new Federation they have not taken part in any European war. Of course, not every European country could have stayed out of the European wars that were triggered by national politics. Neutrality was natural for Switzerland, a country of German and French speakers who would have found it difficult to choose sides in wars that were fought by France and Germany against each other.

2.3.2 Interactions with Europe

Despite an inclination towards neutrality and a desire to shape its own society and future, Switzerland's fortunes were always deeply intertwined with European history and markets. The Swiss would clearly not be doing so well if their prosperity had to be based on opening and managing bank accounts for each other. They benefit from their freedom to formulate and implement independent policies within an integrated set of markets, and from their ability to exploit that opportunity, exerting regulatory and fiscal competition on larger, less homogeneous, and more inertial economies.

Both the Confederation's economic opportunities and its institutional structure were significantly influenced by its neighbours' revolutions and wars. For example, bank account secrecy was enforced by criminal (rather than just civil) law in 1934, primarily in reaction to France's prosecution of Swiss bank executives, and other efforts to prevent foreigners from opening Swiss bank accounts in order to evade taxes.[4] Surrounded by fascist dictatorships, Switzerland in the inter-war period built the self-image of a country that was no longer divided along ethnic and economic domination lines, and could be united and strong. A federal income tax was introduced in 1941 in would-be temporary support of the need to defend the country against the German-Austrian-Italian invasion that was carefully planned, but eventually not carried out, as well as against several mistaken bombing raids by American plane formations.

While Switzerland's geographical position made it easy for it to partake of Europe's economic progress, the Swiss economy long remained as medieval as possible for a country surrounded by nations where uniform legal and institutional frameworks made economic interactions possible beyond the circle of personal acquaintance and customary trust. Even although freedom of economic establishment was envisioned in the 1848 Constitution, and freedom of commerce in the 1874 Constitution, Switzerland has only much more recently begun to implement such principles, and to develop the welfare state safety nets and insurance schemes that make labour mobility possible within nations and beyond the boundaries of village-based socio-economic relationships.

Switzerland largely skipped the nation-building phase of European history, and the many associated wars, revolutions, hyperinflation, and excessive fluctuations resulting in social and political crisis episodes. Not surprisingly, it (and all the small "pebble states" other than Luxembourg) also remained on the sidelines of the European integration process that, in the wake of World War II, began to use market unification as a vehicle of cultural convergence, with the ultimate aim of preventing further wars. The many peculiarities of Switzerland's society and economy that originate in its non-national character make it feel that it can provide "growth, stability, and cohesion" independently, and lead it to remain separate within Europe not only politically, but also by economic barriers. A 1992 referendum narrowly rejected Swiss membership in the European Economic Area at the Confederation level (but the polls were in favour of it in all non-German cantons).

This left Switzerland free to selectively adopt European Union rules and regulation ("autonomer Nachvollzug"). The evolution of Swiss institutions has since been influenced strongly by this process. The Swiss Single Internal Market Act was only introduced in 1996, when Switzerland adopted the product market specifications harmonised in 1992 across the boundaries of all the

[4] To improve Switzerland's self-esteem and foreign image (and appease the sizable domestic minority that does not like to shelter foreign tax evaders) it was later emphasised that tightening of bank secrecy in the 1930s was chiefly meant to help German Jews to shelter their assets from the Nazi regime, also a reaction to another type of neighbouring-nation policy.

European Union countries that had long since removed technical barriers to trade. The act was revised in 2004 and, like its European Union supranational counterpart, does not do much to unify services markets, which remain strongly segmented within Switzerland. And just as the European Court of Justice plays a key role in the implementation of the Single Market within the European Union, in Switzerland the principles laid out in the 2004 revision of the Internal Market Act make it possible for its courts to enforce the freedom of services provision that canton-level regulation has been restricting despite constitutional provisions. Since Switzerland adopted European product specifications unilaterally, it was impossible for its own requirements to be taken into account by single market rules (for example, electric appliances sold in the European Union may be equipped with any of the plugs that fit one of the many sockets installed in the member countries, but not with the peculiar offset ground socket used in Switzerland). It still maintains some explicit trade barriers (most notably in food and agricultural products). Labour mobility between Switzerland and the European Union, while hampered (as is, after all, the case within the European Union) by the poor harmonisation of social and labour policies, was harmonised with the rules that apply within the European Union by the Agreement on the Free Movement of Persons that came into force on 1 June 2002, and was subsequently reaffirmed by plebiscite in 2009. These bilateral agreements are less permanent than European treaties: In mid-2013 the Federal Council invoked a safeguard clause of the Agreement, not only to extend existing limits to labour mobility from new European Union member countries, but also to establish annual quotas for the long-term employment of all European Union citizens. A referendum in February 2014, aimed at "regaining control of immigration into Switzerland," adds to pressure against the bilateral labour mobility agreement with the European Union.

2.4 Crises

During the crises regularly generated by capitalist development, markets show their limitations and the extent and character of collective policies play an even more crucial role than in normal times. A shrinking pie can make it difficult for societies to remain cohesive, but facing a common problem may foster solidarity and ease coordination.

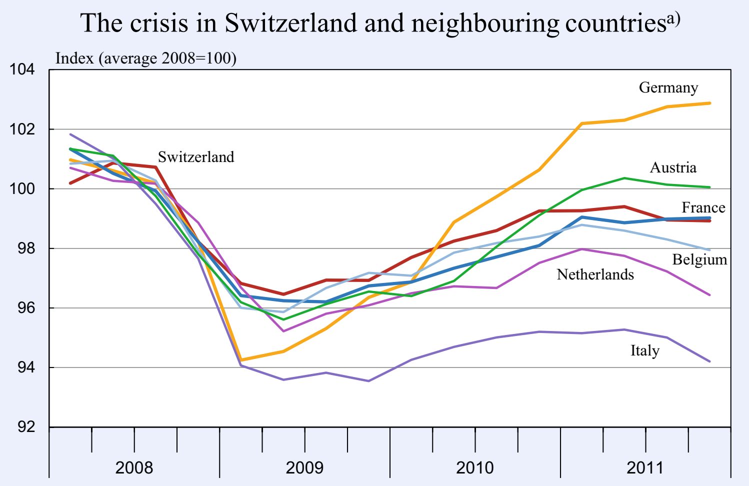
During the 1930s Great Depression, in an increasingly tense geo-political situation, Switzerland generated a new consensus around a kind of national solidarity. At present the deep connections between Switzerland and Europe imply that its problems are much more similar to those of its neighbours than may be expected. Its welfare state, while much less pervasive than that of traditional continental European nations, faces serious sustainability problems. The actuarial present value of Swiss pension plan liabilities often far exceeds that of their assets, as is also the case for the partially funded plans that should pay the pensions of cantonal civil servants, and will only be able to do so as a result of pension cuts and additional public capital injections (such reforms are underway in Berne and some other cantons). Since the 2009 crisis, the unemployment rate has been hovering around an average of 4.3 percent, and the federal ALV unemployment insurance fund has an accumulated deficit of some 5 billion Swiss francs.[5]

Switzerland's experience of the macroeconomic crisis that began in 2009 has been milder, but quite comparable to that of the euro area countries that surround it. Figure 2.5 shows that, in terms of real per capita income, the initial negative shock was shallower in Switzerland than in most of its neighbouring countries; consistently with Swiss stability, the subsequent rise was also much less dynamic than in Germany or Austria. The Swiss experience was comparable to that of Belgium or France in per capita terms, but better in total terms because population growth was faster in Switzerland during this period. The crisis was also not uniform across all regions of Switzerland. As Figure 2.6 shows, the experiences of the seven NUTS-2 macro regions of the Confederation were heterogeneous in the course of a crisis that, as was the case within and across other countries, featured particularly sharp declines and relatively quick recoveries in the manufacturing sector. Local economies where services or construction are more important sources of income tended to experience more persistent crises than those with a stronger manufacturing presence. Overall, the crisis experience was not significantly different, across regions of Switzerland and neighbouring euro area countries.[6] And like the crisis problems, the policies put in place to

[5] The portion of salaries over 126,000 Swiss francs is not included in the benefit replacement rate, but it has been subject to a 1 percent solidarity tax up to a ceiling of 315,000 Swiss francs since 2011, and will be taxed above this ceiling as of 2014.

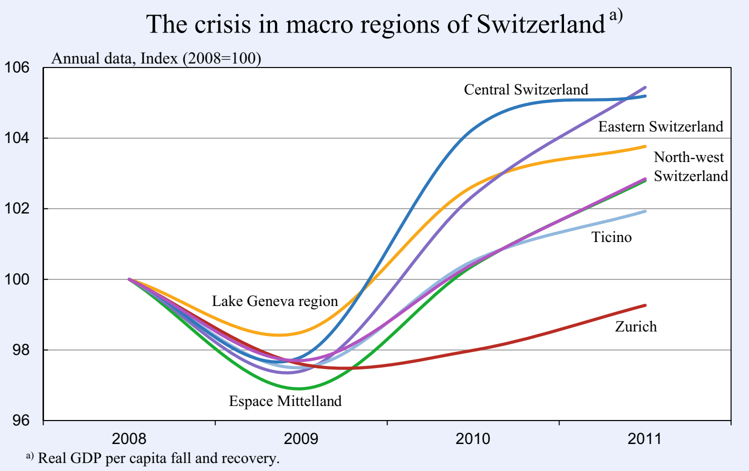
[6] Across the six euro area countries shown in Figure 2.5, the population-weighted standard deviation of per capita annual real income growth rates was 1.0 percent in 2009, and 1.4 percent in both 2010 and 2011; all country-specific growth rates differed from the population-weighted average by less than 1.9 standard deviations. Across the regions of Switzerland shown in Figure 2.6, the population-weighted standard deviations were 0.5 percent, 1.8 percent, and 0.7 percent in the same years. The only statistically significant different growth rate was the Lake Geneva region's relatively shallow decline in 2009.

Figure 2.5



[a)] Per capita real GDP in chain-linked local currency prices.
Source: Eurostat, last accessed 26 November 2013.

Figure 2.6



[a)] Real GDP per capita fall and recovery.
Source: Swiss Federal Statistical Office of the Confederation.

address them were interestingly similar, but different in Switzerland, as we discuss below.

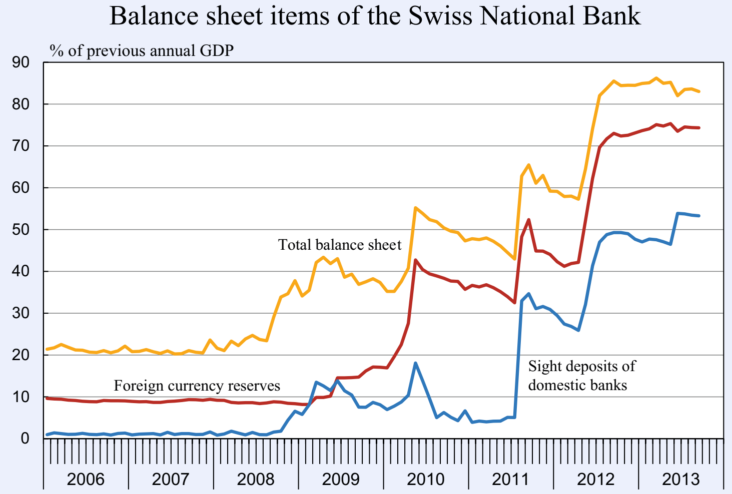
2.4.1 Finance and money

The systemic importance of Swiss banks goes far beyond the Confederation borders. The SNB and the government controversially organised a bailout of one of the two large Swiss banks, UBS. The operation was successful and ex-post profitable, but certainly very risky: It was possible for UBS to raise some equity (from a foreign sovereign fund) only because its woes narrowly predated Lehman's bankruptcy, and the deepest phase of the financial crisis. Swiss policymakers have since aimed to reduce the riskiness of the country's banking system, aiming to protect its financial infrastructure from investment banking and trading operations, and requiring larger capital. Hosting two "too big to fail" banks is dangerous for Switzerland, and the traditionalist component of Swiss public opinion does not like or trust big financial institutions and other international big business. But it clearly offers economic opportunity for at least some of the Swiss population, even though insurance, pharmaceuticals, and mid-size manufacturing are actually more important for the Swiss economy than banking.

In the crisis, the SNB chose to defend a minimum exchange rate of 1.20 Swiss francs to the euro for the same reasons that led its neighbours to adopt and maintain a single currency. Expectations of appreciation alter the exchange rate in ways that threaten money's role in denominating transactions. By accommodating portfolio shifts, and carrying risks that the public wants to avoid, monetary authorities can continue to provide the safe and liquid transaction services that make it possible for a monetary economy to function.

As a Swiss franc denomination became more attractive, preventing appreciation required the accommodation of an extremely large portfolio shift. By the end of 2012, the SNB had the fifth largest foreign currency reserves in the world, amounting to around 75 percent of the country's annual GDP. As Figure 2.7 shows, the counterpart of this was a large increase in the Swiss monetary base in the form of central bank deposits. In the euro crisis phase of the Great Recession, exchange rate management preserved the Swiss economy's ability to trade with its neighbours, preventing large income declines in the more export-oriented Swiss regions, and actually intensified its European links. The accumulation of large euro-denominated reserves at the SNB implies Swiss ownership of a significant share of European debt. This does not entitle Switzerland to any right of control over euro area and country policies, but makes it as important for Switzerland as for euro area members to look for constructive solutions to debt problems.

Figure 2.7



Source: SNB, SECO, last accessed on 26 November 2013.

Almost half of the SNB's foreign exchange reserves are denominated in euro. Debt restructuring is unlikely to be a major issue, because about 70 percent of its total bond holdings are AAA-rated, but an increase in long-term interest rates would reduce the market value of those bonds. The SNB's portfolio preferences triggers declines in the market value of peripheral assets and in the interest yield of core bonds, and its attempts to diversify the risk of its euro holdings tends to put pressure on the euro exchange rate with such currencies like the Swedish krona and the Australian dollar. Use of a common currency makes it easier to trade, but also more difficult to adjust to shocks hitting regions, households, or firms within a country, or countries within a currency union. While the disadvantages of a common currency have become apparent in the debt crisis, the SNB's willingness to prevent revaluation and take on large and risky foreign exchange reserves (and the volatility caused on the fringes of the euro area and beyond by its attempts to manage the resulting risk) may cast a better light on the advantages of a single currency system.

Within the European System of Central Banks, a role that is similar to that of the SNB's foreign exchange asset purchases (meant to prevent a revaluation of the Swiss franc in the face of portfolio shifts) is played by the TARGET2 payment system balances (see Sinn and Wollmershaeuser, 2012; EEAG, 2013; Cour-Thimann, 2013; for an explicit comparison between the TARGET2 balances and the Swiss reserves, see Sinn 2012 and 2014). Relative to GDP, the TARGET2 balances are larger than the Swiss reserves for Luxembourg (255 percent by the end of 2012), but smaller for Germany (25 percent). As collateralised credit that pays interest (at the European Central Bank's main refinancing rate), they are riskless within a well-functioning euro system. They are more controversial than Swiss reserves, however, because the collateral requirements for central bank refinancing were reduced below investment grade in the crisis countries, and positive TARGET2 balances would constitute a legally dubious claim if the single currency were to collapse. The Swiss reserves are instead held in marketable assets with clear legal validity, yet exposed to redenomination and other euro crisis risks. In fact, when the crisis calmed down and the interventions were stopped, the SNB reported a profit of about 6 billion Swiss francs in 2012, 4.5 billion Swiss francs of which was due to a rise in the value of its foreign exchange reserves.

2.4.2 Fiscal policy

A small open economy is limited in the range of policies its government may adopt. It would be ill-advised for a small country to implement a public stimulus to support export-oriented industries. In the 1970s, Switzerland was severely affected by a worsening of the global economic climate, and the crisis was amplified by a very restrictive immigration policy, which caused a reduction in the population: In 1977 the population was 2.2 percent lower than in 1974, and this reduced domestic demand substantially. Among other woes, the Swiss watch making industry initially missed the move to quartz watches. Recovery from the crisis wan not brought about by fiscal policy, but by innovation and trade. A revival of the watch making industry came with the introduction of cheap, but elegant plastic Swatches, and Swiss tool makers and other industries regained strength when the world economy and neighbouring Germany recovered in the second half of the decade.

The Swiss are weathering the current crisis well because they recognised that a fiscal stimulus would again be ineffective in an export-driven crisis and adopted a "Schuldenbremse", a debt brake that limits its spending growth to average revenue increases over a multiyear period, based on forecast revenues, and correcting for business cycle conditions. Some infrastructure investment, financed through a special fund, as well as public transportation, is outside the structure of the debt brake; so is the social insurance system, although there are many voices calling for an equivalent control mechanism. However, the exceptions are clearly defined, and this ensures that the fiscal constraint is more binding than would be implied by generic "golden rules" excepting investment, a spending category that under political pressure can be reconfigured to include almost anything (education is investment in children and thus in the future of the country, military spending is investment in security, cultural spending is investment in cultural capital etc.).

The debt brake was devised as a response to the experience of the 1990s, when in the wake of a property bubble bursting and a substantial economic slowdown, the federal debt expanded from 12 percent of GDP in 1990 to 26 percent in 1998 (when because of the parallel expansion of cantonal debt, the total public debt was at 56 percent of GDP). In the wake of the introduction of the debt brake in 2003, after a referendum in 2001 where almost 85 percent of the voters supported the measure, the federal budget showed considerable surpluses, and continued in surplus through the post-2007 financial crisis. As a consequence, the debt share is likely to fall to below 30 percent of GDP by 2016.

The Swiss introduction of a debt brake addresses problems that are common to many other countries. It came at a propitious moment, when strong global expansion allowed a substantial economic growth that generated fiscal surpluses, and when the budgetary cuts that were needed as part of the original reform impetus did not look so painful. The Swiss term for this type of fiscal control, "Schuldenbremse" or debt brake, became an internationally accepted concept, and Germany pushed successfully for it to play a central role in formulating the European Union's response to its own fiscal crisis. Underlying the concept is a belief that high rates of debt are likely to impose costs that lower economic capacity and growth, although it has been notoriously difficult to establish a particular limit at which debt becomes dangerous, since the extent of danger depends directly on prevailing interest rates and growth rates, but also on less tangible factors such as the degree of confidence in state capacity. One of the effects of a debt brake, however, is to raise the degree of knowledge about the likely fiscal path, so that the market's perception of state capacity increases.

What makes the Swiss approach conspicuously successful in this more general context is the high degree of democratic legitimacy. Switzerland's adoption of the public borrowing limits in 2001 by a referendum majority of 85 percent compares well with the less democratic and much less effective implementation of its European Union neighbours' "Stability and Growth" and "Euro Plus" pacts, and is arguably more credible and permanent than even the balanced-budget constitutional rules that member countries have to adopt. Like the overwhelming rejection of a proposal to guarantee six weeks of annual paid holidays, the success of the debt brake proposal shows that pragmatic Swiss voters recognise economic constraints more clearly than those who, in other countries, are only too often attracted to myopic and populist policies.

Another way in which Switzerland can provide useful lessons for Europe is in its handling of local public debt. About one third of the general government debt is a liability of sub-federal entities, and all except five cantons also have debt brakes (the first measure, in St. Gallen, was introduced in 1929). The 2003 debt-brake law, moreover, sets tight quantitative limits on the ability of cantons to transfer fiscal liabilities to the federation. The fiscal responsibility of sub-federal government levels had previously been made clear when the cantons of Berne, Solothurn, Geneva, Waadt, Appenzell Ausserrhoden, and Glarus were left alone as their cantonal banks had problems in the 1990s. The formal bankruptcy of a small and profligate commune, Leukerbad, in 1998 (Blankart, 2013) eventually clarified beyond doubt that Switzerland's fiscal federalism excludes debt mutualisation. This, in turn, has a strong disciplinary effect. Swiss cantons and communes keep their debt under control because they cannot be expected to be bailed out. Their own debt-brake rules are meant to signal to financial markets that they are fiscally responsible, and financial market interest spreads between the cantons, based on rating differences, ensure fiscal restraint and prevent excessive debt accumulation. Similar arrangements are in place in the United States (see EEAG, 2013), but in the euro area, even though envisioned by Article 125 TFEU, the no-bail-out principle has – depending upon interpretation – been set aside or its implementation remains unclear and untested.

2.4.3 Tax competition

Like Luxembourg within the European Union and the small pebble states that pepper Europe (and like Delaware in the United States and such global tax havens as Bermuda or the Virgin Islands), Switzerland exerts tax competition pressure on neighbouring countries. This is superficially motivated by historical and cultural differences, and tolerated by national powers, possibly because the super-rich do not easily accept Leviathan state powers. The crisis is making a difference: As the usefulness of government powers becomes more apparent, tax havens are under attack. In 2013, the European Commission began a process of renegotiating its tax treaties with Switzerland, as well as with Andorra, Liechtenstein, Monaco, San Marino, and introducing a Directive that will extend the banking information exchange now applicable to savings to all income sources.

Such tensions are clearly on the mind of Swiss public opinion and policymakers. The Swiss movie "Der grosse Kanton" depicts an intriguing solution to tax and other tensions with Germany: The Federal Republic joins the Confederation as a twenty-seventh canton, causing concern among the Swiss because of its large public debt, as well as of its sheer size and somewhat different approach to social organisation. The Swiss Army's summer 2013 exercises considered a different scenario: Its first armoured brigade was tasked to deal with a multi-pronged invasion, aimed at the wealth of Western Switzerland's bank vaults, by the "Sâone" splinter of a French nation destroyed by unsustainable public debt and the collapse of the euro. Questioned by the Geneva newspaper "Le Matin", the unit's commander emphasised that the military do need to train "in a realistic environment" and that the exercise had been planned in 2012 when fiscal relationships were "less tense" between France and Switzerland. He offered no information as to whether the simulated invasion was successfully repelled in the exercise.

Not only concerns about less than peaceful international relations, but also considerations of fairness are making tax competition increasingly less acceptable to the Swiss themselves. Following Zurich's example in 2009, several (German-speaking) cantons have abolished by plebiscite the forfeit expenditure tax regime, which allowed foreigners with no Swiss labour income and high taxable income from abroad to be taxed only on an estimate of their expenditure on Swiss soil, and therefore to pay much lower taxes than Swiss citizens in the same situation. Those cantons' voters accepted the budgetary implications of removing such an aggressive tap into foreign tax bases. While similar plebiscites did fail in other (also German-speaking) cantons, Switzerland is slowly but clearly outgrowing tax competition. A federal plebiscite is pending on the forfeit expenditure tax regime, and in October 2013 the Swiss Confederation's government decided to join the OECD/Council of Europe multilateral convention on administrative assistance in tax matters, opening up the Swiss bank accounts of foreign taxpayers to international information requests.

2.5 Lessons for the future of Europe

Switzerland is only slowly completing its internal market, accepts tax and local public good competition across its cantons and communes, and maintains many barriers to international economic integration at the same time as it takes advantage of external tax-competition opportunities. In these and other ways it differs from its neighbours, which have developed other mixes of administration, authority, and social pressure to address the balance of moral hazard and reciprocal trust that was and remains difficult and fruitful for individuals in families, and for families in local communities. Just as Switzerland is becoming more European in these respects, so Europe may find it useful to become more Swiss in other respects.

2.5.1 Culture matters

It is certainly far from surprising to find that language and culture significantly influence economic interactions within Switzerland. More generally, in Europe and elsewhere, language (and television, cellular networks, and other media) certainly shape economic boundaries even more forcefully than voting rights and tax obligations. But culture is not everything. Just as heterogeneity does not prevent individual interactions (and, in fact, makes them more interesting), so cultural differences do not prevent economic and policy interactions across communities (and arguably make them more productive). Conflicts of economic interest are a more likely source of disagreement across regional entities than ethnic differences, and very common not only across, but also within nations, and not only between ethnic groups, but also within families. Cooperation is fortunately also very common, and is based on mutually beneficial market exchanges, as well as on the enforcement of more or less democratically agreed behavioural constraints. In a well-organised society, taste and productivity differences are magnified by specialisation and generate economic gains from well-regulated trade, and cultural differences are smoothed out to make communication and cooperation possible. Organising trade and enforcing rules requires the efficient communication of individual resources and needs, and need to be based on a clear framework of mutual understanding and trust. All of this can be achieved by different societies in different ways that evolve over time, and continue to exert an influence, even after they have long ceased to be superficially visible.

The Swiss solution to such problems and its evolution over time suggests that cooperation and trade across culturally different societies is possible and fruitful, but neither easy nor riskless. Like many Swiss things, the Konkordanzdemokratie is actually a product of the country's history and cultural heterogeneity. It was introduced after the civil war, when the (protestant) merchant bourgeoisie defeated more conservative (and catholic) corporatist cantons. The Confederation had to manage the peaceful coexistence of cultures ranging from the Germanic, Catholic, rural, and conservative culture of the original cantons, to the Protestant, Romanic, and enlightened culture of Geneva, which had fought both the Savoy and the Germanic cantons to remain independent until Napoleonic times.

The United States were also initially socially and economically diverse enough to engage in civil war in the 1860s and have largely retained this heterogeneity. Their history offers not only a model for Europe's need to unify its economy and harmonise policies, but also represents a cautionary tale as regards the difficulty of doing so. While Alexander Hamilton's famous negotiation in 1790 of an assumption of state debts by the federal government is often cited as a model for how a United States of Europe might be created, the actual developments of that historical move are less than appealing (EEAG, 2013, offers a detailed review of experiences with state debt in the United States). The individual states went on a borrowing binge in the late 1830s, which was followed by widespread default in the early 1840s. The revenue stream that was used to service the federal debt – the external tariff – was a necessary part of the Hamilton scheme, and stirred the economic (and not only cultural) tensions between the American North and the South that ultimately caused the War of Secession.

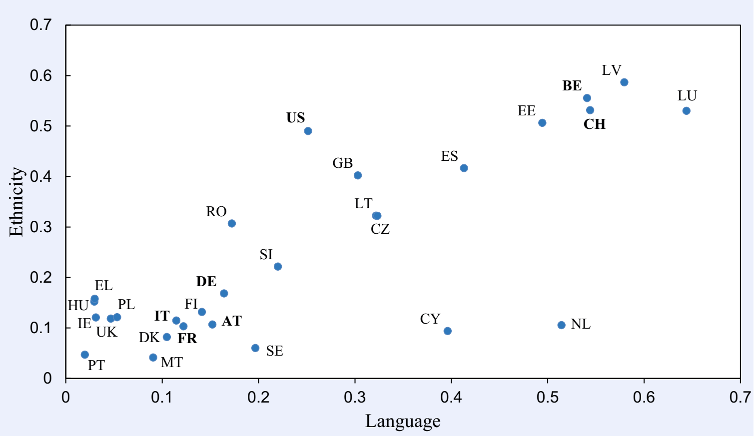
2.5.2 Dealing with diversity

Nations traditionally aim at homogenising diversity, but every society needs to manage unavoidable heterogeneity across ethnicities, families, and indeed individuals. Experiences other than the Swiss and American ones can provide equally useful insights, and deserve to be at least briefly reviewed. Switzerland is very special, but similar to other European countries in key respects. Like San Marino, Monaco, and other small countries, Switzerland has been embedded for a few centuries in a Europe that was becoming increasingly nationalistic. Like Belgium, but unlike most of the countries generated by that process, it is rather less than fully homogeneous in terms of language, religion, and culture. Figure 2.8 reports fractionalisation indices for all EU27 countries with available data, for the United States, and for Switzerland. While Switzerland does stand out in terms of overall diversity, two smaller countries are even more diverse in some respects, and Belgium is not far behind.

Linguistic minorities are present and recognised in most European countries, and culture does vary very significantly even within countries where a unified lan-

Figure 2.8

Heterogeneity within Switzerland and comparison countries



Source: Alesina et al., 2003.

guage replaces, or coexists with, local dialects.[7] Some European countries were put together through royal marriages, but most were drawn together by war – Bismarck's "blood and steel" – and Switzerland is no exception to this rule, although the 1848 War of the cantons was brief and not very violent. However, durable cooperation cannot be ensured by force and redistribution: it requires the permanent conviction of citizens of all regions to participate in a mutually beneficial deal. Public policies and institutions need to seek cooperative solutions to common problems, and to produce durable compromises cemented by the self-enforcing realisation that breaking agreements in pursuit of immediate gains would entail larger losses.

Cultural diversity has economic and policy implications. In Switzerland, it may lead Romanic speakers to enjoy spells of subsidised unemployment that are some seven weeks longer than those of their Germanic neighbours, but it does not lead the Swiss social insurance system to envision language-specific entitlements. National policies also have vastly different implications across regions in countries as diverse as Italy, Germany, and Spain, but uneasy compromises between homogeneity and diversity are the price of common market and national solidarity. Nation states traditionally root the cooperation and solidarity they need in processes of cultural assimilation, market integration, and internal migration. In Switzerland, a different sort of cooperation is rooted in the Konkordanz principle of mutually beneficial political trade and compromise between heterogeneous special interests with decentralised decision powers. The fundamental working principle for pragmatic compromises is a well-established system of subsidiarity, with decisions being left to the smallest suitable territorial units in cases where compromises would be too difficult to craft.

2.5.3 What about Belgium?

The comparison between Switzerland and Belgium is interesting not only because both countries include multiple ethnicities and main languages (and in Figure 2.8 they are close to each other and very far from Switzerland's neighbours), but also because they have similar values and lifestyles. Individual excellence tends to be viewed as domination and perceived negatively in Switzerland (de Rougemont, 1965) as well as in Belgium: more troublesome neighbour countries do boast many more internationally visible heroes, criminals, inventors, scientists, and artists.[8]

For our purpose of drawing lessons for Europe, differences across the two countries are more important than their similarities. Belgium's economic performance is more than respectable, as shown in Section 2.2, and quite comparable to Switzerland's. But its diversity-management performance is worse than Switzerland's: Francophones and Flemish speakers are increasingly disconnected in Belgium, where electoral results and political structures became so fragmented at one point as to make it impossible and apparently unnecessary to form a government for a time.

It is therefore interesting to try and relate Belgium's and Switzerland's different regional and ethnic cohesion to differences between the countries' structures and histories. Some institutional features may be relevant. The central government plays a more important role in Belgium than in Switzerland, and this makes it harder to formulate policies when interests conflict across economic and cultural lines. In Belgium, many decisions have to be made or ratified by a plurality of government levels, because the structure of subsidiary powers is not as clear as it is in Switzerland. A broad majority of the international treaties signed by Belgium touches on both regional and federal competences. Ratification of such "mixed treaties" involves a large number of legislative bodies, each of which has veto power. While in Switzerland only cantons mediate between local communities and the centre, in Belgium there is an additional level of government: three regions (one French-speaking, one Flemish-speaking, with 5 provinces each; and Brussels, which is officially bilingual). And while Switzerland has several bilingual (and one trilingual) cantons, within which stable language borders exist, only one language is used in most of Belgium's sub-federal entities. This may have made it less necessary to confront and resolve cultural issues, and Brussel's residents (who speak and think in French) disrupt traditional language borders when they relocate to Flemish-speaking suburban areas.

[7] Within the Federal Republic of Germany, the historical pattern of Protestant expansion exerts a significant influence not only on current religious beliefs, but also on more general cultural and economic differences, arguably reflecting Protestant encouragement of reading and personal learning (Becker and Woessmann, 2009); and traces of the Roman Empire's border are still visible at the so-called "Weisswurst-äquator" cultural boundary which, while much less well defined, is somewhat similar to Switzerland's "Röstigraben". Regional heterogeneity within each European country can more generally be traced back to the socio-economic conditions prevailing in pre-national states (Tabellini, 2010).

[8] Both countries have, of course, contributed very significantly to European culture. Famous Swiss artists include Paul Klee and Alberto Giacometti (the famous architect known as Le Corbusier, born in Switzerland, chose to become French), while Belgium's recent contributions include Jacques Brel and many prominent comic-strip authors.

As for historical factors, there is no equivalent to Switzerland's Wilhelm Tell in Belgian folklore. The country was not brought together by home-grown opposition to external power, but created as a buffer state by external powers after the Napoleonic wars. That new state's historical roots (in the ancient Kingdom of Burgundy, which at times also included part of what is now French-speaking Switzerland) were too loose to excite nationalist independence feelings, but Belgium's position among the powers did bring it to build a colonial empire (albeit on the initiative and as personal property of its king), and did not allow it to stay out of European wars. By contrast, Switzerland's internal cultural diversity naturally prevented international projection in the form of colonisation (hampered by lack of direct access to sea) or wars of aggression. The country's cohesion was cemented by successful neutrality-oriented organisation of military defence against clear and present external threats (de Rougemont, 1965).

The most important factor in Belgium's poor diversity management, however, is arguably the interaction between historical heritages and regional economic development patterns. Like those of Switzerland, Belgium's regions and peoples were economically as well as culturally heterogeneous, and briefly fought each other in the nineteenth century. In Switzerland, the militarily and economically dominant component was Germanic; in Belgium, it was Francophone: In the recent past, globalisation has had very different implications for the regional specialisations that happened in Belgium to coincide with cultural boundaries. While the French-speaking regions suffered the demise of European heavy industry and mining, the Flemish-speaking regions could take advantage of the trade and high-tech opportunities afforded by access to oceanic routes and by a more flexible mercantile culture. The Belgian experience of economic takeover by a previously dominated group has no parallel in the history of Switzerland, where the Germanic element exercised Konkordanz rather than centralised dominance, and did not experience the relative economic decline that raises issues of socio-political as well as cultural cohesion in Belgium.

2.5.4 And what about Europe?

Geography and history play a crucial role in shaping the economic destiny of people and regions not only in Belgium or Switzerland, but in all of Europe. Social capital, culture, reforms, and hard work may certainly explain why some become or remain rich, while others stagnate or decline. The wealth of regions, however, also depends on luck, and on shifting patterns of trade. Control of the Gotthard and other crucial mountain passes was a key determinant of the Holy Roman Emperor's decision to free the original Swiss cantons; Nuremberg and Samarkand were privileged crossroad markets until trade began to cross the Atlantic; and Bavaria, Tyrol, Veneto were transformed from peripheral battlefields into prime production and trade locations by the process that, since World War II, has been removing the economic boundaries of European Nations.

Homogeneous national identities were the political and social element of the commercial and industrial revolutions that made Europe rich, but unstable, and prone to wars. To achieve its currently elusive "growth, stability, and cohesion" objectives, the European Union project aims to dissolve them into a new type of socio-economic framework.[9] A common set of policies and institutions, however, is not easy to craft for a culturally heterogeneous society. Trust and cohesion cannot rely on traditional nationalistic feelings at the European level, and are even strained by economic woes and market failures within countries, often along ethnic and nationalistic lines as in the United Kingdom and Spain.

In Switzerland, cultural heterogeneity is widespread and multi-dimensional. Borders across languages, religions, and traditional versus progressive cultures overlap far from perfectly. They do not separate the homogeneous sets of humanity that national states would like to be. In Switzerland, each individual belongs to several of a multitude of communities. This makes it natural for power to be dispersed, and for decisions to be collegially shared. The resulting "Konkordanzdemokratie" is more conducive to conservative compromises than to the sweeping reforms that may be possible for the majoritarian decision-making processes of national political systems. The stability fostered by consensus-based democracy may support long-term investments and process innovation, but can reduce productivity growth in cases where drastic frontier innovations are necessary. Like other tradi-

[9] The transition from national to inter- or supra-national economic and policy relations effectively presents the same challenges and opportunities as that from the feudal to national level, extensively discussed by Adam Smith in Chapter IX of the Wealth of Nations (Bertola, 2007). Many of the same issues are now arising for China's "hukou" system of local citizenship rights and obligations, which is hardly compatible with an urban-industrial socio-economic organisation.

tional Swiss features, the Konkordanz style of politics is becoming less relevant as parties at the margins of the political spectrum gain political weight in Switzerland. At the same time, multiple cultural identities have become common in other countries (and it may not be a coincidence that "grand coalition" governments have been formed recently not only in Austria, where they have been nearly as common as in Switzerland, but also in Germany and in Italy).

Political developments are shaped by the evolution of communication and media technologies. While television and newspapers are still largely national in Europe, face-to-face interactions can only work at much lower levels and are so crucial as to perhaps justify Tip O'Neill's view that "all politics is local" and Montesquieu's view that democracy can only work on a small geographical scale as expressed in his Spirit of the Laws. But in a modern economy, where long-range trade exploits specialisation opportunities and economies of scale trade, and public redistribution policies replace family or village solidarity, the conflicts of interest that need to be addressed by political compromises arise along dimensions that are not geographically or ethnically local. Belonging to the same age group or the same occupation is often a more powerful source of common interests (as student revolts and labour unrest powerfully showed around 1970) than belonging to the same family, or coming from the same small village. Technological progress reduces cultural as well as physical distances:[10] Internet-based media and social networks are not constrained by geographical or political boundaries, and electronic translation may blur cultural boundaries even across the uneducated. As compromises between the economic advantages and policy disadvantages of diversity can no longer rely, as they did in the past, on the coincidence of national geographical, cultural, and political boundaries, the constant communication and monitoring needed to build democratic consensus might become possible on a larger scale than that of the Swiss communes or of the Swiss Confederation, and may even become possible on the European Union's continental scale.

The current configuration of the European Union features some, but by no means all of the key ingredients of a traditional state. It has a bureaucracy and some common rules, but no central decision-making power, no common army or foreign policy, and no political sense of common purpose. While the currently malfunctioning combination of international political compromises and supranational bureaucratic administration needs to be improved, it does not seem possible to replicate the dirigiste political model of nation states at the European level, with infrequent majority votes and the delegation of decision powers. Unfortunately, supranational politics do not appear to be the automatic consequence of economic integration that the founding fathers of the European Union hoped for. In Europe, there is an educated elite that feels comfortable in many countries, but a large majority of each country's citizens feels that migration would only offer access to low-paid jobs in other countries, and justifiably fears that, in the absence of a European harmonisation of social and labour market policies, economic integration undermines their own country's familiar safety nets. To foster trust in a supranational European socio-economic framework, it might be advisable to organise a mass version of the year-abroad experience that the Erasmus student exchange program currently offers rich university students: Young Europeans of all social groups should be enticed or obliged to work for some period in another country and using another language, as proposed by the writer Umberto Eco in 2012. A "European social year" for young people might help to build a common identity across the borders of nations where military service served a similar purpose.

It is hard, however, to envision development of a European identity so well-defined as to support supranational political decision processes. This difficulty is made evident not only by the failure of past French and German attempts to engineer continent-wide versions of their own nations' conquest-based origins, but also by the very mixed success of the European Union elites' top-down approach to supranational policy-making, which has proved unable to tackle the most politically important social and fiscal aspects of policy. The exercise of top-down decision powers has limited the democratic legitimacy of the European Union integration process, as shown by rejection of constitutional referenda and by the steady decline of European Parliament electoral turnout. Moreover, the idea that such issues as pension scheme generosity and bank supervision could be left to national subsidiarity was always theoretically dubious, and has been shattered by a crisis that clearly showed that such important matters cannot be left to uncoordinated national policies.

[10] The travel time from Geneva or Grisons to Berne in 1848, when the Swiss Confederation was established in 9 months, was measured in days (De Rougemont, 1965), and was much greater than air travel today from Stockholm or Athens to Brussels.

Montesquieu thought that empires were the better way to organise larger units. For economic governance of economically and culturally heterogeneous areas, a structure in some ways similar to that of the ancient Holy Roman Empire, or of China, might indeed be a better model than the federal national structure of the United States or Germany. The European integration process should replace the opacity of deals between national political leaders with pragmatic, explicit, and accountable compromises between socio-economic conflicts of interests that do not necessarily occur across national boundaries. It should accept the limitations that this approach implies for the scope and character of common policies and institutions, but also focus on the policy dimensions that do need to be harmonised. As in Switzerland, pragmatic policy action is also needed in Europe and is crucial to the management of a common currency and an integrated financial and fiscal system, as well as of common external positions. Unification of the European product market logically requires a single European voice at the World Trade Organization, but external unity is lacking in many other respects.[11] The slow and cumbersome organisation of the European External Action Service, headed since 2011 by the High Representative of the Union for Foreign Affairs and Security Policy, contrasts sharply with the quick and divergent reactions from the member countries' diplomatic services and foreign ministers to emerging crises like the current situation in Syria. The same security threats that in the past helped to build Swiss national identity cannot, unfortunately, be ruled out for Europe. As the United States retreats from the Middle East in the wake of its shale gas bonanza, Europe may need to develop a truly common foreign policy and military power that could, as in Switzerland, come to be seen as a necessary means for preserving peace. Although certainly unfortunate in other respects, armed neutrality may prove as helpful as it was in Swiss history in terms of fostering a European identity.

2.6 Conclusion

At the same time as the Swiss Confederation implements some institutional features of the European socio-economic system, the European Union may find it possible and useful to implement some Swiss institutional features that are looser and less centralised than in traditional nation states, but pragmatically focused on the administrative, legal, monetary, and fiscal instruments that support market relationships, and held together by shared external concerns. Imitation and learning, of course, are not the same as copying. Solutions need to be adapted to the problems that are evolving and to some extent converging in Switzerland and Europe: They entail reforms of legal, political, and policy frameworks, and need to be supported by a self-enforced sense that a future together is possible and fruitful. As in Switzerland, traditionalist views of the world will continue to interact with progressive ones in Europe too, while different cultures will continue to coexist and evolve. Europe cannot become entirely German or French, but in some ways all Europeans can become more Swiss. In a possible future, being Dutch or Portuguese might well become be as folkloristic within Europe as being from Uri has largely become in Switzerland, or being from Texas is in the United States, or as being Franconian (an ethnicity that Bavaria's alliance with Napoleon deprived of polity status) already is within Bavaria and in Germany.

[11] The segmentation of European service markets, itself rooted in historical and cultural heterogeneity, still makes it impossible to formulate and defend a common position in services-trade negotiation (Bertola and Mola, 2010).

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