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Foreword

The OECD Review of Regulatory Reform in Switzerland is one of a series of country reports carried out under the OECD's Regulatory Reform Programme, in response to the 1997 mandate by OECD Ministers.

Since then, the OECD has assessed regulatory policies in 21 member countries, and in Russia, the first non-member country to be reviewed. The reviews aim at assisting governments to improve regulatory quality – that is, to reform regulations to foster competition, innovation, economic growth and important social objectives. The review draws on the 2005 Guiding Principles for Regulatory Quality and Performance, which brings the recommendations in the 1997 OECD Report on Regulatory Reform up to date, and also builds on the 1995 Recommendation of the Council of the OECD on Improving the Quality of Government Regulation.

The country reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, on competition policy and enforcement, on market openness, and on the regulatory framework of specific sectors against the backdrop of the medium-term macroeconomic situation.

Taken as a whole, the reviews demonstrate that a well-structured and implemented programme of regulatory reform can make a significant contribution to better economic performance and enhanced social welfare. Economic growth, job creation, innovation, investment and new industries are boosted by effective regulatory reform, which also helps to bring lower prices and more choices for consumers. Comprehensive regulatory reforms produce results more quickly than piece-meal approaches; and they help countries to adjust more quickly and easily to changing circumstances and external shocks. At the same time, a balanced reform programme must take into account the social concerns. Adjustments in some sectors have been painful, but experience shows that the costs can be reduced if reform is accompanied by support measures, including active labour market policies.

While reducing and reforming regulations are key elements of a broad programme of regulatory reform, experience also shows that in a more competitive and efficient market, new regulations and institutions may be necessary to ensure compatibility of public and private objectives, especially in the areas of health, environment and consumer protection. Sustained and consistent political leadership is another essential element of successful reform, and a transparent and informed public dialogue on the benefits and costs of reform is necessary for building and maintaining broad public support.

The policy options presented in the reviews may pose challenges for each country. However, the in-depth nature of the reviews and the efforts made to consult with a wide range of stakeholders reflect the emphasis placed by the OECD on ensuring that the policy options presented are relevant and attainable within the specific context and policy priorities of the country.

Each review consists of two parts. Part I presents an overall assessment, set within the macroeconomic context, of regulatory achievements and challenges across a broad range of policy areas: the quality of the public sector, competition policy, market openness and key sectors such as civil aviation, railways, telecommunications, postal services and electricity in the current case. Part II

summarises the detailed and comprehensive background reviews prepared for each of these policy areas, and concludes with policy options for consideration which seek to identify areas for further work and policy development in the country under review. The background reviews for Switzerland have been posted on the OECD Web site: www.oecd.org/regreform/backgroundreports.

Acknowledgements. The Horizontal Programme on Regulatory Reform is headed by Deputy Secretary-General Richard Hecklinger. The country reviews are co-ordinated by the Public Governance and Territorial Development Directorate.

The Review of Switzerland reflects contributions from all participating parties in Switzerland, the Working Party on Regulatory Management and Reform of the Public Governance Committee, the Competition Committee, the Working Party of the Trade Committee, the International Energy Agency Standing Group on Long-term Co-operation, representatives of member governments, and members of the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC), as well as other groups.

In the OECD Secretariat, Odile Sallard, Rolf Alter, Josef Konvitz, Stéphane Jacobzone, Caroline Varley, Claude Giorno, Alain Schoenenberger, Milad Zarin-Nejadan, Delia Rodrigo, Philippe Gugler, Michael Wise, Patricia Hériard-Dubreuil, Bernard J. Phillips, Charles Tsai, Evdokia Möise, Anthony Kleitz, Doug Cooke, Ian Cronshaw, Fabienne Cerri and Lisa Heldwein contributed substantially to the review of Switzerland. The documentation was prepared by Jennifer Stein.

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Summary

Switzerland's successful performance of recent decades rests in large part on an effective management of the economy

Switzerland has a record of strong economic performance, reflected in high living standards and successful public policy management in the social, regional and environmental fields. The roots of Switzerland's traditional success can be found in a combination of factors:

- The economy has been skilfully piloted to make the most of its central geographic position in Europe and to promote the development of value added niche markets.
- Openness to international trade and investment is underpinned by traditionally liberal policies on international trade. There is a broad mix of SMEs and large multinationals. Exposure to international competition does, however, vary by sector, and market openness today shows signs of fragility.
- The Swiss labour market functions well, combining one of the highest participation rates in the OECD with low unemployment. Labour market flexibility largely accounts for this good performance, promoted by policies and governance traditions such as the decentralisation of the wage negotiation system, the absence of a legal minimum wage, and a social consensus that prefers negotiation to confrontation.
- A high level of human capital development draws its strength from a strong system of secondary and tertiary education, with over 80% of the labour force in possession of a secondary diploma or having received vocational training.
- Monetary policy has secured an unusually low and stable inflation record.
- A highly developed financial sector (financial services account for 10% of GDP) makes a significant contribution to the economy. This has been encouraged by the openness of the economy, a relatively low tax burden, and a policy framework that has found an effective balance between protective rules and non-interventionist monetary and fiscal policies. Some parts of the sector perform less well however, and are not adequately exposed to competition, including venture capital markets and cantonal banks.
- Innovation has been traditionally strong, though there has been a tendency over recent years to focus on quality improvements rather than the more risky development of new products and processes, such as in the fast growing ICT sector.

Strongly anchored political and public governance traditions support a highly stable economy and society, but slow the process of change

The Swiss system of governance has played a defining role in shaping the economy and society. It is based on highly decentralised federalism and a system of participative

democracy by referenda, features that have hardly changed for well over a century. This has led to a high level of trust in government, public institutions and the legitimacy of public action. When decisions for change are well accepted, reforms are soundly anchored. But the system also slows the decision-making process, which affects the rate of reform. The referendum results of recent years suggest the emergence of sufficient consensus for reform, but differences of opinion over the details can be sharp, and it usually takes several years to reach agreement on important changes.

Slow growth in recent decades highlights the need for reform

The core problem faced by Switzerland is that growth has been slower than the OECD average for nearly two decades. During the 1990s, average annual GDP growth per capita stagnated, whilst it grew on average by over 1% or more in other developed economies. If this trend continues, it will undermine past achievements, lead to a continuing relative erosion in living standards over time, and leave the country ill equipped to face the demands of a rapidly ageing population. The proportion of elderly (65 years and over) to the working age population will reach 44% in 2035, compared with 25% today.

The reasons for slow growth: faltering productivity in the context of inadequately functioning product and services markets

The growth problem has its roots in the slow growth of labour productivity, and to some extent also in the inefficient use of productive capital, which together suggest low total factor productivity growth. The main explanation lies in the inadequate functioning of product and services markets, reflecting a lack of competition, together with the high cost of services supplied by the public sector or financed through compulsory contributions. Swiss prices are very high in international comparison, evidence of a problem with competition both within the Confederation and externally, as well as problems with the performance of the public sector. Another major policy challenge is to restore sound public finances. Inadequate control over public spending since the early 1990s has led to rising public deficits and debt. If this trend continues, it risks strangling growth prospects. A particular source of concern is control over health and social spending.

Important political and societal trends need to be taken into account in reform plans

The broader political and societal framework for the implementation of reform matters in the Swiss context. The Swiss system of democracy has a direct influence over decisions, small as well as large, that shape the economy and society. Factors of change today include an increasingly high age profile for the voting population, a growing influence of vested interests and single issue lobby groups especially in the organisation of referenda, and the growing importance of new media in political communication.

Growing Confederation responsibilities over time sit uneasily with the Swiss tradition of highly decentralised power. An important reform based on changes in fiscal relationships between the different levels of government is currently underway, and should help consolidate a new and more productive relationship with more timely decision making.

Beyond Swiss borders, there is the longstanding but growing challenge of keeping up with EU structural and regulatory change. Switzerland is not a member of the EU but its open economy and geographical position mean that it is heavily influenced by developments there. The EU influence encourages reforms which would be harder to push forward otherwise, such as in the network sectors. Changes enacted in the EU to the regulatory framework of sectors important to the Swiss economy need to be reflected in appropriate Swiss adjustments, if Switzerland is to remain a full participant in the EU Single market. Swiss companies and consumers otherwise risk losing out through exclusion from the wider EU Single Market.

Reforms so far: an awareness of the need for reforms, but moving forward at the right pace is proving difficult

There is rising awareness in Switzerland of the need for further reform to address the problem of slow growth, building on reforms that were started in the early 1990s, though not all stakeholders share this view. The rejection by popular referendum of accession to the European Economic Area (EEA) in 1992 triggered the adoption of a wide ranging “Revitalisation Programme”. One major success of these reforms was the possibility to conclude a series of agreements with the EU covering a wide range of economic sectors.

Overall, reform remains often piecemeal and incremental, with much “work in progress” that needs completion. This is reflected in the construction of the internal market, where scope for further integration remains. Sectoral reforms are progressing at different rates across sectors, and the process of setting up independent regulators is slow. Efforts are also continuing to develop a more systematic framework to address the future of universal service in the network sectors. The population is deeply attached to public service, linked to concerns about ensuring the servicing of remote rural and mountain areas.

The Growth Package is a recent initiative by the Federal Department of Economic Affairs which proposes a strategic agenda of key reform priorities. It sets out 17 specific measures for enactment in the legislative period 2003-07. If increasing competition in the internal Swiss market is one of the main objective of this programme, pursuing integration with the global economy is the goal of the new strategy for foreign economic policy, adopted in January 2005.

The need for further reform is underscored by the results of the OECD’s recent Product Market Regulation project, part of a wider OECD study to identify the economic reforms that matter for sustained economic growth. Switzerland emerges with a relatively high level of product market regulation, including in comparison with other small countries, such as Austria which is also a federal country.

Further reform is needed across a range of policy areas

Policy areas for further reform include the following:

- Promoting internal market competition. A necessary reform of the current Internal Market Law is currently underway. It aims to tackle continuing restrictions on access to their markets by the cantons more effectively, by applying the EU inspired “Cassis de Dijon” principle, under which goods, and more importantly services, may be freely traded on the basis of mutual recognition of different rules (the principle can be applied internally as well as across international borders). Despite significant recent developments, competition policy also needs further strengthening to help in the development of the internal market. Public procurement markets, a key area for the integration of the domestic market, remain relatively closed, notwithstanding reforms started in the mid 1990s.
- Promoting a positive environment for international trade and investment flows. Foreign competition can be enhanced by adopting the “Cassis de Dijon” principle, which would help to eliminate technical barriers to trade. As Switzerland is not a member of the Customs’ union of the EU, it would benefit from fostering imports through a closer integration of agricultural markets and through more effective competition from parallel imports of patented products. Allowing parallel imports (shifting to a regional, if not international, exhaustion regime for patent law) would be another positive move. EU markets are of central importance to the Swiss economy, absorbing 63% of Swiss exports and providing 83% of Swiss imports in 2004. The current set of agreements provides a good basis for further development.
- Promoting a more efficient and effective public sector. This includes applying regulatory quality processes to changes aimed at curbing public spending, improving the management of public sector activities and publicly-owned enterprises, and promoting efficiency in health care.
- Improving the performance of the infrastructure sectors. These include electricity, telecommunications, postal services, rail, air transport and natural gas. Many of these sectors are of particular importance for the Swiss economy, being large relative to the size of the country. There is a need to ensure convergence with EU developments so as to secure efficiently connected and reliable markets. The extent of the Swiss lag with the EU varies, but all are in need of accelerated efforts to consolidate, complete or even in one case (electricity) to start reform.
- Reforming other sectors which have a broad impact on the economy. This includes the reform of the agricultural sector, and ensuring that the regulatory framework for financial services remains effective. There is an issue of increasing regulatory burdens on the financial sector.
- Sustaining a high level of innovation through support for SME growth. This includes further efforts at reducing administrative burdens. SMEs are an important part of the Swiss economy, accounting for two thirds of employment and 99.6% of enterprises.

Moving forward: building up a shared country wide strategy to mobilise support for change, harnessing both internal and external levers of reform

To help move reform forward at an appropriate pace, a variety of approaches, many of which are mutually reinforcing, should be considered. Governance and regulatory mechanisms that already exist can be used to better effect.

Encouraging the adoption of a country wide regulatory reform policy, together with stronger sustained communication, are important starting points. A broad “ownership” of regulatory quality principles to support reform at all levels of government needs to be developed. Strengthening the regulatory institutional infrastructure will help. This requires identifying current structures that could play a stronger role and ensuring that they are adequately resourced. Switzerland does face a need for co-ordination and increased policy coherence across a highly dispersed decision-making processes, spanning the collegially-based decision making of the Federal centre, the important role played by Parliament, and the powers devolved to the cantons. A permanent, visible and influential mechanism would help foster a greater coherence in regulatory frameworks, keep the focus on the policy priorities, and ensure that regulations are fit for their intended purpose.

Although current Swiss consultation processes are a major strength, a more co-ordinated approach to communication about reform, its rationale, implications and benefits, and involving all relevant stakeholders and citizens especially, is needed. This would help, not least, to counter the perspectives of vested and single issue interests which often succeed in taking the centre stage.

Specific internal levers of reform exist already but are not necessarily identified as such. They include a more strategic approach to the development of a network of strong and independent regulators which will help to clarify the different roles of government as owner and regulator of services, developing the role of the competition authority, and strengthening the voice of consumers. An important external lever of reform is the EU, where a closer relationship and broader strategic view of objectives for the development of agreements will help to strengthen internal reform efforts.

The more effective deployment of regulatory tools is another area for attention. These include administrative simplification, mutual recognition of rules to circumvent long delays in regulatory harmonisation, benchmarking regulatory practices and competition between firms, and a more determined approach to implementation of Regulatory Impact Analysis, which is not yet firmly rooted in the Swiss rule-making process. This could benefit from an improved linkage with the existing consultation processes.

A more systematic and timely approach to reform is needed

Because Swiss economic growth has stalled, there is a pressing need to find a path for stronger growth. Achieving this is possible within well established governance and regulatory processes, and is consistent with social and environmental objectives. But aspects of traditional approaches need to be adjusted and strengthened, in order to ensure timely change and to avoid Switzerland falling back over time relative to its OECD peers. A

more systematic co-ordination of reform efforts, encouraging the participation of key stakeholders at all levels of government and including citizens, will also improve the functioning of a major Swiss asset, its system of direct democracy and related emphasis on consensus building, which ensures that change when it comes is well accepted. As a relatively late reformer in many sectors, Switzerland can benefit from the experiences gained in other countries to define an optimum path.

PART I

Regulatory Reform in Switzerland

PART I
Chapter 1

Performance and Appraisal

Introduction

Switzerland has a longstanding global reputation as an economic success story, but also as a special case (*Sonderfall*). The reasons for its success are not obvious. It is a small to medium size country of some 7.2 million inhabitants with a restricted land area (140th in the world). It has a small internal market, and is not particularly favoured in terms of its geography, with few mineral resources, mountains making up two thirds of its landmass, and no direct access to the sea. Yet Swiss citizens enjoy very high living standards in international comparison. In 2003, GDP per capita (US dollars) was the third highest in the OECD, and fifth highest on a purchasing power parity basis (overtaken only by Luxembourg, the US, Norway and Ireland). As this review and government reports make clear, however, it is time to look at the regulatory governance system as a whole, to see what works well, and where improvements could lift the rate of growth and improve productivity, which are urgent priorities.

Switzerland's impressive economic performance in past decades can be explained by the interaction of a number of factors, linked to a unique and historically deep seated political and institutional environment and a complex multicultural society. Significant contrasts exist across rural/urban areas and across cantons of various sizes. Diversity drives a constant quest for balance, particularly in linguistic and religious terms, reflected in consensus building at all levels; a federalist structure that vests significant power with the regional and community levels of government; and direct democracy for political decision making at all levels. The result is a very stable political system.

The constraints of being a landlocked small country divested of natural resources, except the landscape, have stimulated what might be called a creative approach to development. The limits of its internal market have historically encouraged Switzerland to adopt an integrationist policy towards the world economy, exploiting its comparative advantages and using the fact of its relative lack of mineral resources to specialize in high value added niche markets, avoiding the development of industrial sectors that are in decline in many countries. It has put its outstanding alpine scenery to good use for tourism, and has exploited its significant hydro power to become an important producer of peak electricity to European neighbours. It has also developed an efficient financial sector which can offer lower interest rates than in most other countries, thereby favouring a high level of investment relative to GDP. It has, besides, a high level of human capital development reflected in a highly qualified labour force, supported by a strong infrastructure of secondary and tertiary education. The Swiss labour market is flexible, which has helped unemployment to remain structurally low, reflected in labour participation rates that are among the highest in the OECD.

However, the positive factors that have contributed to Switzerland's past achievements seem to have been less effective in recent decades. The Swiss particularities have a number of implications, not all uniformly positive for the economy and society, and are a main reason why necessary reform today is often difficult and slow. This poses in turn the question of the factors that may have contributed to the recent trends. Federalism, where the

centre enjoys limited prerogatives, together with direct democracy, have led the state – at all its levels – to intervene *ad hoc* in a number of important areas. The Federal centre faces considerable challenges in sustaining a country wide strategy. Many parts of the internal market do not function well because of differences in regulation across local authorities. Switzerland's important relationship with the EU may be affected by the difficulty of getting timely agreements under the direct democracy system. These are particularly necessary in some sectors, because Switzerland's central geographical position in Europe makes it a major transit and trading hub for key regional infrastructures such as road, rail, air and electricity. Convergence with EU regulation for an efficiently functioning infrastructure is often hard to achieve.

The high economic performance achieved to date leaves no room for complacency. A warning of trouble ahead lies in the fact that economic growth has been slower than the OECD average for over twenty years. The economy's real growth rate has been just 1.5% on average since 1980, against a 2.75% OECD average. The gap has also been widening since the early 1990s. Other economic indicators underscore this: a sharp growth in unemployment in the 1990s (from 0.5% in 1990 to 5.2% in 1997) though it has come down since to around 4%, the structural deterioration of public finances linked to a hike in spending on social security, and a lack of dynamism in productivity growth.

This report considers what can be done to improve future prospects. The findings of the report underline that reform at an accelerated pace is essential if Switzerland is to continue into the 21st century confident in its ability to sustain its high living standards as well as objectives in the social, regional and environmental fields. The report also raises a number of questions of wider interest, which may address the political economy of reforms, as framed by this review:

- The speed of reform. Is Switzerland undertaking the necessary reforms at a speed that is fast enough to close the gap with other countries? What is the economic and social cost of lags when implementing reforms? How much change can be absorbed given the institutional framework?
- The understanding of the necessity of reforms. In spite of the economic slowdown, economic performance remains impressive, with high standards of living, macroeconomic stability and external accounts surplus. Switzerland has enjoyed economic and political stability over a very long period. In contrast, other countries have adopted policies for regulatory reform when facing a crisis. How can Swiss citizens be convinced that reforms are necessary and how can popular and political support be built up?
- How can the institutional framework be adapted while respecting the core characteristics of the political system? This may involve both the relationships between sub-national authorities and federal authorities when increasing competition in internal markets, and implementation of a specific institutional framework to support a coherent reform agenda from a whole-of-government perspective.
- How can the delivery of some core public services in the field of infrastructure be modernised? Switzerland is a key hub for a set of important European infrastructures, including air transport, rail transport and electricity. Sustaining secure and efficient connections across the region requires a high level of cross border co-operation. In the face of high public expectations, how can standards for public service be set and maintained? What is the impact of the regulatory environment on needed investment, prices, and access to services?

- Redefining the relationship with the surrounding European context. Many small economies are adjacent to large, integrated markets, which offer a number of opportunities. To be a part of a changing world in which there is no single model, countries have to understand how others regulate. The European framework also has a pervasive influence on the Swiss regulations for a number of sectors. How can regulations help improve cross-border investment and trade flows?

These questions involve addressing governance issues that draw on deeply-rooted institutional and historical factors which evolve slowly. In this respect Switzerland is not an exception, and many OECD countries face similar challenges. Given the demand of people in most countries for control over the institutions whose decisions affect their daily lives, the challenge lies in using the political process to achieve objectives in the medium term, and in the ability to communicate properly about the risks but also the benefits and rewards of reforms.

The report offers proposals to improve the prospects for more rapid and successful reform, both from the political and economic perspective. Swiss governance structures have proved their worth in the past and can be adapted to contribute to reform. The experience of other OECD countries offers a considerable choice of approaches as well as best practice. Part I of the report is divided into three sections. The first considers the factors behind the traditional success of the Swiss economy, and reviews the reasons for its relatively slow growth over more than two decades. The second looks to the future, starting with a review of key underlying trends and issues that need to be taken into account in mapping a robust path to stronger growth and the effective management of a variety of public policy goals. It also assesses what has been done so far along this reform path. The third section addresses the practical way forward. After reviewing the contribution of regulatory policy as a tool for policy coherence and economic growth, this section discusses the policy areas where regulatory reform can make a significant difference, and the regulatory institutions and tools for supporting progress.

Section 1. The Macroeconomic Context

Factors behind the traditional success of the Swiss economy

Some important features of the economy and of its management have contributed to Switzerland's traditionally strong economic performance and high standard of living. Aspects of its political and regulatory governance system have also helped to promote a successful economy and society.

An open economy

A key characteristic of the Swiss economy is its openness to international trade and investment, indicating the relative weight of exports compared with domestic production. In 2002, the Swiss share of global exports was 1.3% (goods) and 1.8% (services), well above its share of global production (0.8%). The share of international trade (average of imports and exports) as a proportion of GDP was for many years above the OECD average. It has, however, lost ground since the 1990s. The share in 2002 was 40.5%, slightly below the OECD average of 43.1%.

The traditional openness of the economy rests on a number of factors. To reduce the risk associated with excessive dependence on trade with a given country, a small country like Switzerland needs a large number of commercial partners. The lack of natural resources is another spur to trade. A key factor is the country's position at the crossroads of Europe, sharing a frontier with four EU countries, including three of the largest. This sets it up as an essential route for the intercontinental transit and trade of goods by road and rail, as well as for the transmission of electricity and to a lesser extent, natural gas in the European market.

The economy's openness has also been encouraged by traditionally liberal policies on international trade. Tariff barriers are lower than the OECD average, and non-tariff barriers have tended to come down thanks to efforts aimed at the reduction of technical barriers to trade. A longstanding policy objective is to secure a ready supply of goods, services and capital for the country. To this end, policy has been aimed at removing obstacles to the activity of Swiss enterprises on foreign markets, and to support international rules of the game which are favourable to international trade. Switzerland is linked in international trade by nearly 200 international accords, most of which have a commercial objective. The country's main partners are the industrialised countries, most prominently the EU.

As well as a large number of SMEs, Switzerland is also home to a significant number of large multinationals (chemicals, pharmaceuticals, food industry, financial services and insurance, etc.). Foreign Direct Investment (FDI) has long driven the internationalisation of Swiss enterprises. FDI flows are significant, but irregular. They have risen rapidly in recent years, especially in the services sector. Outside Europe, Switzerland often ranks higher than some of its neighbours as a country of origin of FDI. By the end of 2003, some CHF 424 billion worth of FDI (the equivalent of 98% of GDP) had been made, 42.9% in the EU

and 66.3% in the services sector. FDI flows into Switzerland, albeit less significant, are also quite high (CHF 200.1 billion by end 2003, the equivalent of 46% of GDP), mainly in financial services. The net surplus of capital outflows has raised Swiss investment income and the current account surplus (which has been over 10% of GDP in recent years), with the effect of raising national revenues faster than GDP.

That said, the extent to which the economy is exposed to external competition varies significantly across sectors, creating a sharp divide between exposed and sheltered sectors. Agriculture is strongly protected by tariff and non-tariff barriers. Import penetration is low for some capital equipment sectors in which the Swiss have specialised, but also in the textile and agro-food, drink and tobacco industries, which reflect the existence of certain barriers to trade, particularly non-technical barriers, in some of these sectors. Pharmaceuticals protected by patents are sheltered against parallel imports. Market access to some services such as life insurance is more difficult than in EU countries. Switzerland is losing competitiveness as a production centre but hosts many foreign firms which have established their headquarters, due to tax incentives and other factors.

The economy's openness today shows signs of fragility. The 2004 World Competitiveness Report (WCR) ranked the openness of the Swiss economy a low 50 out of the 60 countries covered based on the question "Does protectionism in your economy negatively affect the conduct of your business?". It also ranked Switzerland among the lower half of surveyed countries as regards relocation of future production as a threat to the future of the domestic economy. The OECD's Product Market Regulation Database echoes these findings by ranking Switzerland among the bottom third in terms of regulatory openness to foreign trade and investment. Switzerland seems much more open outwardly than inwardly.

A flexible labour market

The labour market has a number of distinctive features, the first being the large proportion of foreign labour. Despite the selective immigration policy practiced since the mid 1960s, the proportion of foreign workers in the labour force is one of the highest in the industrialised world at nearly 25%. Another distinctive feature is that Switzerland combines a high participation rate with low unemployment. The overall participation rate and the rate for males are amongst the highest for the OECD countries (77.8% and 84.9% respectively in 2003), as is the rate for older workers in the 55-64 age bracket (65.6% in 2003). Although women, too, have a high participation rate (70.6% in 2003), 56.5% of them work part time, which is well above the EU average of 34%.

Unemployment was insignificant prior to the mid 1970s, and remained very low until the early 1990s. It increased rapidly after 1991, and then gradually fell with the economic upturn, reaching 1.7% in 2001 before picking up again during the last recession, though without reaching the previous high. In 2003, the standardised unemployment rate of 4.2% was well below the OECD average of 7.1%. The relative insignificance of unemployment can be explained by a number of factors, mainly relating to labour market flexibility: the decentralisation of the wage negotiation system, which allows increases in real wages to differ according to productivity; a social consensus which prefers negotiation to confrontation ("industrial peace"); the absence of a legal minimum wage; a strict unemployment insurance system which prevents benefit dependency; the absence of protection against dismissal which can be an obstacle to recruitment; and active measures to encourage re-employment of the jobless with the aim of combating long term unemployment.¹

A confidence inspiring monetary policy

The main objective of the Swiss National Bank (SNB), which is responsible for conducting an independent monetary policy, is to ensure medium term price stability, meaning an annual price rise of less than 2%, while at the same time avoiding deflation. To achieve this target, the SNB also has to take account of the cyclical situation. With rare exceptions, Swiss inflation has remained remarkably low and stable compared to other countries. Sound monetary policy performance has strengthened the SNB's credibility on financial markets. Together with high levels of saving, this good performance could explain why long term interest rates are lower than in most other OECD countries.

The fact that Switzerland is a small country with an international currency no doubt offers another explanation for its low interest rates. But it also means that the Swiss franc is exposed to the various shocks affecting the international financial markets at times of worldwide economic and geopolitical uncertainty. The role of safe haven currency played by the Swiss franc complicates the work of the SNB, because it can trigger exchange rate fluctuations resulting in monetary conditions that are inappropriate to the domestic economic situation. Exchange rate instability can also be a threat to the country's international openness, and thus impact negatively on economic growth. During the last two decades, the Swiss franc has shown a tendency to appreciate in both nominal and real effective terms, though without demonstrating any especially marked volatility in international terms, with rare exceptions. The introduction of the euro seems, however, to have reduced the risks of tension stemming from the Swiss franc's safe haven status in the event of parity problems between European currencies. The Euro zone could help to make the Swiss franc more stable against European currencies in the future as well.

A highly developed financial sector

Financial services are a pillar of the Swiss economy, by virtue of their direct and indirect effects on value added and employment. The sector's share in total value added was 13.6% (2002), and the share in employment was 6.5% (2001). These figures broadly doubled during the 1990s thanks to strong growth in the banking sector and the bank-related and insurance financial sector. Traditionally, the sector is strong on wealth management, which accounts for more than half of the banking sector's value added. In 2001, assets managed in the form of customer deposits totalled CHF 3 224 billion (764% of GDP), before falling to 2 870 billion (665% of GDP) in 2002, following the financial markets crisis. Deposits are divided between private clients (42.1%) and institutional investors (47.5%), with the remainder accounted for by commercial customers.

The Swiss financial market is an important player on the international scene. In terms of the volume of assets managed in investment funds, it ranks 9th in the world. In 2001, 2.4% of some € 13 000 billion invested in such funds were managed in Switzerland. The financial market also plays an important role in terms of capital market transactions. The Swiss stock market was 8th in the world in terms of market capitalisation in 2002, even though it comprises relatively few companies, while on the foreign exchange market the Swiss franc ranks 5th in the world behind the US dollar, the euro, the Japanese yen and the pound sterling.

The development of the Swiss financial market has been encouraged by a number of framework conditions: an open economy, well performing and diversified industries and services, an efficient, modern and interconnected technical infrastructure (payment system, trading platform, clearing and settlement of securities), protection of the private

sphere through banking secrecy, a relatively low tax burden, and non-interventionist monetary and fiscal policies. The sector's competitive context and structures underwent important changes in the 1990s as a result of technical progress and a great capacity for innovation – notably the introduction of electronic stock markets and financial transactions via the Internet – as well as measures taken to combat financial crime. The sector has experienced some consolidation through mergers, and the number of banks fell from 495 in 1990 to 356 in late 2002. Some aspects of the sector are less efficient. The private equity and venture capital markets remain underdeveloped, unstable and relatively untransparent. Inadequate competition also characterises the financial services sector, especially at the cantonal level.

A strong record of innovation, supporting competitiveness

Switzerland has a very active tradition of innovation. In 2000, 3% of GDP went into research and development (R&D), well above the OECD and EU averages (2.2% and 1.8%, respectively). Nearly three quarters of R&D, of which nearly 90% went on experimental development and applied research, involved private companies. Public sector R&D activities, 90% of which concerns fundamental research, are mainly carried out by higher education establishments, the Confederation and other bodies accounting for only a very small proportion (3%) of the total. R&D activities are funded mainly by the private sector (71%) and virtually all R&D expenditure by private companies is financed out of their own resources (95%). That the public sector contributes so little to private companies' R&D spending is attributable to a clear political understanding of the respective roles assigned to the public and the private sector in financing basic research on the one hand, and assuming the costs of entering a market on the other. A lot of R&D investment by Swiss firms occurs abroad, mainly in the electrotechnical and chemical fields. In 2000, they spent some CHF 9 billion in these areas, much more than they spent on the same activities in Switzerland.

Innovation by firms is not confined to R&D expenditure. Most firms are too small to engage in R&D. Innovation surveys show that 68% of Swiss firms produce innovations, making Switzerland one of the OECD's most innovative economies, which is confirmed by the number of patents per inhabitant, the highest in the OECD.

Swiss innovation, however, is mainly geared towards quality improvement and enhancement rather than the development of new products and processes involving high risks. It is also recognised that the level of co-operation between firms – above all SMEs – and public university research is low, despite government policies to encourage this. While there is a need to maintain adequate public financing for research, basic research could be better connected with the market. This challenge probably reflects the need to improve conditions for entrepreneurship, especially for SMEs in the sheltered sectors. Swiss patents derive mainly from sectors which are not among the fastest growing in the world. Switzerland is therefore not much involved as producer in areas such as information technology and electronics, and its general performance on innovation has tended to decline somewhat since the early 1990s. With 16.9% of its exports in high technology, Switzerland is now an average performer among the industrialised countries. It has been overtaken in recent years by such countries as Ireland and those of South-East Asia. Countries like Finland and Sweden have also made more progress in R&D during the last decade.

Although the country remains attractive to multinationals, it is important to develop the innovative capacity of SMEs and remove obstacles to their growth as gaining market share at world level is linked to a firm's size. Obstacles to SME growth include inadequate

competition in a number of service markets, complex administrative procedures, unhelpful bankruptcy laws, relatively undeveloped venture capital markets, and certain unfavourable tax and regulatory practices (double taxation of dividends, for example).

A high level of human capital development

In 2002, 82% of the labour force aged between 25 and 64 had a secondary school diploma or had received vocational training, a higher proportion than the OECD average (65%), and the proportion is increasing in all age brackets. However the proportion of people with higher level degrees (universities, specialised higher education establishments) was not particularly high (26% of the reference population), slightly lower than the OECD average (28%), despite an increase since the early 1990s as a result of the expansion of higher level vocational education in specialised schools. The success of the apprenticeship courses no doubt largely accounts for this. Women with higher education qualifications are still distinctly under-represented in international comparison and the gender disparity as regards education is significant but with signs of improvement. For example, the proportion of working age women without a high school diploma or vocational training is nearly twice as high as that for men, but they accounted for 45% of those enrolled in tertiary education in the 2003-4 school year.

Human capital formation is financed mainly by the public authorities, the private sector contributing mainly via the dual apprenticeship system. In 2002, public financing of training establishments totalled CHF 23 billion, or 5.4% of GDP (against an OECD average of 5%) and expenditure per student was amongst the highest in the OECD.

The performance of 15 year olds, as highlighted in the last OECD PISA study, is reasonable but not exceptional. Switzerland is in fourth or fifth place in mathematics and natural sciences, behind Finland and Japan. It is at an OECD average level for reading.

A unique governance system based on citizen wide consensus building

In many respects, Swiss governance is a strength which can be tapped for the promotion of durable reform. Switzerland has a strong framework of public governance built up over centuries which rests on two main pillars: federalism and a system of highly participative democracy via referenda. Although the Constitution has been amended many times, federalism and the referendum system have remained basically unchanged since 1874. The Swiss legal system is highly developed, with a strong focus on the protection of individual rights as well as private investments. There is a high level of trust in government, public institutions and the legitimacy of public action which can be directly linked to the need for consensus in decision making and the extensive use of consultation mechanisms to achieve this.

Citizen participation in decision making

The referendum process is central in shaping the composition of the government, and has given rise to consultation procedures aimed at involving a wide range of interested parties in the political process. It is an integral part of Swiss direct democracy and a powerful example of a public governance system which gives citizen choice and collective public action a central role in shaping both large and smaller decisions.

Citizen participation in decision making via these processes, both in relation to specific issues and more broadly, not only reinforces democracy in the fundamental sense of reflecting the will of the people, but is often positive for the economy. Fiscal issues, at

least in the past, have been one good example of this process at work. A distinctive feature of the Swiss public management system is that citizens may, via their right of initiative and the referendum system, decide on most tax rates. At cantonal and communal level, they can also make their views known on the government's spending programmes. Any legal provisions relating to the allocation of tasks across levels of government, and which may increase revenue, are the subject of a mandatory referendum and a positive majority vote, from both the people and the cantons. The combination of a federalist approach and the system of direct democracy applied to public finances, have traditionally contributed to budgetary discipline, and hence to the traditionally modest size of the public sector, which has prevailed for a long time. Pragmatic concern for unnecessary or inefficient spending can be seen in other areas: the popular rejection of a support scheme for solar energy for example. But the effectiveness of this framework seems to have dissipated in recent years, as it has failed to prevent a sharp rise in fiscal share since the early 1990s.

The popular vote also helps shape decisions that have a direct impact on quality of life issues. The development of rail transport and the related rejection of an initiative to expand the road system (which was rejected by a significant margin in 2004) is one example. Concern for the preservation of the alpine environment has contributed to the development of the railway system. The search for quality of life can also have economic repercussions which are more controversial. The popular initiative "for the Alps" delayed for years negotiations with the EU which were intended to overcome some of the negative consequences of Switzerland's rejection of the EEA. The threat of a popular vote to limit flights through a night curfew across the canton of Zurich is an important factor which needs to be weighed up in the debate over Zurich airport's future. However, decisions which could have increased regulatory density were turned down by a popular vote.

More broadly, the opportunity given citizens to make decisions helps to promote an unusually high level of compliance with laws and regulations once they are agreed. Respect for the rule of law is high. Successful reforms tend to be based on pro-popular support, which also helps to secure compliance. Referenda legitimise decisions, and the citizen is less likely to oppose the latter if he/she has played an active part in them. Put another way, the direct democracy system has strong roots and is taken seriously.

The referendum process merits attention, because of its practical impact on the decision-making process (as opposed to the decisions themselves). It has significant implications in terms of the time required to enact and implement reforms. The Constitution essentially determines which decisions should be subject to a popular vote. Popular involvement in decision making can slow necessary developments, and complicate the process of change. Evidence of this can be found across a wide range of issues: EEA membership, reform of the basic old age and disability insurance schemes, postal reform and electricity reform being perhaps the most prominent of recent years. The margin of acceptance of certain reforms can be narrow, as was the case for postal reform. Similarly, other reforms were rejected with a narrow majority, as in the EEA and electricity referenda. These rejections were enough to hold up efforts at resolving important issues for several years. Two attempts at a new law are sometimes needed to reach agreement (by referendum).² The first attempt may be unsuccessful, but the procedure also triggers an important process of communication, digestion, and the further consensus building necessary for a successful second attempt, albeit after a gap of what can be several years. The unsuccessful referendum on EEA membership in 1992 is an example of this process at work. It triggered a search for a new approach to an issue that could not be left alone: the

Box 1.1. The Swiss referendum system

Swiss governance is based on a system of semi direct democracy, which allows citizens to exercise important constitutional and legislative powers, based on the right of referendum and the right of initiative. Provisions similar to those set out below covering the federal level of government exist at cantonal and municipal level.

Right of referendum

Citizens have the right to vote on a Parliamentary decision after the event. The referendum is similar to a right of veto, in that it provides citizens with an opportunity to block – or agree – legislative changes adopted by Parliament and by the government. Two types of referendum exist at the federal level:

- **Obligatory (constitutional) referendum.** Any changes to the Constitution, urgent decrees of the Federal Assembly without a constitutional basis, and ratification of treaties involving membership of collective security or supranational organisations must be agreed by the majority of the people and the cantons.
- **Optional (legislative) referendum.** This applies to federal laws, federal decrees of a general nature and state treaties of indefinite duration, important legal clauses, and legal provisions relating to membership of an international organisation and multilateral harmonisation. The proposals are submitted to a simple majority vote by the people if this is requested by 50 000 citizens or a minimum of eight cantons in a signed petition within a hundred days of publication.

A law of a duration inferior to one year does not require a referendum.

Right of initiative (popular initiative)

Citizens may request a change to the Constitution if they can muster 100 000 signatures within eighteen months. The amendment enters into force if the majority of the people and of the cantons accept it simultaneously. A popular initiative may be formulated as a general proposal or – much more often – as a precise new text which cannot be amended by Parliament or the government. A counterproposal (generally less far reaching) may be submitted by Parliament (often following on a project of the Federal Council).

Swiss relationship with the EU. The first bilateral agreements that eventually emerged were submitted to referendum only seven years and a half after the EEA referendum, and passed based on a majority popular vote of 67.2% and a positive vote by nearly all the cantons. As against the EEA case, a majority of cantons was not required as the agreements are in essence static. The better score does not necessarily reflect only a change of public perception, but also a change in the nature of the proposals: the agreements differ from the EEA, as they do not imply an automatic evolution and need to be readjusted over time.

Referenda also lend themselves to a single issue, which slow decision making where it is needed across a range of fronts in a similar timescale. They tend to encourage the emergence of laws that are divested of important details (the Parliamentary process is also responsible for this). These are subsequently covered by ordinances,³ or need to be the subject of a further law (and quite possibly, another referendum). A further stage may therefore be needed to develop or tighten the law that was originally approved. The recent revision of the Cartel Law and the planned revision of the Internal Market Law are examples. The law on postal reform was amended after discussions in relation to a popular initiative, adding safeguards to preserve local post offices. Apart from the fact that the

Box 1.2. **Swiss consultation processes**

An important sequence of internal and external consultation processes is built into the legislative process as it unfolds:

Consultation procedures within the Federal government and administration

To reach the necessary internal consensus, a two part procedure is used for draft laws that the Federal Council submits to Parliament, as well as for ordinances. The federal offices consult among each other before the proposal is submitted to the Federal Council. The second part of the internal consultation, known as the co-reporting procedure, is then initiated. The lead ministry submits its proposal to the Federal Council, with a view to its adoption by the government (*i.e.* a majority of the seven Federal councillors).

External consultation

Opportunities are given for the cantons, political parties, associations and other interested parties to review and discuss major draft legislation proposed by the Federal government. Informal as well as formal procedures co-exist.

A strong legal basis for the formal consultation process

External consultation is explicitly addressed in the Constitution. Article 147 states that “the cantons, the political parties, and the interested circles shall be heard in the course of the preparation of important legislation and other projects of substantial impact, and on important international treaties”. Since 1991 (with the adoption of an ordinance) the procedure has been regulated in detail: body responsible for the consultation, organisations consulted, deadlines, handling, and publication of results. Current rules for the consultation process are set out in a recently adopted 2005 federal law, which reduces the number of subjects that qualify for the process to those that have a significant impact (political, economic, social, environmental, cultural), and puts the main responsibility for triggering a procedure with the Federal Council or a parliamentary Commission. The Federal Chancellery co-ordinates.

Less formalised forms of external consultation

In addition to public consultation on planned legislation, interested parties can express their views in special meetings, popular discussions, public fora, etc. Participation in extra Parliamentary commissions provides opportunities for a wide range of interested parties to intervene at an early stage. It allows them to defend their interests, but it also ensures that the Swiss authorities can judge the mood of relevant parties (which may extend to the whole electorate), and the prospects for a successful adoption of draft laws. For an interest group, showing the capacity to launch a referendum (which can veto a proposal) is relevant as it definitely raises the chances to have its views taken into account. Mixed committees of civil servants and external experts are also used when developing a new draft law, which helps to identify and understand the issues. Similar, albeit less sophisticated, processes operate at cantonal level.

process of reform is slowed even further, it is not always easy to make subsequent adjustments. An example is the establishment of new independent regulators for the network and other sectors, where initial gaps in powers and responsibilities have proved hard to amend. If the original law is vague, or presents some gaps, or sets up an inappropriate legal and institutional framework, ordinances to plug the gap are unlikely to be effective. For example the liberalisation of access to the local loop (the last kilometre of

the fixed network which connects the customer to the supplier) was delayed due to inadequacies in the initial institutional framework for telecommunications regulation.

Referendum results of recent years, taken as a whole, do imply the emergence of a growing consensus for reform, but of a fragile kind which often cannot cope with details that expose underlying – and despite best efforts at consensus building, unresolved – differences of opinion. The challenge is to find ways of innovating in the decision-making process that enhance prospects for necessary reforms, whilst preserving valued and important popular rights.

Traditions of consensus building and consultation

Participation in the political process by a wide range of actors is deeply rooted in the values of Swiss society. Citizen participation by referenda and popular initiative is one key manifestation of this. More broadly, the process is known as Concordance (*Konkordanz*, power sharing), which was historically rooted in the need for compromise across various linguistic and religious groups. The Swiss governance system emphasises, indeed requires, the need to achieve consensus in decision making of all kinds. A readiness to compromise is a major feature of the political process, supported by the fact that there is a coalition government which includes all major parties, no presidential veto (the Swiss president is a rotating and largely honorary post) and no strict party discipline in Parliament. The collegial decision-making process of the Federal Council involves a continuous search for majorities, both within Parliament and among the voters. The risk of a rejection by referendum is always present for the more important issues, which stimulates efforts to find compromise solutions involving all groups that are capable of launching a referendum already at an early stage (after public consultation has been held), and in Parliamentary debates at the latest.

Comprehensive and transparent consultation mechanisms are essential to this end. The consensus building and consultation process does, however, exact a cost in terms of the time it takes to make changes.

The Swiss growth challenge

Switzerland is an enviably wealthy and well functioning economy on many counts, relative to most other OECD countries. Living standards remain high, and it is not therefore obvious to many people why reform is necessary, or why it may even be urgent. But there are important warning signs that all is not well. Swiss trend growth has been very weak (one of the slowest in the OECD), since 1990, which has generated an erosion of its relative position, and a consequent relative erosion of the standard of living. The rise in living standards has been lower compared to Austria, the United States and the major euro area countries (between 0.5-1% lower over the last fifteen years).⁴ The gap with European and OECD peers is therefore narrowing.

Slow trend growth and a gradual erosion of living standards

Mapping the development of the Swiss economy over several decades shows that the 1990s were a watershed, during which growth stalled relative to the OECD average, although there is some debate about the extent of the slowdown (see Annex A). During this period average annual GDP growth per capita stagnated, whilst it grew on average by over 1% in other developed economies, in many cases by over 2% (Ireland, Luxembourg, Norway, Australia, Spain, US and Denmark). This mediocre performance is partly due to a long period

of stagnation marked by a double recession in the first half of the 1990s, which contrasted with a less morose picture elsewhere in Europe and a positive boom in the US. It is likely that the rejection by popular referendum of Swiss accession to the EEA in 1992 was a factor in the difficulties of the early 1990s but difficulties with monetary policy from 1989 to 1996 and overspending in construction investment in the late 1980s are also relevant.

Leaving aside the modest long term trend growth, other macroeconomic indicators show a good performance (Figure 1.1). A flexible labour market ensures that the unemployment rate remains relatively low, and participation rate high. Inflation is well under control, and the sustained current account surplus indicates that competitiveness is still good. On the other hand, despite the rapid growth of compulsory contributions through the 1990s, the public authorities have difficulties in balancing their budgets.

There is a need to look ahead and consider how the future will be if these trends continue. The question may well be asked why the economy needs to grow, if current living standards and other measures of welfare are still so high. The answer is that stronger growth is needed to prevent the further relative erosion of living standards, and to ensure that current and future challenges to the economy can be financed. These challenges relate especially to the long term financial sustainability of the welfare system, where spending dynamics remain high, against the background of an ageing population.

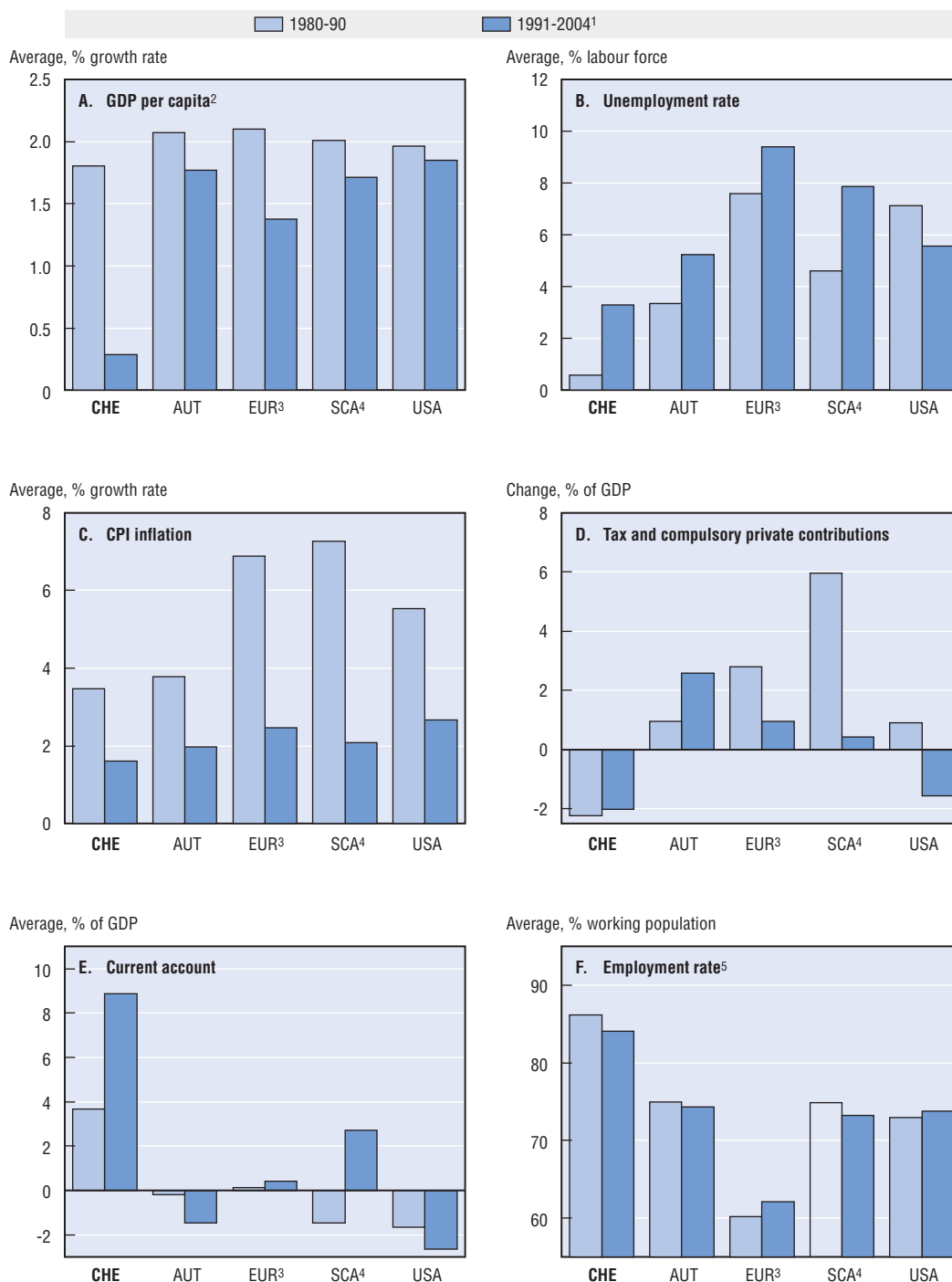
Raising potential growth will require an improvement in labour utilisation and, more importantly, a boost in productivity growth through a better functioning of product markets and stronger competition in sheltered sectors. Maintaining a strong innovation performance, which has waned somewhat in the 1990s, is also key for preserving the competitiveness of the economy and a high standard of living.

A linked challenge of relatively slow productivity growth, mainly related to an inadequate functioning of product and services markets

Switzerland's low trend growth is not due to inadequate factor utilisation. Productive capital has been available in sufficient quantity thanks to high investment ratios. Potential labour has been ample and of good quality. The total population grew by 5.9% during the 1990s, which was faster than in the majority of European countries, thanks to immigration. This potential supply of labour has also been used intensively, even if a margin still exists as regards the full time employment of women. In fact, both male and female participation rates have remained high (though women have a high part time employment rate) and the labour force has grown by an average of 0.4% pa over the past decade, about twice as fast as in the euro area.

The increase in potential output has been limited above all by the slow growth of labour productivity, even if accurate measurement of the latter is the subject of some controversy (Annex A). Available estimates of labour productivity measured in full time equivalent terms range between 1% and 1.6% pa, depending on the employment data used, whereas the hourly productivity gains for Switzerland's main economic partners are estimated between 2 and 2.5% pa during the 1990s. However, gains in hourly labour productivity measured in full time equivalent terms, even of the order of 1.5% instead of 1%, the most optimistic assumption, remain small compared with other countries. This is all the more marked in that the efficiency of productive capital is very low in Switzerland, against the background of a higher investment ratio than in most other countries, which indicates low total factor productivity growth.

Figure 1.1. **Economic indicators for Switzerland and the EU/OECD countries 1980-2004**



1. Or latest available year.
2. At constant prices and in 2000 PPPs.
3. Unweighted average of France, Germany and Italy.
4. Unweighted average of Denmark, Finland and Sweden.
5. Average of 1991-92 for the first period and average of the last two years for the second period.

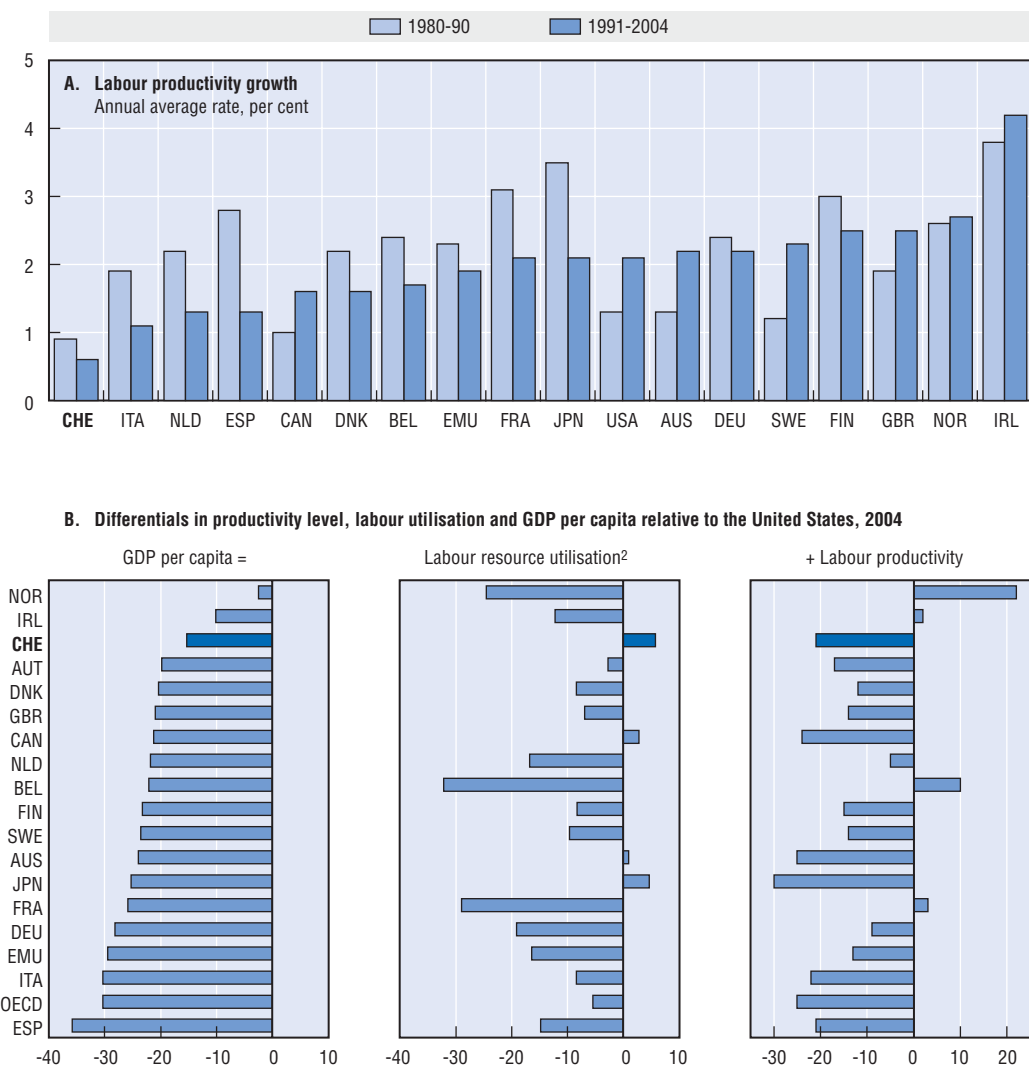
Source: OECD, National Accounts, Revenue Statistics and OECD Economic Outlook No. 77 databases.

To the extent that labour resources are already highly utilised (leaving aside the scope for a higher participation by women), an upturn in economic growth requires improving factor productivity, including capital productivity, especially since population ageing can be expected to slow the increase in labour supply over the long term.

The growth deficit, even if it was less marked in the 1980s, has been evident since the first oil shock of the 1970s. This weak trend growth performance lends weight to the view that the growth problem has structural roots.

The main explanation for the lack of a vigorous productivity performance lies in the inadequate functioning of product and services markets which is largely driven by a lack of competition, as well as the high cost of services supplied by the public sector or financed through compulsory contributions.⁵

Figure 1.2. **Swiss labour productivity¹: an international comparison**



1. Defined as GDP per hour worked.

2. Labour resource utilisation is measured as total number of hours worked divided by population.

Source: OECD, Productivity database.

High prices: evidence of structural problems

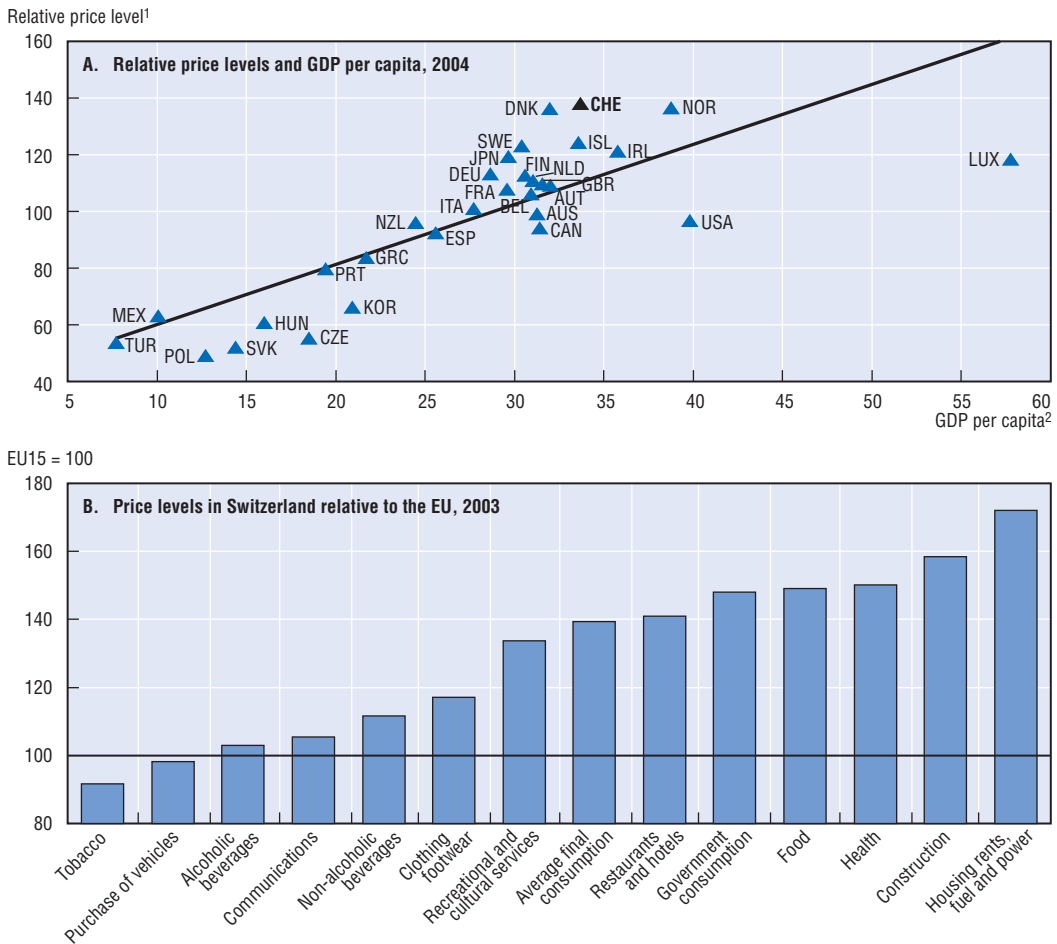
The high level of Swiss prices provides strong evidence of problems with competition both within the Confederation and externally, as well as problems with the performance of the public sector. High prices for public services (electricity, transport, etc.) and regulated sectors (agriculture), raise the cost of production of goods and services destined for consumers. Cartel and other agreements find fertile ground in the Swiss context, given the traditions of corporatism and regionalism and the density of regulation. Salaries paid for activities in the domestic market and sheltered sectors (personal services, retail trade, public services, agriculture, etc.), are matched by the high salaries paid by export sectors with a higher level of productivity. A vicious circle ensues, as high salaries may encourage consumers to pay high prices, albeit perhaps partly to secure higher quality goods and services. The existence of non-tariff barriers, which persist due to Swiss technical regulations on production, packaging and display, and to legal and commercial obstacles to parallel imports (patent protection, exclusive distribution channels, etc.) also plays a part. In effect, the Swiss domestic consumer pays the price of ensuring that its multinational companies stay internationally competitive, as Swiss multinationals often charge the Swiss consumer higher prices than they charge in other markets.

A competition “deficit” in domestic markets is therefore a key explanation for the slow growth experienced by the Swiss economy over the last decade or so.

Box 1.3. High prices in product and services markets

Known in Europe as an “*îlot de cherté*” (island of high prices), Switzerland has a deserved reputation for high prices. Average prices are considerably higher than in other OECD countries, even allowing for a high per capita income (30% above comparable countries). This not only contrasts with Luxembourg, a small and very open economy, but also with the United States where per capita income is equally very high. The gap is less marked relative to Denmark, Iceland or, to a lesser extent, Norway, but these countries are characterised by much higher indirect levels of taxation. The prices of goods and services consumed by Swiss households in 2004 were 52% higher than in Italy, 45% higher than in France and 34% higher than in Germany, and overall, 40% higher than the EU average.

Figure 1.3 shows that these price differences cover a wide range of goods and services. Food products are 50% more expensive than in EU countries, the direct consequence of significant agricultural protection. Prices are also high in construction and housing. Part of the explanation lies in the high cost of land (population density combined with a shortage of buildable land). But significant regulation is another important factor. High housing and construction prices have an important generalised impact on the economy and on prices. Although price comparisons are difficult to make in the health sector, available evidence suggest that prices for health services might be about 50% above the EU average, reflecting to a certain extent the cost of inputs as well as possible differences in the organisation of health services between countries. Significant price differences can also be observed in the tourism, leisure and cultural sectors. Price differences are less marked in the clothing, communications and beverage sectors.

Figure 1.3. **Swiss price levels: an international comparison**

1. Purchasing power parities divided by the exchange rate, OECD = 100.

2. In thousand USD, converted with the PPPs.

Source: Eurostat and OECD, National Accounts.

Deteriorating public finances: a cause for concern

A second major policy challenge is to restore sound public finances. Inadequate control over public spending since the early 1990s has triggered rising public deficits and debts, followed by a sharp rise in the tax burdens which contributed to reducing the public deficit to 1.25% in 2004. Problems to be tackled include a lack of efficiency in certain government programmes, inadequate control of social spending programmes, and deficiencies in the fiscal framework over the medium to long term. In particular, the legal and institutional mechanisms for limiting the deficits and restraining the growth of indebtedness which have been growing at the cantonal and federal levels appear to be practically inoperative as regards expenditure on unavoidable social security and health care payments. If the overall spending trend continues, it risks strangling growth prospects.

Trend growth in public spending and revenue raising is worrying

Public finances were in good shape until the early 1990s. Public authority budgets started to deteriorate rapidly from then on, due to stagnant public revenues combined with a vigorous growth in public (especially social) expenditure. The budget deficit started to

Box 1.4. Measuring the evolution of Swiss public spending and revenue raising

Swiss public spending may be higher than it appears

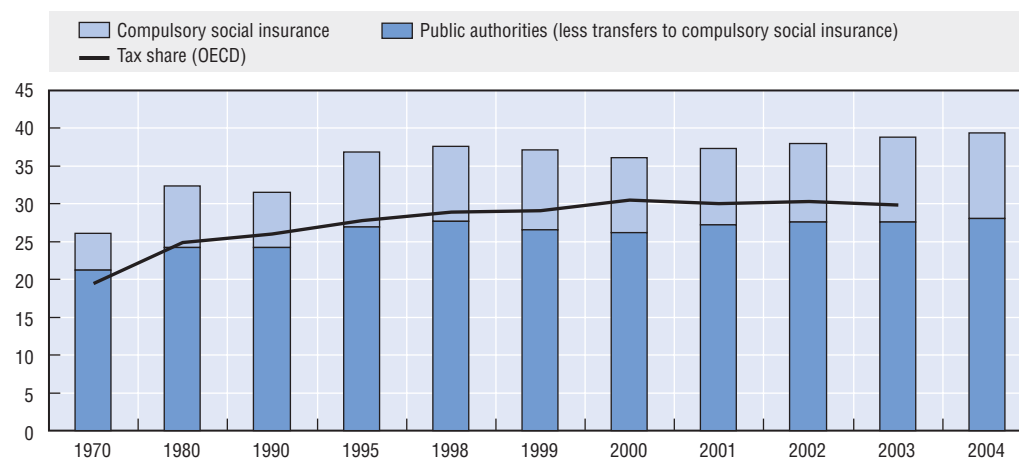
As in other industrialised countries the Swiss public sector expanded rapidly over the twentieth century and this has been reflected in a growth of public expenditure. But although public expenditure has doubled since 1960, it does not look high in international comparison. Public expenditure (spending by public authorities, together with compulsory social insurance spending) as a share of GDP was estimated at nearly 40% in 2003. This is close to the OECD average, but lower than the EU average (48%). A precise measurement of the weight of public spending relative to other countries is, however, difficult because of the way in which Swiss pension and health insurance systems work, as these (unlike in the rest of the OECD) are partly based on private insurance. The OECD's tax burden statistics, which exclude compulsory payments into private insurance schemes, put tax and social insurance contributions at 30.3% in 2002 so that, according to this indicator, Switzerland is well below the OECD average (37%) but above that of Japan (27%) and the United States (29%). On the other hand, taking into account all spending by social security institutions, including non-compulsory benefits, the share would exceed 50%.* In addition, fees for government services have increased significantly over the recent years and might be included as well.

Public spending has in any event risen sharply

In any event, whatever the precise level of tax and social insurance contributions, it has risen steeply – particularly during the 1990s. Between 1970 to 2003, of the 11% increase in tax and social insurance contributions, covering all compulsory insurance but without occupational benefit schemes, 4% is due to the rise in public authority taxes, 4% to the increase in compulsory insurance – according to the OECD – and over 2% to increases in other types of insurance. Between 1990 and 2003, the increase in tax pressure reached 4% of GDP, according to OECD statistics, and the figure would be 6% if compulsory contributions to private insurance were included. These increases are higher than in most other OECD countries.

* As regards the occupational benefit schemes, employees can hardly opt out of the framework of the work contract with their firm, but some pension funds offer old age and disability insurance with coverage well above the minimal standard. Similarly, different options exist for the choice of health insurance. These have been included in the figure of 50%, which reflects broader private social benefits.

Figure 1.4. Share of the State according to the OECD, 1970-2003 (in per cent of GDP)



Source: OFS, Annuaire statistique de la Suisse, Neuchâtel, 2004; OECD and Administration fédérale des finances (for tax and social insurance contributions).

rise and by 1997 it had reached 2.5% of GDP. Budgetary rigour and an economic upturn in the second half of the 1990s eliminated the deficit and even generated a surplus in 2000. But there has been a further deterioration since then, affecting all levels of the administration, and the federal level in particular which was more affected by the burst in the financial markets bubble. Deficits in 2003 and 2004 reached 1.5% of GDP. This trend can be put down in part to the negative impact of economic activity, but it also reflects a deteriorating structural budget balance.

The Swiss deficit remains relatively modest by international standards. But the deterioration in public finances has significantly increased public debt. Gross public debt (government debt relative to GDP) rose from 30% of GDP in 1990 to nearly 55% in 2002. Some two fifths of the increase are due to the (re-) financing of public enterprises of various kinds (cantonal banks for example), and the recapitalisation of pension funds. It must be noted that Swiss gross public debt remains below the OECD average, and low interest rates have limited interest payments (which were 5.7% of public spending – 1.8% of GDP – in 2002). Trends at the different levels of the administration are significant. The percentage of public debt accounted for by municipalities has not changed since 1990 as a proportion of GDP, but federal debt has grown by 140%, from 11.8 to 28.7% of GDP, and cantonal debt by 90% from 9.3 to 17.9% of GDP.

Beyond the issues which this raises for control of the deficit and of public debt, the trend growth in public expenditure and public revenue raising which started in the 1990s is worrying. Also, as Box 1.4 explains, Swiss public spending is likely to be higher in international comparison than it appears, and in any event has risen sharply. All levels of the administration have increased expenditure faster than GDP growth. Expenditure growth has been strongest in the social and health sectors. Privately-financed compulsory social and health expenditure has also risen rapidly. The rise in taxes and other impositions, albeit difficult to measure precisely, has been one of the strongest in the OECD.

Control over health and social security spending is a particular source of concern

Although the overall social security accounts are balanced, this is not true of disability insurance (*assurance-invalidité – AI*) which has been in chronic deficit since the mid 1990s. This can be explained by the strong rise in benefits as well as in the number of beneficiaries, which is partly linked to the social effects of economic stagnation in the 1990s and to unemployment. Following the rejection by referendum in May 2004 of a proposed VAT increase aimed at financing the deficit, it continues to grow. The government, which has not given up on implementing a VAT increase, has meanwhile started a reform process aimed at reducing the number of new beneficiaries by 20%, via early detection of those unable to work due to invalidity. Targeted measures to reduce some of the allowances are also proposed.

The strong increase in health insurance payments, which weigh increasingly heavily on disposable household incomes, is another source of concern. Since 1990, the cost of the health system has grown by over 80%, against a GDP growth of 30%. The 1994 revision of the law on health insurance which came into effect in 1996 has not met expectations in terms of expenditure control. The main factors behind the rise in health spending are: a broadening of the benefits covered by the insurance system; progress in medical technology; the rise in costs linked to population ageing and an inadequate management of the health insurance system which is reflected in a lack of competition among health care providers as well as health insurers.⁶

Notes

1. Other factors are relevant, such as the importance of occupational training and apprenticeship based on a dual work and learning system, balanced economic structures and the absence of declining sectors (steel, shipbuilding), as well as a stable macroeconomic policy geared towards continued low inflation and the maintenance of budgetary equilibrium.
2. This is not always true. Since 1874, 2 200 laws could have been subject to a referendum, 7% actually were, of which half (3.4%) succeeded. In case of a successful referendum a second proposal is quite frequent. Important proposals may also pass the first time. One such important recent referendum, in September 2005, was about extending the free movement of people provision in the first set of Swiss-EU bilateral accords to the new EU member states. This was a potentially controversial issue, as well as raising the possibility that the whole first of accords would be nullified if the vote were negative. It was the first referendum on the issue and the popular vote was in favour, by a significant margin.
3. Issued by the Federal government or a Federal ministry, ordinances flesh out and give effect to Federal laws.
4. Standard of living is estimated on the basis of gross national income adjusted for the terms of trade (OECD Swiss survey, 2005). This indicator includes income from outward investment as well as the positive revenue effect generated by the trend terms of trade gains recorded by the Swiss economy over this period.
5. Some analysts also point to the negative effect resulting from certain distortions in the tax system, such as the double taxation of distributed profits which encourages the accumulation of profits within companies and restricts its reallocation to high growth sectors.
6. The upcoming *OECD Reviews of Health Systems: Switzerland*, jointly conducted with WHO provides further analysis on this issue.

Section 2. Regulatory Reform: Emerging Challenges and the Policy Responses to Date

Emerging challenges: underlying issues and trends

An effective reform path requires an awareness not just of economic challenges, but of governance, societal and other issues and trends that will affect how reform can best be tackled. These include external influences on a country. Some trends can be harnessed to help reform. The EU is an important external driver and encouragement for the Swiss reform process. In the Swiss case, reform can build on traditional governance strengths even if, in Switzerland as elsewhere, governance sometimes presents significant challenges to reform.

A changing context for the effective deployment of Swiss democracy

Demography and democracy: ageing of the voting population

The ageing population is likely to have consequences for the political process, all the more significant because of the Swiss system of semi direct democracy. The median age of citizens with the right to vote, that is, those who in effect have the last word in the Swiss political system, is currently 46.5 years, and will continue to rise until it eventually reaches 54 years in 2035, according to the “trend” scenario. In short, political decisions in Switzerland are already largely taken by the middle aged, and the trend will increasingly marginalise younger generations in the democratic decision-making process.

The influence of vested interests

Associations and powerful vested interests (for example in the electricity sector) play a significant role in the functioning of the political system. Many associations, some of which are partly subsidised, have the financial means to organise referenda. When it prepares proposals, the Federal Council consults these associations as well as the cantons, concerned about the threat of optional referenda organised by the former. The power of the political process therefore rests partly in well organised, well financed associations, many of which represent vested interests that may perceive themselves to be losers if there is change to the *status quo*. Dealing effectively with vested interests, without compromising democratic processes, is important for reform and economic growth prospects.

The blocking power of single issue groups

The slow rate of change can be linked, among other factors, to resistance from special interest groups. These groups have been responsible for a growing proportion of popular initiatives over recent years. Their influence is also an important factor behind the significant rise in the number of referenda over recent years, and consequently they may also be partly responsible for declining voter turn out rates. In addition, these groups are effective in delaying infrastructure projects by initiating court actions, to the point that

their opponents claim that the “Rule of law” is being transformed into the “Rule of legal instruments”. However, these instruments could also be used by neighbours of specific infrastructure projects, which would presumably produce the same effect. Nevertheless, it needs to be recognised that these single issue groups play an essential role in the expression of popular social and environmental concerns.

The growing importance of new media in communication

The expression of popular views plays a significant role in Switzerland, given direct democracy. This means that the press, mass media and increasingly the Internet are important factors in the decision-making process. The mass media is an important vehicle for special interest groups, which are characterised by the high motivation of their members, but with limited resources, or for addressing issues such as the future of public service and the preservation of the Alpine environment. It is important to be aware of the use that is made of the media by opponents of reform and conversely, of the use that can be made of it as a vehicle for clear communication of reform proposals by the government. In particular, the emerging group of independent regulators needs to find its place in the public debate to make its voice heard and become known to the wider public. At the same time, new technologies become important in the decision-making process. Voters already can cast their ballots in certain municipalities by Internet. Using the Internet for collecting signatures for referenda and popular initiatives could significantly lower the costs for these instruments of direct democracy for any group opposing the government’s policy. Internet access by households is relatively widespread. Despite high Internet access prices, Switzerland is ahead of most European countries and the US in terms of Internet access: nearly a third of the total population had access in 2003, the second highest rate in the OECD behind the Netherlands which means that a significant number of households are connected.

Changing roles and relationships within the Swiss federalist structure

Growing Confederation responsibilities sit uneasily with the tradition of highly decentralised power, which over time have given rise to increasing economic disparities between different parts of the country. There is a quest to find the right balance that will respect traditional decentralisation but also allow country wide issues to be tackled more effectively. An important reform based on changes in fiscal relationships between the different levels of government is currently underway, and should help to address this.

Tension between a growing Confederation role and traditional cantonal responsibilities

The influence of the Confederation over the legal and regulatory framework has progressively grown over the last half century. An important factor has been the growth of the Swiss social security system, which developed a little more slowly than elsewhere, and was often initially based on private initiatives and institutions (which remain important). There was considerable development from the mid 1970s: the introduction of compulsory unemployment insurance in 1977, the setting up of the compulsory occupational benefit system in 1985, as an addition to old age and survivors insurance (AVS), and the revision of the law on sickness insurance (LAMal) in 1995, making this insurance compulsory. Most recently, in 2005, maternity insurance was added to the social security system. Both private and public contributions together represented 18% of GDP in 1975 and have now grown to some 27% of GDP. Some other areas also tend to reinforce a trend toward more central co-ordination. The electricity sector, for example, because of its technical characteristics, requires a large element of central oversight.

The growing role of the Confederation can also be considered as an implicit consequence of globalisation, as the Confederation takes responsibility for explaining and diffusing at the domestic level, the impact of internationally agreed rules on the traditional areas of competence of the cantons. This is particularly true as international agreements tend to have an impact not only on goods, but also on the service sectors, where public authorities have a traditional role as regulators and owners in areas such as infrastructure, health, education or public procurement. The setting up of the Conference of cantonal governments reflects the growing dialogue between the cantons and the Confederation on these issues, following the outcome of the EEA negotiations, with a clear obligation in the new Federal Constitution to inform and consult cantons when engaging in international negotiations. International obligations, while negotiated by the Federal Council, need to be transposed into national legislation by the cantons in the fields where they are competent.

There is, at the same time, a deeply ingrained desire to sustain the political tradition of loose federalism, and to restrain encroachment by the Confederation into areas that are traditionally devolved to lower levels of government. One striking example of the process of continuous search and adjustment is that the Swiss electorate decides on about six constitutional amendments every year (half stemming from parliamentary proposals, half from popular initiatives). The cantons still retain their traditionally powerful influence over much of the regulatory landscape. This gives rise to diversity, of course, but also to interesting experimentation. The cantons have been likened by observers to policy and regulatory laboratories, experimenting with new approaches which either spread if they are successful, or are dropped.

Important changes underway to address the Federal-canton relationship

A far reaching fiscal reform has been launched which also has major policy implications for the management of Swiss federalism. The process has been called an evolution towards “co-operative federalism”. Other more specific efforts have been launched to establish a more effective division of labour. The rail reforms for example seek to allocate responsibilities more clearly between the Confederation and the cantons.

The need to manage the effects of an ageing population

Like most other OECD countries, Switzerland needs to consider the future economic impact of its ageing population. A low birth rate combined with growing life expectancy, the retirement of the post war baby boom generation, and large waves of immigration set the scene for a growth in the numbers of elderly people in the population at least until 2035. The “core” scenario of the Swiss Federal Office of Statistics (OFS) shows that the old age dependency ratio – that is, the proportion of elderly (65 years and over) to the working age population (20-64 years) – will reach 44% in 2035, compared with 25% today. This poses a major challenge for the financing of social welfare, health and geriatric services in particular, even allowing for the mixed financing of the pension system which helps to limit the effects of ageing on these parts of the system. Population ageing is also likely to generate a weaker growth in per capita income over coming years.

Sustaining the universality of public services in a more open market

An historic attachment to public service (“*service public*”) is part of the Swiss governance tradition. It is particularly strong in certain geographical areas and closely linked to concerns about preserving service quality in rural and mountain areas. The

Box 1.5. Swiss federalism

Switzerland's Confederation goes back to the pact concluded in 1291 between the three "Waldstätten" (valleys in central Switzerland which are now the cantons of Uri and Schwyz, and the two half cantons of Obwald and Nidwald) in order to preserve their independence. This alliance was gradually extended, so that by the 16th century it included thirteen cantons, which were joined by nine others at the start of the 19th century. The federal pact signed in 1815 following the Congress of Vienna transformed the original alliance into a Confederation of independent states, which was in turn transformed into a federal state in 1848. The constitutional revision of 1874 extended the prerogatives of the centre into the judicial, military and internal market domains.

Structure and general principles

Switzerland's current federal structure is made up of three levels: the Confederation, 26 cantons (six of which are half cantons), and over 2 880 municipalities (*communes* or *Gemeinde*).¹ The Parliament (Federal Assembly – *Assemblée fédérale*) is made up of two chambers which carry equal legal weight: the National Council (*Conseil national*), whose 200 deputies are elected by the people (where the number of seats of a canton is proportional to its share in the total population), and the *Conseil des États*, whose 46 deputies (two per canton) are selected by the cantons according to their own election procedures, which is mostly by popular vote. The Federal Assembly designates the judges for the federal tribunals. The Federal Council (*Conseil fédéral*) is the highest political authority, and is made up of seven Federal councillors, who head up the seven ministries that form the core of the Swiss executive. The president of the Confederation (a largely honorary function) is designated each year from among the seven councillors. Since 1959, the four main political parties in Parliament have taken part in the government.

The working of Swiss federalism is complex but rests on the following broad principles:

- The Confederation is only responsible for those tasks that are clearly allocated to it.² The rest is automatically the responsibility of the lower levels of government. The responsibilities of the Confederation are set out in the Constitution. Any matter that is not defined in this way for the Confederation is the policy, legal and regulatory responsibility of the cantons. To this end, cantons may enact their own legislation and regulations. However, the Constitution sets limits, notably that cantonal regulations shall not interfere with the freedom to contract, thus limiting the scope for cantonal interventions.
- While the Confederation has legislative power through the enactment of federal legislation in its areas of responsibility, the responsibility for implementing federal policies rest largely with the cantons. The Confederation may limit itself to setting out broad principles, in which case the cantons may enact their own more detailed legislation (for example on fiscal matters). The Constitution underlines that the cantons must respect Federal law but retain autonomy in its implementation.
- Responsibilities are shared in some areas (parallel jurisdiction).
- Subsidiarity is applied as a political principle: a task can only be allocated to a higher level if the lower level cannot take it on.

Box 1.5. **Swiss federalism** (cont.)

Division of responsibilities

Policy areas which are the primary responsibility of the Confederation cover: customs (reflecting the Confederation's original purpose), central bank matters (the mint), foreign relations and national security. It also has the main responsibility for social security. Confederation authority also extends to infrastructure, especially alpine transit which must use rail (Article 84). It has a general competence for transport (Article 87), as well as postal and telecommunication services (Article 92).

In addition to the implementation of most Federal law (which may require the enactment of secondary rules), the cantons have main policy responsibility for: cantonal taxes (income, property, corporate taxes), building and zoning regulations, regulation of the professions, regulation of leisure activities such as restaurants, bars and hotels, and shop opening hours. Shared responsibilities include: universities, cultural support, nature protection and monuments. The three levels of public administration are, with very few exceptions, jointly responsible for the provision of public utility services. The cantons have a significant general weight in regulation. Not only do they implement Federal law, but they also must be consulted on international affairs including Treaties if their interests are at stake. They have significant responsibilities for key infrastructure (such as airports, and rights of way for the electricity grids).

Fiscal aspects

Tax revenues support 72% of public expenditure, contributions of various kinds (compensation, fees, franchises and revenues from the provision of services) make up another 19%, and the remaining 9% is covered by property and investment income. Expenditure by the Confederation is spread across a number of areas including social security (though this is not as high as might be expected as much of it is financed directly by payroll taxes and per capita health insurance payments (health). Agricultural and transport subsidies are the only economic activities that receive high levels of aid from the federal level. Nearly half of public expenditure is accounted for by the cantons. A large part of cantonal expenditure goes to public services (mainly health services where 58% of public financing comes from the cantons), to the judiciary (66%) and to education. As for the municipalities, their main activities are related to culture and sports (53% share). But they also play an important role in environmental matters and water supply (62%). They also have responsibility for means-tested social assistance which has impacted their budgets in recent years.

1. Swiss municipalities are small compared to those of other countries. The average population of a Swiss municipality is 2 330, compared to 7 000 in Germany and 30 000 in Sweden.
2. Most other federations work on the same principle. The US for example has 50 state governments. These have legal and regulatory authority in their area of competence, which includes all areas not expressly preempted by federal legislation. They may delegate legal and regulatory authority to regional, local or municipal governments. Perhaps the most important Swiss federal particularity is the absence of a strong federal centre of government. Where competencies are devolved to cantons, the Swiss Confederal authorities have a mainly co-ordinating role.

importance of sustaining geographical equity in living conditions across the country mobilises powerful cantonal and municipal political forces. Views, however, are not always founded on a rational assessment of the facts. The price of electricity for example, as demonstrated by the recent Price Surveillance Authority initiative, varies by as much as 50% not only between regions but between localities.¹

Box 1.6. The fiscal equalisation reform

The starting point for the reform was to improve fiscal management of the relationship between the Confederation and the cantons. As well as their own revenues, the cantons and municipalities receive federal transfers (some 50 in total), the majority of which aim to equalise cantonal revenues. The present system is considered to have major weaknesses. The system's complexity undermines transparency, complicates the division of tasks between the Confederation and the cantons, is ineffective in its goal of equalising cantonal revenues, and inefficient because of built in incentives for the weaker cantons to increase taxation and focus on subsidised expenditure. A new division of tasks between the Confederation and the cantons as well as a new fiscal equalisation is proposed to replace the current system.

Objectives

The reform has four objectives:

- Allocate tasks more clearly between the Confederation and the cantons in order to ensure a better application of the fiscal equivalence principle, which requires that those who decide on expenditure should also fund it. It introduces a disaggregation of tasks which reinforces the role of the cantons.
- Improve collaboration in shared tasks, not least between the cantons, for which more effective and mandatory horizontal collaboration is proposed (canton to canton collaboration used to be less important than vertical co-operation between the cantons and the Confederation, and voluntary). An intercantonal treaty or treaties may be needed to underpin this.
- Improve fiscal equalisation schemes, by dissociating fiscal arrangements from specific tasks and moving to a system of service level agreements incorporating targets (to be checked by the Confederation).
- Improve co-operation and cost sharing within the metropolitan centres.

Timetable

27 Constitutional amendments that were part of this reform were approved by the people and the cantons in 2004. Required changes in dozens of transfer laws will be discussed in Parliament in 2005 and 2006. In 2007 the equalisation parameters of the new system will be determined. In each of these phases optional referenda may be held. In 2008 the new system is expected to be launched. The process is steered by a joint federal/cantonal committee and carried out by a project group made up of federal and cantonal public officials.

There is a need, in many sectors, for a judicious new approach to the promotion of competition that does not destabilise other public policy goals and preserves the values, if not the institutional structures, of the public service. Competition does not mean that other goals can no longer be met; rather the way of meeting them needs to change, so that competition itself is not stifled in the process. This often means not only structural change for the industry, but also the reworking of regulatory frameworks and institutions. It is important to manage change that will allow both effective market opening and the preservation of important public service obligations. A robust regulatory framework which ensures competition while respecting the fulfilment of public service objectives will provide reassurance and diffuse public misgivings.

Fears over the effect of competition in public services are not justified by the experience of OECD countries that have carried out effective and complete reforms of sensitive sectors. Reform can be expected to deliver universal service at least as effectively as before. For example, in the sensitive postal sector, Sweden has successfully carried out a full market opening reform under which the main operator (Sweden Post) still holds 94% of the market but meets its universal service obligations without the protection of a reserved sector or financing through a compensation fund.

A more open and competitive market requires a reappraisal of the specific rules for dealing with public services. There needs, for example, to be transparency over the costs of ensuring that these services reach everyone, and competitive neutrality as to the means of doing this, whether it is via the incumbent or an approach that opens the field to other providers. There is usually scope for considerable efficiency gains from a new framework, with more responsiveness to users' needs. In other words competition can be a help rather than a hindrance to better public services, so long as the incumbent is kept under regulatory control to prevent cross subsidisation of universal services (the core of public services) and other activities, and to prevent it making supernormal profits.

There is a certain apprehension in Switzerland over reform plans for some important sectors such as postal services which is largely driven by concerns over the future of core public services. The debate over electricity reform has been taken up in large part with the question of what happens to universal service in a more open market. These worries have sometimes distorted reform paths or delayed reforms.

A more coherent and visible strategic framework would help, but Switzerland is still some way from establishing this. Different sectors are covered in different ways, which is partly a reflection of genuine differences, but also underlines the absence of any agreed strategic approach which helps to define what should be understood by core public services, and how they should be made available. The legal basis for the issue also varies between sectors. For example telecommunications and postal universal service is required by the Constitution (the means of achieving it is left open). The rail sector also figures prominently in the constitution, including the need for alpine transit. For other sectors the requirements are set out in a less high profile way.

The current initiatives engaged by the Federal Council to bring clarity to the issue are therefore important. It has presented a report "Public service in the field of infrastructure" to Parliament, which examines the main challenges raised by market opening for postal and telecommunication services as well as transport. This has led to new guidelines that set out some important principles, including the need to distinguish between the regulatory function and other functions in order to provide clear and neutral support for public service; the need for core public services to be self financing (excepting public transport); and the need to stay in broad line with the EU.

Efforts have also been engaged, with varying enthusiasm, to set up new means of making core public services available and of financing them. For example, service contracts have been established through tender for the rail sector at the local level. In telecommunications and postal services, however, the regulatory framework has so far been slow in tackling transparency to reveal underlying costs and profits, even if significant progress was achieved recently in the postal sector. A more open market requires flexibility as to the way in which these services are provided, even if the underlying scope can be more fixed. The example of electricity can be used to illustrate the kind of structured approach to sustaining universal service in a more open market, which has so far been lacking.

Box 1.7. **Sustaining electricity public service in a competitive market**

Three main issues need to be addressed for public service to function efficiently in a competitive electricity market:

Definition

A clear definition is an essential starting point but this is not always easy to achieve as different policy goals are often put forward to support public service. The definition nevertheless needs to be narrowed down as far as possible, to cover only those elements that are strictly necessary for meeting the desired goal(s) that public service is intended to support, such as regional or social solidarity. Otherwise it risks excessive distortion of an otherwise competitive market. The EU has developed some general definitions for the gas and electricity sectors. The first defines the possible goals of public service obligations: they may relate to “security, including security of supply, regularity, quality and price of supplies and environmental protection”. The second is a more targeted definition of universal service in the EU Electricity Directive: the “right to be supplied with electricity of a specified quality within (their) territory at reasonable, easily comparable prices”. The concept of universal service (as opposed to the broader concept of public service) seeks to make a distinction between a range of potential very broad policy goals and the very specific policy goal of protecting consumer rights. This is an important distinction. Nearly all the EU member states apply a universal service provision via an obligation to connect and supply all electricity customers, especially households.

Means of delivery

The key principles for public – or universal – service delivery are transparency, cost reflectiveness and use of the least cost approach, both to ensure that consumers get the best deal, and to minimise damage to competition. The EU has defined a concept of Supplier of Last Resort, as a necessary fall back position to protect customers in case of: 1) bankruptcy of the current supplier; 2) supply of vulnerable customers who are unable to pay; and 3) supply to remote customers. Most member states have designated a Supplier of Last Resort, mostly the distribution system operator.

Regulation

There needs to be effective regulation of the costs of public service. Efforts to reconcile the designation of a supplier of last resort with the principles of least cost and cost reflectiveness are still work in progress. The right balance must be struck between compensating the operator for providing the universal service, and ensuring that the operator does not profit from the situation. Methods that have been deployed in the EU so far include compensation funds and direct social payments, as well as attempts to regulate designated operators’ prices to reflect costs. EU public service obligations need to be “clearly defined, transparent, non-discriminatory and verifiable and shall guarantee equality of access for EU electricity companies to national consumers”. The EU electricity and gas directives also stipulate that when a financial compensation is granted by a member state to fulfil public service obligations, this should be done in full compliance with the principles of transparency and non-discrimination.

Although most OECD countries already meet high quality of service standards, it is important to control, maintain and improve standards of service as markets open up to competition and new suppliers emerge. Appropriate obligations should be considered for the transmission and distribution operators, and possibly also for end suppliers.

Box 1.7. Sustaining electricity public service in a competitive market (cont.)

The provision of clear information on public service to customers is important, and this also helps them to assess different sources of supply in an often confusing market. For example, the French gas/electricity utility EDF/GDF identifies the “contribution to the electricity public service” in its itemised bills to households. End user pricing regulation should be avoided if possible from the start, although experience in liberalising markets suggests that this usually does not happen overnight. This may be partly because of an understandable desire to protect consumers against abuse by still powerful incumbents in the early stages of competition. But it should be seen as a transitional measure, to be unwound as quickly as possible. Finally, the vehicle for covering regulation needs attention. For example licences may be used to spell out obligations such as service standards. This also aids transparency.

The growing challenge of keeping up with EU structural and regulatory change

Although Switzerland is not a member of the EU, its close relationship with the EU has driven a significant amount of the country’s internal structural and regulatory change over the last decade or so. This trend can be expected to continue in the future in line with the EU’s own agenda. The number of new rules is growing, and the EU faces the same issue of rule inflation as its member states do individually. It has been estimated that perhaps half or more of new rules in EU member states originate in Brussels.

The EU’s importance goes beyond counting the number of rules. It is shaping whole regulatory regimes, associated with structural change and market opening in key sectors such as telecommunications, gas and electricity markets, postal services and air and rail transport. The EU plays a particularly prominent role in the reform of the network industries where it usually sets *de minimis* regulatory requirements such as the establishment of an independent regulatory authority, and the separation of competitive from non-competitive activities. But its influence extends well beyond these sectors. It includes product markets (such as cars), professional and other services, and horizontal policies such as state aids, public procurement policy and competition policy, as well as social and environmental issues. The Single Market agenda involves a mix of deregulation and market opening alongside rule harmonisation and mutual recognition of standards so that goods and services can move freely within the region. The EU’s common external trade policy is another large area of relevant work.

The effects of the EU Single Market programme have been significant within the EU itself.² It has been a major driver of deregulation and regulatory harmonisation in its member states, has helped to open up their economies, and to promote trade and investment flows. EU rules have also often helped to enhance social, environmental, health and safety and consumer interests, though some important issues are work in progress, for example, developing a robust framework for the regional co-ordination of electricity system operators to avoid future reliability problems. At a broader level the EU has promoted subsidiarity and proportionality in rule making, two concepts which are important for regulatory quality.

The traditionally open nature of the Swiss economy and its central geographical position in Europe means that EU developments have important unavoidable but also very positive effects on the Swiss economy and society. They help to drive necessary regulatory

reforms beyond the domestic context. The development of internal Swiss competition and a more efficient performance in key sectors such as telecommunications reflects EU progress in these areas. The EU has also had a positive influence on the development of competition law, which has adopted tools as a leniency programme reflecting what has been found to work elsewhere. That said, the importance of the EU should not eclipse the importance of developing a strong relationship with other dynamic parts of the globe. A more focused effort to develop trade and relationships with other partners would be helpful too, as initiated by the framework for foreign economic policy adopted in January 2005 by the Federal Council.

Swiss reforms to date

An appreciation of the need for reform, at least at federal level, and important first steps

There is a keen awareness by the federal level of reform needs, linked to a concern about slow growth and its serious implications for future Swiss wellbeing. However this is not shared to the same extent across all stakeholders, due to the role of vested interests, and the impact of different levels of government, some of which perceive that reform will damage their economic or other interests.

The rejection by popular referendum of accession to the EEA in 1992 was a set back. It triggered a reappraisal of the political and economic way forward, as it was clear that economic growth had stalled. A far reaching “Revitalisation Programme” was launched in 1993, paralleled by the start of bilateral negotiations with the EU to plug the gap left by Switzerland’s failure to accede to the EEA (which would have required automatic adoption of the EU *acquis communautaire* and of its evolution). The Revitalisation Programme covered competition law and policy, opening up the internal market, liberalisation of the network industries, agriculture, labour market regulation (unemployment insurance), and education and training. The negotiations with the EU eventually succeeded as well, leading to the system of bilateral agreements that now provides the framework for the Swiss/EU economic and legal relationship in addition to the Free Trade Agreement of 1972.

Uneven progress in practice so far

Some major country wide reform issues, especially as regards the consolidation of the internal market, are very much “work in progress”. Major steps started to be taken in the mid 1990s via a series of laws covering public procurement (the 1994 LMP), competition (1995 LCart) and merger control (1996 ordinance), the internal market (1995 LMI) and technical barriers to trade (1996 LETC). Some of these laws have subsequently been tightened up to address weaknesses. The Cartel Law has been revised as competition supervision was too weak to deal with anti-competitive practices and abuse of dominance without the possibility of sanctions. The Internal Market Law is in the process of revision because the internal market remains very segmented. Public procurement is insufficiently open to competition, and further efforts are required to address the reduction of barriers to trade (including parallel imports).

Sectoral reforms have also been tackled, with varying speed and success. Progress can be cited in the telecommunications sector where competition to the now partly privatised incumbent Swisscom has developed, even if room for further progress exist on the mobile market and for broadband Internet access. Reform of the rail and air sector is moving forward in line with EU developments, but some adjustments remain to be implemented

for rail to reflect recent progress at the EU level. Postal sector is making some progress, albeit relatively slowly due to the concerns with the geographical distribution of local post offices. By contrast reform of the electricity sector suffered a major setback with the negative popular referendum in 2002. Agricultural reform has encouraged farmers to adopt methods that are less harmful to the environment, but the very high level of protection enjoyed by this sector remains unchanged. The issue of independent regulators for effective oversight of many of these sectors is a major one due to a certain resistance to devolve powers to non-elected institutions. Switzerland is therefore still struggling to set up effective regulators and currently applies an *ad hoc* approach without a systemic perspective across sectors.

Regulatory policy is also still struggling to establish itself. Although important initiatives have been taken to establish Regulatory Impact Analysis, this still has a limited influence on rule making as revealed by a report of the Parliamentary control of the administration.³ Efforts at the federal level have mainly focused on the deregulation of specific sectors and the reduction of administrative burdens on business, especially SMEs. Recent efforts have involved the preparation of an “Administrative Simplification Report”, which has brought forward further proposals on the reduction of barriers to business, including a reduction of 20% in terms of the number of permits and licences, and which will streamline administrative procedures for business start ups, the administration of wages, fiscal declarations, and requests for authorisations as well as in terms of prosecution and bankruptcy.

The growth plan and other plans to reinvigorate reform

The need for more reform is acknowledged. Encouraged by the federal administration and in particular, the Federal Department of Economic Affairs, the issue of “slow growth” has been firmly placed on the national agenda, and a broad consensus on the need for reform has been emerging. This was given substance in 2002 when the Federal Department of Economic Affairs published its “Growth Report”. The report set out the main lines of a comprehensive economic reform programme, recognising that weaknesses in the regulatory environment are a major factor behind slow growth. The report argued that a pro-competitive transformation of the regulatory framework could make a significant contribution to growth.

The Growth Report was used by the Federal government to establish a broad programme of reforms in February 2004, known as the Growth Package (“*train de mesures en faveur de la croissance*” – programme of measures to encourage growth). The programme sets six objectives, supported by 17 specific measures for enactment in the legislative period 2003-07. The six objectives are:

- Increase competition within the internal Swiss market.
- Pursue integration with the global economy.
- Limit the fiscal burden and optimise the activities of the state.
- Maintain a high level of labour participation.
- Guarantee the competitiveness of the training system.
- Adjust economic law so as to promote growth.

The first objective involves a revision of the Law on the Internal Market, aimed at reducing barriers to the free trade of goods and services within the Confederation, imposed by different cantonal and communal regulations. The Public Procurement Law will have to

Table 1.1. **Swiss Federal Government Growth Programme 2003-07**

<i>Objective 1:</i> Increase growth in the domestic market	<ol style="list-style-type: none"> 1. Revision of the law on the domestic market 2. Revision of the law on public procurement 3. Revision of the law on sickness insurance (LAMal), with the emphasis placed on competition 4. Reorganisation of the electricity sector 5. Agricultural policy 2011 6. Analysis of the need to adapt to EU developments in the area of services
<i>Objective 2:</i> Pursue integration in the world economy	<ol style="list-style-type: none"> 7. Extending the free movement of persons to the new EU member countries and increasing labour recruitment potential in light of the requirements of the economy
<i>Objective 3:</i> Limit the tax burden and optimise State activities	<ol style="list-style-type: none"> 8. Second reform of corporation tax 9. Discussion of a revision of the law on VAT in the context of the response to the Raggenbass postulate and the Zuwachs project 10. Elimination of the Confederation's structural deficit and checking of the increase in income tax and social insurance contributions 11. Easing of the administrative burden on companies
<i>Objective 4:</i> Keep participation rates high	<ol style="list-style-type: none"> 12. Set of measures aimed at encouraging labour market participation by older workers from the perspective of the 12th revision of Old-Age and Survivors Insurance (AVS) and the 2nd revision of the law on occupational benefits (LPP) 13. 5th revision of Invalidity Insurance (AI)
<i>Objective 5:</i> Guarantee the competitiveness of the education system	<ol style="list-style-type: none"> 14. Discussion of the need to reinforce tertiary education and measures aimed at improving effectiveness in this area 15. Discussion of the role of the Confederation in the context of continuous occupational training
<i>Objective 6:</i> Revise economic law to encourage growth	<ol style="list-style-type: none"> 16. Improve corporate governance 17. Improve the legal framework of economic law

be amended to increase transparency and reduce red tape for tenders at the federal level. Sectoral reforms in health and electricity shall also include elements intended to better integrate the internal market.

The measures were selected for their potential impact on the economy as a whole; for coming within the ambit of Federal government responsibility; and for the fact that they were not, as yet, the subject of any draft legislation already before Parliament.

Public expenditure

To cope with the problems raised by growing public expenditure, the Swiss authorities have developed a fiscal consolidation strategy. At federal level, fiscal consolidation programmes have been established aimed mainly at containing the growth of expenditure, as reflected in objective 3 of the Growth Programme above. As regards the cantons, the strategy depends on their individual situation: adjustment is sometimes to be achieved via mechanisms to check expenditure, the deficit or debt, or via budget packages to raise revenues and reduce expenditure. Structural reforms of social programmes to guarantee lasting control over expenditure are scheduled, but it is the population that will, in the final analysis, have to be persuaded to adopt them. Obviously the sacrifices required will be less onerous or could even be avoided if growth were to pick up strongly. In objective 3, which is to optimise taxation and the activities of the State, eliminating dividend double taxation (reform of corporation tax) could increase the efficiency of capital utilisation. Simplifying VAT and easing bureaucracy reduces the burden of work on firms.

Given their difficulties in controlling deficits and public indebtedness, a number of cantons and the Confederation have brought in constitutional fiscal rules and adopted targets which include keeping their accounts in balance. Some cantonal rules require, for example, that taxes be increased if the deficit rises above a certain threshold (e.g. 3% of own revenues). Other cantons are not allowed to present a budget deficit to Parliament, and any negative balance has to be carried forward to future budgets. Fiscal rules can also concern the investment budget, the level of debt or the majority needed to approve a budget deficit. A number of cantons provide for a degree of flexibility in the way such rules are applied, so as to allow for cyclical trends. At federal level, a constitutional debt containment rule was adopted by referendum. Under this rule, the Confederation is required to maintain the structural equilibrium of its accounts on a permanent basis. This means that the level of expenditure cannot exceed that of revenues, adjusted for a factor reflecting the cyclical situation. The application of this rule did, however, run into difficulties from the moment it was implemented in 2003 because the structural level of revenues was overestimated due to the impact of the financial markets bubble, meaning that the federal structural deficit was underestimated and stood at the time at around 0.75% of GDP, instead of being in equilibrium as intended. To avoid the risk of further undermining an unfavourable economic situation, the authorities decided, in line with the spirit of the law, to eliminate the deficit in stages instead of right away as the law required. Parliament therefore adopted a temporary provision aimed at cancelling the federal deficit by 2007, together with plans focused on reducing expenditure in order to achieve this target and persist with it until 2008. As the authorities recognise, however, the measures adopted will not be enough to guarantee adequate control over expenditure and the budget balance in the long term.

Market openness

The external dimension of reform is also being pursued. As part of its annual report on foreign economic policy, the Federal Council presented its strategy in January 2005, which rests on three pillars: securing and extending access to foreign markets based on a set of internationally agreed rules, making the domestic economy more competitive, and supporting trading partners in their economic development. Within the first pillar, it is recognised that small open economies are best served by a firmly established multilateral framework for trade relations. It is also acknowledged that regional economic integration shall be pursued. This is reflected in the conclusion of further bilateral agreements with the EU. A risk of discrimination is identified given the extension of the networks of preferential trade agreements concluded by the large competing nations. A possible remedy here is to engage in similar negotiations regarding the conclusion of Preferential Trading Arrangements (PTAs), according to a list of priorities. The new strategy states further that negotiations should go beyond trade in goods and give similar attention to trade in services, to foreign direct investment opportunities and to trade in intellectual property rights. Firms of all size shall benefit from the strategy, justifying some support measures, and sufficient attention shall be devoted to the enforcement of the concluded agreements.

Social welfare reforms

These involve adapting the old age insurance system (*assurance vieillesse* – AVS). The initial changes proposed at the end of 2005 involve setting an equal retirement age for men and women at 65, introducing early retirement at actuarially fair conditions, with exemptions only when specific conditions do apply. Further measures are also envisaged

including a later retirement age than the current 65 years, a change in the pension indexation system which is currently based on a mixed index linked to inflation as well as salary increases, and an increase in the contribution from VAT so as to minimise the burden on labour. These types of measures, however, are not expected to be submitted to Parliament before 2008-9, following the rejection by referendum in 2004 of the 11th AVS revision which sought to move in this direction.

Regulatory governance

Recent years have seen a growing emphasis on measures to improve regulatory quality and to raise its profile:

- New instruments under discussion (Speck Postulate, 1997). The Federal Council has been invited to consider new instruments such as sunset clauses and a “budget” for the introduction and application of new laws.
- Amendments to the Federal Constitution in 1999 aimed at improving the clarity and transparency of the regulatory process, including a new Article 164 which states that “all important provisions establishing rules of law must be enacted in the form of Federal Statutes”.
- Measures to improve the framework for SMEs. SMEs Compatibility Test. SMEs Forum (consultative body that identifies challenges for SMEs and discusses possible solutions) set up.
- Introduction of Regulatory Impact Analysis (RIA) – an economic assessment of the consequences of new or reformed legislation – became compulsory in 1999.

Notes

1. Switzerland is not the only country with this issue. The OECD regulatory reform review of France (2004) notes that the understanding of the French public over public service can be out of date with current reality: passenger train services are considered to be part of public service but the SNCF no longer offers the same service country wide.
2. The OECD’s PMR project suggests that product market regulation in EU countries is typically more homogeneous than in the rest of the OECD. Convergence towards lower barriers to product market competition has been stronger than in other OECD countries, via stronger convergence in state control and to a lesser extent, barriers to entrepreneurship. This is likely to reflect efforts to implement the Single Market programme.
3. Contrôle Parlementaire de l’administration, 2005.

Section 3. Regulatory Reform: Strengthening the Foundations for Growth

Switzerland is grappling with the issue of how to strengthen its economic growth, as many other OECD countries, particularly in Europe. The traditional factors behind the strong economic performance in the past are no longer sufficient to ensure sustained economic growth in the face of emerging challenges, such as the need to provide for an ageing population, or the challenge of keeping up with EU structural and regulatory change. Regulatory reform, as a multidisciplinary toolkit, can offer useful insights for analysing the comparative situation of Switzerland from an international perspective, with its strengths and weaknesses. It also contributes to identifying policy areas where specific regulatory measures can help.

An effective and dynamic regulatory policy as a tool for policy coherence and economic growth

Regulatory policy is the policy that determines how laws and regulations, needed for a well functioning economy and society, are developed, implemented, enforced and updated with a view to maximising their efficiency and effectiveness. Its scope is therefore very wide, helping to define relationships between the state, society and the economy. The OECD 2005 Guiding Principles for Regulatory Quality and Performance provide an overall framework for the analysis, which is undertaken in this report (Box 1.8).

The experience of other OECD countries which have moved furthest in this area confirms that the existence of a regulatory policy, backed up with appropriate institutional structures and resources, has two key benefits. First, it fosters policy coherence through a “whole of government” approach, with the capacity to act across the whole range of government activity, not just “one off” reform initiatives but all law and rule making over time. Structural reforms in the infrastructure sectors, for example, need to be backed up by a clear understanding of the limits of the role of the legislator, with the role that sectoral regulators can play to ensure that desired public policy goals – efficiency, security, and social goals for example – are achieved. Second, regulatory policy works alongside, and in support of, other core government policies for growth and social achievements such as competition policy, international market openness, structural reforms and sound fiscal and macroeconomic management. An effective regulatory policy is a *dynamic process*, and it embraces *re-regulation as well as deregulation*. Deregulation (the removal of unnecessary, obstructive, ill conceived, outdated and burdensome rules) is often the starting point but an effective regulatory policy also includes re-regulation where this is necessary, and other approaches such as the mutual recognition of rules and standards within and across national jurisdictions.

There is accumulating evidence over the last few years of a strong link between regulatory reform and a strong economic growth, as evidenced by the OECD’s growth study,¹ supported by the OECD database on Product Market Regulation. This database,

seeks to measure, over time, regulatory barriers to competition in product markets. Data collected in 1998 and 2003 cover issues such as firm ownership and control, antitrust exclusions, and market access; regulatory and administrative policies; administrative requirements for business start ups; regulation of professional services; regulation in transportation industries; and regulation in the retail distribution sector. The results show that there has been clear progress in removing regulatory barriers to product market competition since 1998, as countries with relatively restrictive policies move toward the regulatory environment of the more liberalised countries. There remains nonetheless a divide between the more restrictive and the more liberal countries, with a “middle of the road” group, which includes Switzerland. Across countries, the largest reductions are in the area of barriers to international flows of trade and investment where all the specific indicators show progress. The area which shows least progress is barriers to entrepreneurship where the only significant change is a decline in the number of licence and permit systems. Despite progress, a “hard core” of regulations still persist in virtually all OECD countries.² Labour market regulation, as analysed through Employment Protection Legislation, is the other key economic factors. Empirical evidence also generally suggests a correlation between product and labour market reforms, as evidenced through the links between Employment Protection Legislation and Product Market Regulation. There is an increasing connection between competition enhancing policies, regulatory

Box 1.8. 2005 OECD guiding principles for regulatory quality and performance

These Principles capture the dynamic and ongoing whole-of-government approach to implementation of regulatory quality. They are based on the 1995 *Recommendation of the OECD Council on Improving the Quality of Government Regulation*, on the *Report on Regulatory Reform*, welcomed by Ministers in May 1997, and on the existing set of country reviews. They include the following key points:

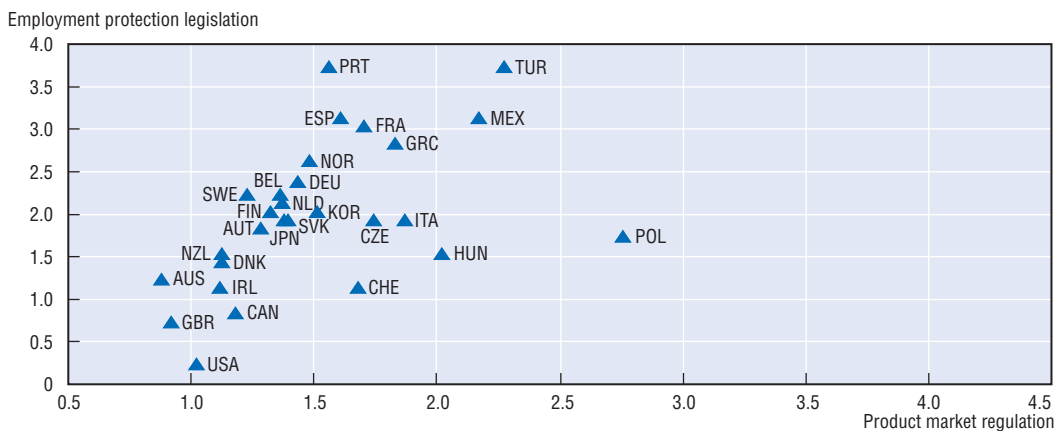
1. Adopt at the political level broad programmes of regulatory reform that establish clear objectives and frameworks for implementation.
2. Assess impacts and review regulations systematically to ensure that they meet their intended objectives efficiently and effectively in a changing and complex economic and social environment.
3. Ensure that regulations, regulatory institutions charged with implementation, and regulatory processes are transparent and non-discriminatory.
4. Review and strengthen where necessary the scope, effectiveness and enforcement of competition policy.
5. Design economic regulations in all sectors to stimulate competition and efficiency, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests.
6. Eliminate unnecessary regulatory barriers to trade and investment through continued liberalisation and enhance the consideration and better integration of market openness throughout the regulatory process, thus strengthening economic efficiency and competitiveness.
7. Identify important linkages with other policy objectives and develop policies to achieve those objectives in ways that support reform.

reform and enhanced productivity performance.³ Countries that have reformed their product markets by opening these to competition have experienced an acceleration of productivity over the 1990s, compared to slowdown or stagnation elsewhere.

Switzerland's position: flexible labour markets with significant product market regulation

Switzerland has a specific situation, as it is a country with a flexible labour market, with low employment protection legislation, but with a relatively high level of product market regulation. The index for product market regulation is higher than for Austria and the Netherlands, Denmark, and Australia. As a result, Switzerland appears on the bottom right of the group of countries on Figure 1.5.

Figure 1.5. **Product market regulation and employment regulation legislation**



Policy areas for regulatory reform in Switzerland

This report analyses a range of policy areas where regulatory reform and the application of quality regulatory principles, can be expected to make a strong contribution to the Swiss economy and society. Some of the policy areas have been analysed in detail as part of the background chapters prepared for the study, and summarised in Part II of the report. This section presents only the key findings. The policy areas highlighted for attention are:

- *Promoting internal market competition.* This includes strengthening competition policy as a key tool for the development of an efficient internal market (Part II, Chapter 3, *Competition Policy*).
- *Promoting a positive environment for international trade and investment flows.* This includes the removal of regulatory and technical barriers to trade, and pursuing market integration with the EU and beyond (Part II, Chapter 4, *Market Openness*).
- *Promoting a more efficient and effective public sector.* This includes applying regulatory quality processes to changes aimed at curbing public spending, improving the management of public sector activities and publicly-owned enterprises, and promoting efficiency in health care.
- *Improving the performance of the infrastructure sectors.* These include electricity, telecommunications, rail, air transport and natural gas (Part II, Chapter 5, *A Framework for High Quality Regulation, Air Transport, Rail, Postal and Telecommunication Services*).

- *Reforming other sectors which have a broad impact on the economy.* This includes the reform of the agricultural sector, and ensuring that the regulatory framework for financial services remains effective.
- *Improving regulatory governance and supporting SME related initiatives to foster innovation.* This includes further efforts at reducing administrative burdens and fostering the use of ICT (Part II, Chapter 2, *Regulatory Governance*).

Promoting internal market competition: consolidating the “*espace Suisse*”

Structural reforms aimed at improving the functioning of the internal market are especially necessary. Switzerland still does not have an effective “*espace Suisse*”, despite major efforts to put in place a set of measures to address key issues.

Addressing the fragmentation of the Swiss internal market

The creation of an internal Swiss market was a founding principle of the Swiss Confederation, but it remains extremely fragmented in practice. Although competition policy is a federal competence, the cantons still have extensive powers to intervene in markets for safety and social reasons, and in relation to public property. They are closely involved in the supply and pricing of public services such as water, electricity and regional transport, via the local public utilities (which are often wholly owned by them, or even in some cases an integral part of the local administration). Professional and other services, and the construction industry, are also especially affected. According to SECO some 7% of those in work (250 000 people) exercised one of the thirty or so professions that are subject to cantonal regulations. The latter cover issues such as qualifications and training, notably in the liberal professions and health sectors, and conditions of local market entry (*personal worthiness, concession licences, etc.*).

The Internal Market Law (*loi sur le Marché Intérieur – LMI*), adopted in 1995, was intended to improve the conditions for internal competition. It is a framework law which defines general principles to be observed, and an approach which rests on mutual recognition of different regulatory regimes. Despite some progress the law has not been very effective, and substantial barriers to competition still exist. Institutional and legal factors are largely responsible for this:

- The Federal Tribunal’s case law has put the principle of federalism before the internal market, in effect excluding the right of establishment from the scope of the law.
- The law as it stands gives the cantons significant scope to continue to restrict access to their market (a variety of public interest may be invoked for example).
- The right of appeal against abusive practices has not had the intended effect. Few actions have been brought to court because of the length and cost of the procedure.

A reform of the LMI is underway to improve the law’s impact, which also aims to ensure that Swiss citizens are not disadvantaged relative to EU citizens who can take advantage of the Swiss/EU agreement on the free movement of people, which involves an agreement on the mutual recognition of diplomas. In this it seeks to apply the *Cassis de Dijon* principle for goods and services circulating within Switzerland to enhance both foreign and domestic competition.⁴ Key proposed changes are:

- Extension to commercial establishments of the rights of market access according to the rules of their place of origin.

- A more restrictive formulation of the exceptions used to restrict market access.
- The application of EU rules regarding the mutual recognition by cantons of capacity certificates as a minimum standard.
- A strengthening of the competition authority's supervisory role, via the introduction of a right of recourse enabling it to challenge administrative decisions which it considers are unduly restraining market access. As matters currently stand, Comco can only address non-binding recommendations to the cantonal and municipal authorities.

Benefits of the changes may be relatively slow to come through, but should grow over the medium term, driven by economies of scale and synergies between professional activities which are not yet fully exploited. The challenge of developing cantons' commitment to change will be significant. An integrated market puts them in competition with each other, while they have a number of incentives to remain relatively closed economic units. These include, not least, current fiscal arrangements: 80% of tax revenues go to the cantons and they have the powers to raise taxes and spend the proceeds as they see fit.

Strengthening competition policy as a key tool for the development of an effective internal market

Competition policy plays a key role in the promotion of market opening reform, as well as in the promotion of consumer welfare. The analysis in Part II details the substance of the competition law, the handling of issues related to "fair" competition, and consumer protection; the independence and resources of competition policy makers and enforcers; the scope of exemptions and special regimes; and the record of policy analysis and advocacy in support of reform.

Switzerland's competition culture and framework have been steadily progressing. The competition authority, Comco, communicates decisions openly and makes information available. Comco's decisions and those of related authorities such as the Price Surveillance Authority are published five times a year in a review, and their Internet sites are well presented. Comco put significant effort into communicating the implications of the recent Cartel Law revision to enterprises.

Yet despite significant developments over the last decade or so which have brought it more into line with other OECD and especially, EU countries, Swiss competition culture remains relatively weak. It lacks the dynamism and determination which is sorely needed to help tackle major continuing barriers to an open internal market. Switzerland can still be said to have an equivocal attitude to competition, and its competition framework offers uncertain scope for the vigorous application of competition principles. Efforts to tackle anti-competitive behaviour often lack severity. The Swiss approach may sometimes reflect an inclination to find ways of co-operating rather than competing, at least on the domestic stage. Some tools of the modern competition toolkit are also not yet part of the Swiss culture. The leniency programme set up under the recent revision of the law was a landmark development for Switzerland, as it is not in the Swiss judicial tradition to act in this way.

An important part of the problem is a legal one, due to the broad scope for exemptions in the competition law, which stem from a variety of other legal and regulatory regimes such as technical barriers to trade. For legal reasons, the Comco may also find it difficult to challenge cantonal provisions that segment and close up the internal market via a wide range of restrictive regulations on prices and market entry, as well as monopoly rights and concessions which are often held by publicly-owned local enterprises, if not even more

Box 1.9. **Swiss competition laws**

The Federal Constitution establishes competition policy in Article 96 in broad terms, but says very little about the restrictions to competition that are forbidden. The issue is covered in primary laws, notably the 1995 Cartel Law (whose objective is “to prevent the adverse economic or social consequences of cartels and other restrictions on competition, and to promote competition in the interests of the market economy based liberal principles”), as well as the 1995 Internal Market Law.

The development of competition principles which clearly recognise the damage that can be caused by anti-competitive behaviour has been relatively slow. Prior to 1985 there was a lenient approach to cartels. A law was then passed which introduced a distinction between the suppression of efficient competition which was forbidden, and obstacles to competition, which were assessed on a case by case basis. The law was successfully used to dismantle banking cartels, but suffered from a lack of decision making powers and procedural weaknesses.

This set the scene for the adoption of the 1995 Cartel Law, adopted alongside the Internal Market Law and the law on Technical Barriers to Trade (*loi sur les entraves techniques au commerce* – LETC), part of the Revitalisation Programme launched in 1992. A revision of the law was adopted in 2003 which came into force in 2004, but has only been fully applied since April 2005, seeking to align Swiss competition law closer to the EU (and broader OECD) framework. The 1985 Price Surveillance Law (*loi sur la surveillance des prix*) is also an important part of the competition enhancing legal framework.

directly by the cantonal and municipal authorities themselves. Public ownership of dominant enterprises and the considerable influence exerted by the cantons’ legislative and regulatory role in local markets require additional tools to make progress. Some sectors of the economy are especially affected by these other regimes, notably construction and the professional services, as well as a range of public services from water to electricity. Competition policy alone cannot therefore be the sole lever for exerting change in the internal market.

Competition law and principles can help to move reform forward in the infrastructure sectors. These exert an uneven influence in practice across these sectors. Relatively weak in some areas, they are responsible for a notable success in electricity market opening, and have had some success too in telecommunications (forcing an improvement in access conditions for telecoms networks: Comco obliged Cablecom to open access of its network to Teleclub AG, invoking the argument of liberalisation of infrastructures). This uneven influence is partly to do with different legal regimes, not least the recent legal changes that have (or not in the case of electricity) established new regulators. A particular situation exists for air transport, where the federal aviation law, based on the bilateral agreement with the EU, gives Comco the role of evaluating the compatibility of draft federal laws which favour certain companies and involve public participation, or support measures for cantons and communes.

Recent amendments to strengthen the Cartel Law, the proposals to strengthen the Internal Market Law, and a number of other proposals which form part of the growth plan, signal a considerable determination on the part of the Confederation to tackle the problems. It is too early to say how effective they will be and the extent to which they

will encourage a change in general attitudes, notably among the sub federal levels of government. Institutional issues such as the independence and resources of the competition authority also need attention.

Promoting a positive environment for international trade and investment flows

The external (trade and EU) lever is widely accepted in Switzerland as essential for reform, and helps to counter slow change. Opening up in the interest of the export sector on a reciprocity basis is usually well accepted. Progress within Switzerland in the past has often been encouraged by external pressures.⁵ However, the benefits of unilateral opening remain contested. International benchmarking can highlight areas for improvement or review. Technical barriers to trade (TBT) can be reduced, notably by the process of international agreement on alignment of technical rules.

Removing regulatory and technical barriers to external competition

A striking feature of the recent OECD work on Product Market Regulation is that countries have a more homogeneous regulatory approach on barriers to trade and investment than they do for the other two areas covered by the project.⁶ This reflects the fact that many of the regulations in this area flow from multilateral agreements which are debated and decided by international organisations such as the WTO. They often impose high standards of openness to trade and investment on their members. In short, international trade agreements can help to drive reform and market opening within national jurisdictions, as well as facilitating international trade flows. At the same time, as tariff barriers lose their significance, national regulations increasingly define the conditions of market access for foreigners. Domestic regulations and regulatory regimes increasingly need to be assessed not only for their impact on domestic players, but also for their effect on market access by foreigners. Problems of market access can arise because national regulatory regimes are divergent, and/or because they impose an unnecessarily heavy burden on enterprises seeking to enter a new market. The effect can also be perverse for the competitiveness of domestic companies. A firm may have relatively low production costs, but may face high costs of compliance with inefficient regulations in its home country, to the point that this can undercut the firm's initial cost (and locational) advantage.

Switzerland broadly reflects the wider trend. Because tariff barriers for manufactured goods are generally low, attention needs to be focused on non-tariff barriers. There is some compelling evidence of barriers: some sectors of the economy (certain capital goods industries in which Switzerland has specialised, textile and agro-food industries, beverages and tobacco) are characterised by especially low import levels, a sign of likely barriers to imports.

Foreign competition can and should be enhanced by:

- The “Cassis de Dijon” principle, which would help to eliminate technical barriers to trade. The Cassis de Dijon principle is an EU rule which states that a product legally manufactured and marketed in one EU member state may circulate freely in the other member states. Free trade can be impeded only if it is demonstrated that the product is a danger to public health. The principle does not yet apply between the EU and Switzerland, but a proposal has been sent to Parliament.
- Greater openness to parallel imports of patented products, at least regionally at the EU level.

Some overall impact on Swiss price levels relative to the rest of Europe can be expected from such reforms. Much of the difference in price levels arises in sectors such as housing,

construction, education and training, health services and tourism, which are not likely to be affected. This still leaves a very large range of goods and services which are easily traded internationally such as food, medicines, and some leisure and cultural products and services. International trade in these sectors is currently constrained by legal and technical barriers. The possible application of the international exhaustion principle to patent law, even limited to an EU principle of regional exhaustion, as advocated by Comco, should lead to a marked reduction in prices with gains in efficiency. It is significant that price differences relative to the rest of Europe are least marked in sectors which are already more open to foreign trade because of the limited impact of non-tariff barriers, such as automobiles, housing services and clothing.

Adopting the Cassis de Dijon principle

While technical barriers to trade have diminished since the Technical Barriers to Trade Act (LETC) was adopted in 1995, administrative and technical regulations in areas such as production, packaging and labelling still persist. This makes imported products more expensive. Some products cannot enter Switzerland at all. For instance, the resemblance of product names for slightly differing products is barring imports of cream.⁷ In 2004, Comco called on Parliament to adopt the Cassis de Dijon principle. In May 2005, the Federal Council proposed to transpose this principle unilaterally into Swiss jurisdiction. This is a break with the previous approach for reducing these non-tariff barriers, which was based on negotiating with the EU on a case-by-case basis, requiring continuous adjustments because of evolving standards. If the proposal is endorsed by Parliament, it will cut the cost to businesses and prices for consumers. This would be a very welcome development. The question as to whether pharmaceuticals, which are very expensive in Switzerland, could be covered by the measure, remains open.

Opening up to parallel imports

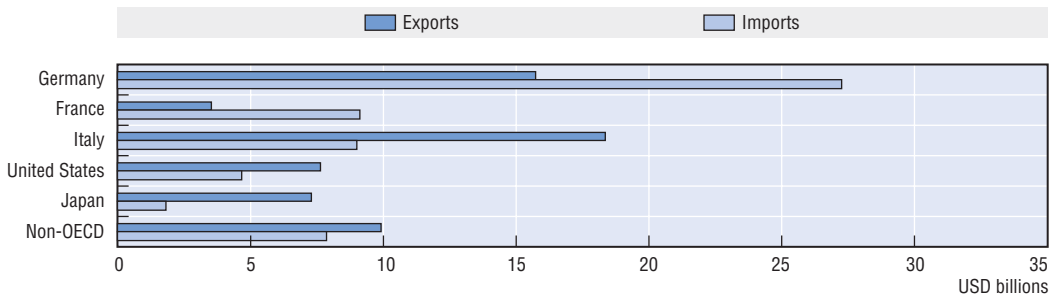
Higher costs and prices in Switzerland are also due to the right given to a patent holder to prohibit parallel imports of products protected by his patent. Arbitrage possibilities seem large for pharmaceuticals and certain consumer durables, many of them not necessarily protected by patents. Allowing parallel imports (shifting to the international exhaustion regime for patent law) has sparked much controversy. The Federal Council rejected such a change in 2004, because the estimated gains appeared very small – less than 0.1% of GDP (Conseil fédéral, 2002), the move could pose health risks and could undermine incentives to do research. More recently, the proposal to negotiate a regional exhaustion regime for patent law with the European Commission allowing parallel imports from EU countries was also rejected. The estimated gains were again considered too small, especially because agreeing the adoption of this principle with the EU would have required applying it to copyrights and trademarks, which are currently subject to the more liberal international exhaustion principle in Switzerland. The Federal government is therefore in favour of the *status quo* which allows Comco to intervene if there are large price differences with similar marketing conditions between Switzerland and the country of origin. However, this will lead to parallel imports only on a case-by-case basis. Moreover, even if Comco were hyperactive, there would still be high barriers to trade in sectors such as agriculture (for customs duty reasons) or where technical barriers to trade exist, which would need to be overcome to make a real difference. On the other hand, previous estimates of only very small gains induced by a liberalisation of parallel imports may be on

the low side.⁸ Shifting to the international exhaustion regime for patent law, which is supported by Comco, or adopting the regional exhaustion regime unilaterally, which seems possible according to certain experts,⁹ would contribute to raising competition without weakening research activity.

Pursuing a policy of market and regulatory integration with the EU

EU markets are of central importance to the Swiss economy. The three most important EU markets are Germany (by far), France and Italy. The most important market beyond the EU is the US, followed by Japan. In contrast to its trade with the US and Japan, Switzerland has trade deficits with its two largest European partners.

Figure 1.6. **Swiss trade with the world**



Source: OECD, 2005e.

The ongoing construction of the Single Market is a process which matters greatly to Swiss companies. The long term health of the Swiss business community largely depends on access to this market. A declared priority for Swiss entrepreneurs is a closer relationship with the EU. The business community has much to gain from participation on an equal footing with EU competitors in the EU single market. Pressure from this community has been important in developing political momentum for internal reform. The rapid recent growth of FDI flows out of Switzerland, especially in services, reflects the efforts of Swiss companies to establish bridgeheads in EU markets.¹⁰ Their efforts need to be supported by government action to align regulatory regimes and to reinforce the process of integration between Switzerland and the EU. The bilateral agreements that have been put in place are essential in helping with the challenges of keeping up.

The first set of agreements allows Swiss companies, in essence, to operate in the Single Market under virtually the same conditions as their EU competitors, guaranteeing a reciprocal opening of markets on a progressive and controlled basis. These agreements take Switzerland a considerable way beyond the limited scope of the 1972 free trade agreement. The second set is also expected to have significant economic effects. The agreement on processed agricultural products should allow the agro food industry better access conditions to the EU market. The agreement on taxation should create an effective and stable framework for future evolution of the financial sector. Accession to the Schengen agreement – via the unification of visas – will increase Switzerland's attraction as a tourist destination. Extension of the free movement of people to new EU countries¹¹ should indirectly provide more scope for Swiss product markets as well as improved opportunities for the recruitment of specialist labour against a background of sharper competition on the labour market.

Box 1.10. **Switzerland's formal relationship with the EU**

Switzerland is not a member of the EU. The issue of membership remains very sensitive, although the Federal government has recently reaffirmed that accession remains an objective. Switzerland has nonetheless developed a strong and longstanding relationship with the EU. The bilateral agreement route that has been developed allows it to retain a certain freedom, albeit at the expense of not always keeping up in important areas of EU development. In Switzerland, international law takes primacy over domestic law, and international treaty provisions have direct effect (they may be applied directly by the courts).

Early membership of EFTA and limited free trade agreement

Switzerland was a founding member of the European Free Trade Association (EFTA), set up in 1960 to establish a free trade zone, mainly for industrial goods, between European countries outside the then EC (unlike the EC, EFTA members still controlled their external tariffs). An EU/EFTA free trade agreement for industrial products was signed in 1972. As a response to the EU launch of its Single European Market, the European Economic Area (EEA) was created by EFTA members (including Switzerland) in 1990-91. This sparked a Swiss debate about accession to the EFTA/EU Treaty, which would have extended the Swiss free trade zone with the EU to services, capital and people, but would also have meant adopting 60% of EU rules (the so called *acquis communautaire*). Ratification of the EEA Treaty was rejected by popular and more clearly by cantonal referendum in 1992, albeit by a narrow margin. This was a landmark development as it froze any realistic political prospect (at least in the short to medium term) for accession to the EU.

Post EEA rejection: Bilateral Agreements which extend the relationship into a number of important sectors

With the EEA losing much of its importance following the accession of several members to the EU* the Swiss government sought a new framework, aimed at securing but also at developing the relationship with the EU. The objective was that Switzerland should be able to march in step with EU developments. A key motivating factor was the loss of growth momentum in the Swiss economy, which became increasingly evident. The objective was initially achieved through the development of a set of sectoral and essentially economic bilateral Agreements, on which negotiations started in 1994, covering the following sectors:

- Land transport, (progressive opening for road and rail transport, both passenger and freight).
- Air transport (progressive granting of line access rights, access for Swiss air transport companies to the liberalised European market on a reciprocal basis).
- Free circulation of people (introduction of free movement of people between Switzerland and the EU from 2002, via a progressive opening of labour markets until 2014).
- Agriculture (mutual recognition of technical requirements in biological agriculture, veterinary medicine, and protection of plant varieties, plus free trade in fruit and vegetables outside the growing season, and free trade in cheese after five years).
- Research and development (provision for Swiss entities to take equal part in EU research programmes).
- Public procurement (opening of EU markets to Swiss companies, in exchange for which the Swiss public administration (all levels) extend their calls for tender in the water, transport, energy, telecommunication and rail traffic sectors to the EU).
- Technical barriers to trade (framework for the mutual recognition of conformity assessments (tests, certification) for most industrial products).

Box 1.10. Switzerland's formal relationship with the EU (cont.)

Known as *Bilateral Agreements I*, these were concluded in 1998, and came into force in June 2002 (following approval by the Swiss people in 2000, and ratification by EU members). The agreements are treated as an indivisible whole: if one agreement is nullified, this invalidates all the others. Another cycle of negotiations on ten new areas started at the same time as the first set of agreements came into force, and has given rise to *Bilateral Agreements II*. All but one of the areas (services liberalisation) has been successfully negotiated and approved. The nine new areas cover:

- The taxation of savings (which will enable interest on the savings of EU citizens to be taxed without undermining Swiss legal provisions including on banking secrecy).
- Increased co-operation in the fight against customs fraud.
- Co-operation in the fields of justice, police, asylum and migration (Schengen/Dublin).
- Trade in processed agricultural products.
- The environment (including Swiss participation in the European Environment Agency).
- Statistical co-operation.
- Education and training.
- Audiovisual and media (including Swiss participation in EU programmes).
- Provisions for the avoidance of double taxation for pensioners of Community institutions.

The second set of agreements has a political as well as an economic reach. They were recently approved by Parliament as a single package, and following the positive vote in a popular referendum for the agreement on asylum and migration, each of the agreements may now come into effect, separately.

* Today's membership covers only four small countries: Switzerland, Norway, Iceland and Liechtenstein.

The agreement route avoids the need to take up, automatically, the whole EU *acquis* (as happens with EEA membership), which allows flexibility in the choice of issues to be covered and the way they are covered. This explains the patchy coverage which excludes some key areas such as electricity. Agreements also need to be negotiated in the context of the Swiss political system and its provision for referendums. Two approaches have been taken: the promotion of a single package (one referendum but with the danger that everything could fall, as well as stand, under this referendum) or a separation of the issues (with the potential for several referendums). The agreements either provide for Swiss and EU legislation to be treated as equivalent (the case for public procurement, trade in agricultural products, rail and road transport, and free movement of people); or they provide for the transposition into Swiss law of the EU *acquis* (the case for air transport). Federal as well as cantonal laws will need adjustment to comply with the new set of agreements.

The agreements are essential to the Swiss economy. The importance of agreements is clear from the issues that arise when there is no agreement (as yet) to cover an issue. For example the rejection of an agreement with Germany on aviation rights triggered restrictive actions by Germany limiting the scope of flights over German territory using Zurich airport. A complaint by the Swiss authorities to the EU Commission was rejected in 2003, and taken to the European Court of Justice (ECJ), but this is still without effect. There is, as yet, no agreement on electricity which seriously hampers Swiss efforts to be part of the discussions

on the future development of the European electricity market. The effective management of competition issues where these involve cross border aspects is disadvantaged by the absence of a formal agreement to share information, as already exists for the 25 EU members. The need to ensure convergence with the EU is particularly clear in core infrastructure sectors, such as electricity, postal services or telecommunications. Electricity provides a particularly strong example, raising broader issues about current EU developments in support of a competitive and reliable regional European market.

Opening up public procurement

Public procurement markets remain relatively closed. This is a key area for the integration of the domestic market. Reform of public procurement law started in the mid 1990s, in order to secure conformity with WTO accords and, later, the EU bilateral agreement. Procurement contracts above a certain threshold are subject to a call for tenders covering extra regional or foreign companies. There are some indications that the new regulations have had a positive impact: lower prices for similar calls for tender and an increased number of bidders.

Promoting a more efficient and effective public sector

Improving the management of publicly-owned enterprises

Compared with the OECD average, the Swiss public authorities own relatively few enterprises in the commercial sector following a historical tradition. As in other countries, there has been a progressive withdrawal through privatisation from certain activities traditionally attached to the public sector. The sale of Swisscom's participation in the major cable TV provider, Cablecom, stands out as an example. Today, the picture varies by sector, as important areas of public ownership remain, especially at sub Federal level. Some enterprises have been partially privatised (Swisscom), whilst others such as Swiss Post and the Federal Railways (CFF/SBB) remain under full Confederation ownership. Some regional transport enterprises are privately owned (although still publicly subsidised). The very large number of distribution companies for gas, water and electricity are mainly under cantonal and municipal ownership. Most cantons also control a cantonal bank which benefits from public guarantees for savings by the general public.

Managing these public enterprises for greater efficiency in a more open market is a challenge that is not yet tackled consistently. In the infrastructure sectors for example, arrangements vary between enterprises. The Confederation's management of Swiss Post, Swisscom, and the Federal Railways (CFF/SBB) is based on four year strategic objectives but the similarity of treatment stops there. There is no economic quantification of objectives (productivity targets or price caps for example) for Swisscom and Swiss Post. By contrast the railways have received specific productivity targets.¹²

Better management of publicly-owned enterprises can help to improve efficiency and establish competitive neutrality for other market players. The effective separation of the different roles of public authorities (policy-making, regulation and ownership) is a priority to avoid conflicts of interest. This calls, among other actions, for the establishment of independent regulators (see Part II, Chapter 5). Beyond this key institutional change, other mechanisms such as a thorough review of corporate governance practices and the establishment of competitive neutrality frameworks should be considered:

- Competitive neutrality frameworks have been successfully deployed in other OECD countries. This involves careful measures to ensure that publicly-owned enterprises do

not enjoy an unfair competitive advantage relative to private sector competitors, and in particular, that the prices charged fully reflect costs, to avoid distorted decisions on production, consumption, and investment. Several OECD countries – including the Netherlands and Australia – have set up competitive neutrality frameworks to address these and other issues with an overall aim of promoting equitable treatment between activities carried out by public authorities and those of the private sector. This may call for reviewing the following elements: the initial balance sheet, pension and other liabilities, taxation, separation from the public budget, internal subsidies and cross subsidies, rate of return on assets and public guarantees.

- Good corporate governance involves the development of a set of principles, in close discussion with key stakeholders such as the business community. The OECD has developed Principles on Corporate Governance which were originally endorsed by Ministers in 1999 and updated in 2004. They state that “Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company”. These include issues such as company objectives, financial results, governance structures and an independent annual audit. A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies.

Improving the performance of the infrastructure sectors

The experience of other OECD countries shows that the infrastructure or network sectors¹³ are challenging but necessary reform candidates. Reforms are essential to promote more efficient and effective modern infrastructures, and to secure interconnectedness across borders. Reform involves very careful re-regulation to manage complex emerging market structures and interactions. A key challenge of the network sectors is that they have economic and often also technical characteristics which require central management and control. It is hard if not impossible to circumvent this natural monopoly core,¹⁴ and competition needs to develop around the latter. Many of them are also considered to be a public service, which means that reform is politically sensitive, linked to concerns that social or regional policy functions which have traditionally been secured by a single monopoly incumbent will be weakened or lost with reform and the advent of new market players. Safety considerations are another feature of some sectors.

The potential efficiency gains from reform are, however, significant, and international best practice shows that means can also be devised to secure public service functions. Achieving efficiency gains as well as other public policy goals involves not least, the establishment of effective independent regulators with clear objectives. Chapter 5 in Part II focuses on the regulatory frameworks, including independent regulators, in four sectors that are of particular importance to Switzerland, Air Transport, Rail, Telecommunications and Postal Services. Electricity is analysed in Chapter 6.

These areas of the economy are of particular importance to Switzerland. The relative size of the postal, rail and air transport sectors is strikingly large relative to the Swiss population, in international comparison. The electricity sector is also disproportionately large in terms of grid

density and the existence of major international players in the European power market, reflecting Switzerland's position as a vital European trade and transit route. Most of these play a key external as well as internal role, not only for the closer integration of regional and local economies, but also for the regional market beyond, in Europe.

This makes it all the more important for the regulatory framework for these sectors to be adequately modernised. Switzerland has made some commendable progress in modernising regulatory frameworks. Nevertheless, all the Swiss infrastructure sectors are in need of accelerated efforts to consolidate, complete or even in one case (electricity) to start reform. Part of this means keeping up with related EU developments, in order to ensure that regional connections are smooth and that Swiss business has the same advantages as its competitors.

The Swiss position relative to recent EU developments varies greatly from sector to sector. Rail reform for example is fully in line with EU developments. Telecommunications has made significant progress, even if significant steps are implemented with a delay, such as the unbundling of the local loop. However the reform of postal services moves slowly and electricity reform has yet to begin, despite long established reform plans by the Confederation. The well functioning of these sectors directly affects Swiss competitiveness, within and beyond the internal Swiss market. It is vital for Swiss enterprises to be well integrated with efficient and low cost connections into Europe, their most important market, just as it is vital for the long term development of the internal Swiss market to be efficiently connected.

A warning signal of the need for effective and timely reform is that two important sectors – air transport and electricity – have experienced serious problems. This highlights the dangers of a relatively slow and piecemeal approach to complex sectors facing rapid change. In the case of air transport, the slow adjustment of the institutional framework to a liberalising environment was an important factor in the difficulties experienced over recent years. Electricity has raised problems too. The deep causes for the breakdown which affected Switzerland and Italy in 2003 stem from the incompatibility between the needs of international trade and the technical constraints of the transnational electric network. One of the problems in Switzerland was the lack of an independent and effective Transmission System Operator (TSO). For the moment, the Swissgrid operator has been set up on a voluntary basis.

Electricity reform figures prominently in Swiss reform proposals. Countries that have established an independent regulator, an independent system operator, and a wholesale market underpinned by regulated third party access to the grid have generally achieved the best results in terms of price and competitiveness performance. However, as none of these elements yet exist in Switzerland, change is therefore essential. Reform is also needed to harmonise with market opening in the EU, as Switzerland's central geographical position in Europe makes it a major electricity transit and trading hub. For now, the electricity market remains closed to effective competition, despite attempts by some market players to test the limits of what is possible under the current competition law framework. Security of supply is also an issue of growing urgency. This issue is analysed in further detail in Chapter 6, Part II.

The Swiss Federal government is aware of the need for reform. After the rejection of a first attempt in a popular referendum in 2002, the Federal Council proposed a new reform package. Even if this proposal may be the subject of a popular vote as well, the need for change is now more acutely felt. The majority of political and commercial interests are

conscious of the need for change, and they are better informed about, and therefore more supportive of, key issues such as the need for independent system operation and an independent regulator.

The reform process raises some specific challenges for Swiss policy makers. First, a way needs to be found to manage complex reforms which takes account of the ordinary Swiss citizen's direct involvement in decision making. Second, significant responsibilities for the sector lie at sub-Federal level. Third, effective reform will involve a fundamental change in the structure and orientation of a highly fragmented industry, in which certain powerful interests have been traditionally dominant, and no two sets of interests easily converge. Managing the transition to a new approach will be as important as getting the technical elements of the reform package right in the first place. The reform in the electricity sector also requires adequate complementary reforms of the natural gas sector (see Chapter 3).

Other infrastructure sectors, analysed in Chapter 5, Part II, also involve significant challenges. While significant progress had been achieved at the start of the liberalisation of the telecommunication sectors, the pace of reform was slower in recent years, with a need to tackle remaining blockages, including unbundling of the local loop. Air Transport is now undergoing a phase of stabilisation, after several years of rapid change and the collapse of the former national operator, Swissair. Safety-related failures led to a comprehensive audit, as well as a partial overhaul of the supervisory framework with increased staff. The rail sector is fully integrated with the EU, through the bilateral agreement. Railways in Switzerland are part of the Constitution, as the need to preserve alpine transit is a shared policy objective. The density of the network and general performance levels reached in this sector put it above the European average. Liberalisation has made progress, albeit limited to the freight sector, while local transportation has been subject to efficiency-enhancing contracting procedures. However, regulatory arrangements need to be overhauled to ensure full compatibility with the latest EU advances, while preventing the risk of conflicts of interest. Progress has been more timid in the field of postal services, where the need to preserve universal service, particularly for rural and alpine areas, is acutely felt. While performance is generally satisfactory, with high levels of consumption and outputs, recent progress with transparency as to how the universal service is financed has revealed that the Swiss Post was making the bulk of its operating profits from operations related to the universal service. Scope for further market opening clearly exists, but will also require a strengthening of the regulatory body.

Reforming other sectors which have a broad impact on the economy

Some sectors of the economy have a significant impact on the economy, for example because high costs and prices in these sectors feed through to higher overall price levels and hence costs, both for businesses and households. This may for example involve health care, agriculture or financial services.

Promoting greater efficiency in health care¹⁵

The health services sector accounted for some 11.5% of Swiss GDP in 2003. Prices are very high relative to other OECD countries. They are 13 to 38% higher than in the UK, Germany, France and the Netherlands. As in other OECD countries, the sector is heavily regulated. Basic health insurance (the Swiss system consists of compulsory basic cover and optional additional private insurance) is regulated by a 1994 federal law on health

insurance (*loi fédérale sur l'assurance-maladie – LAMal*) which came into effect in 1996. This provided for a major overhaul of the health care system, aimed at ensuring effective access for the whole population to quality health care based on the solidarity principle. But control of spending is a major issue. The federal authorities are aware of the problems and reforms have been proposed. However the second reform of the Health Insurance Law (LAMal) failed to be approved in Parliament. A third reform proposal is under discussion in Parliament. A key element of successful reform will be to ensure that the sector's regulation provides the right incentives for greater efficiency. Getting there will require further efforts, with a more level playing field ensuring competition among providers and improved market access for less expensive goods and services.

Agricultural sector: subsidies remain far too high

According to the Federal Constitution, agricultural policy has three objectives: security of supply for the population, natural resource conservation and preserving the landscape, and decentralised occupation of the territory. Putting this policy into practice is very costly. Agriculture is highly subsidised and regulated, with the result that rates of protection and the level of prices of agricultural products are among the highest in the OECD. The producer support estimate (PSE) indicator used to measure total implicit (difference in relation to world prices) and explicit subsidies in relation to production, amounted to 73% in 2000-02. What is more, these subsidies have hardly diminished since 1986-88 (76%), despite changes in agricultural policy during the 1990s. However, it became less trade distorting as during that period, the Confederation reduced its price support measures and production linked payments, replacing them with an increase in direct payments designed to encourage more environmentally friendly production methods. In 2002, 62% of farm subsidies were used for direct payments and social measures, while 30% went into price support measures and production disposal, the remaining 8% being used for general programmes relating to agricultural research, training and consultancy. Fresh efforts are currently being made to reduce subsidies, particularly in dairy farming with the abolition of production quota fixing by 2009 as part of the “2007 Agricultural Policy” programme. The latter also ensures that meat import quotas are allocated more flexibly, while the bilateral agreements with the EU also stipulate that cheese and horticultural product markets are to be increasingly opened up on a reciprocal basis.

Financial services: making sure that the regulatory framework continues to support an effective performance

Financial services accounts for 10% of Swiss GDP and the Swiss financial sector is highly developed. The banking sector is made up of two large international banks and private banking that coexists with 24 publicly-owned cantonal banks and credit co-operatives, as well as 100 regional banks, dealing with retail banking and domestic customers. The insurance system is also highly developed. Switzerland has the highest spending on insurance per capita in the world.

Effective regulation of this sector therefore matters. This needs to address prudential (systemic) risk, but also to ensure that markets are well functioning for the benefit of consumers and service providers alike. Reputational considerations are also relevant. The regulatory framework is currently made up of several supervisory authorities, but this is about to change, with proposals from the Federal Council to Parliament for the establishment of a new fully integrated Federal Financial Market Supervisory Authority

(FINMA). One of FINMA's advantages over the current situation is that its starting principle is "same business, same risks, same rules", that is, regulatory neutrality between similar entities which will ensure a level competitive playing field. A few exceptions have been justified by a desire to avoid excessive regulation of small entities, though this will have to be monitored. Much more damaging to competition though are the ongoing state guarantees, and other fiscal privileges enjoyed by the publicly-owned cantonal banks according to the competition authority. A corrective step in this direction has been to put these banks under federal supervision.

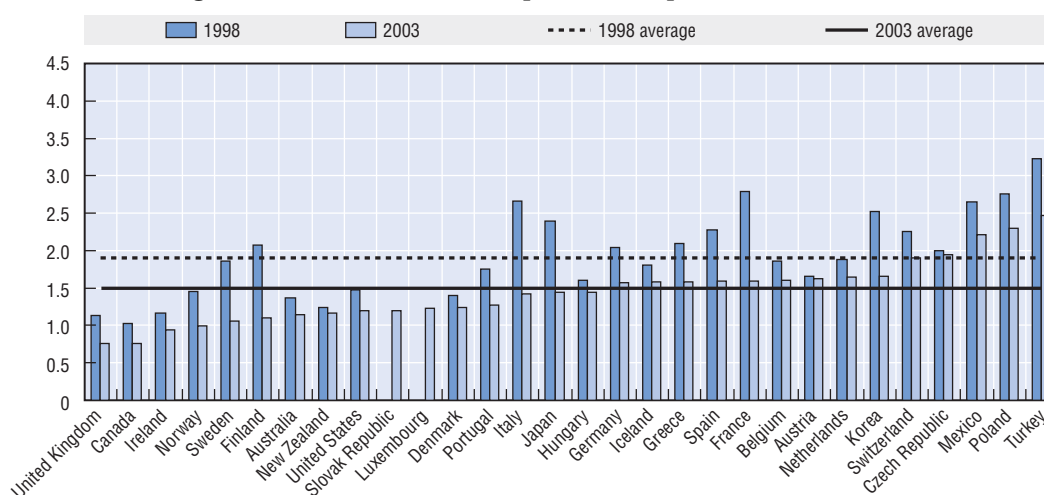
The Finance ministry publishes guidelines for financial market regulation. The guidelines provide the Swiss financial authorities with a unified structure of assessment for regulation, which takes into account issues such as a regulatory proposal's economic significance and political sensitivity. The aim is to ensure a systematic approach to the review of legislation for this sector, to raise the effectiveness of financial market legislation for stakeholders and the economy as a whole, and to improve the transparency, comprehensibility and practicability of regulation. A link is made with broader mechanisms such as RIA. Updated guidelines were published in September 2005. The Federal Council also proposes to incorporate a regulatory review standard into legislation governing FINMA.

The guidelines which have just been published have yet to be implemented to show their efficiency; the debate about regulatory burdens in Switzerland has partly focused on the financial sector. A recent survey of banks estimated their regulatory costs to be around 4.5% of total expenses. This appears to be on a rising trend. The number of full-time staff on compliance increased from by 60% between 1998 and 2002. Smaller banks are particularly affected. Their regulatory burden is estimated to be about twice that of larger banks.

Improving the climate for entrepreneurship and simplifying administrative requirements

Removing obstacles to the growth of firms and more generally to entrepreneurship represents a key policy objective as SMEs account for two thirds of employment. However, Switzerland tends to lag behind in terms of barriers to entrepreneurship compared with OECD countries. There is a close link between SMEs and innovation, a traditional Swiss strength that needs to be sustained. Among other actions that might be considered for the promotion of innovation (such as improved training, and a review of funding priorities), a better integration of SMEs, especially the smallest, into innovation support structures is needed. This may involve, for example, encouraging co-operation between SMEs and public research organisations on innovation. Product market reforms would help in this respect, alongside efforts to improve financing conditions (such as reducing the double taxation of dividends and improving the availability of venture capital). Reform of the bankruptcy law, which currently allows an entrepreneur to be sued indefinitely in some cases that are typically relevant for new and small businesses, is also crucial if risk taking and entrepreneurship are to flourish.

Switzerland faces the challenge of a general increase in legislative activity, driven by pressures to regulate new areas, protect individual, business and community rights, and ensure compatibility with regional – EU – and international law, as many other OECD countries. Government formalities are important tools to support public policies in many areas and can help enterprises by promoting level playing fields for competition. But they

Figure 1.7. **Barriers to entrepreneurship, 1998 and 2003**¹

1. Sorted by 2003 values. The scale of indicators is 0-6 from least to most restrictive of competition.

Source: Conway, Paul et al., *Product Market Regulation in OECD Countries: 1998 to 2003*, Economics Department Working Papers, No. 419, OECD, Paris.

can also discourage SMEs, as well as investment, and raise barriers to trade. Administrative requirements in Switzerland (social insurance, permits and taxes) are quite heavy and have been estimated at up to 2% of GDP.¹⁶ Regulation starts out necessarily dense and complex in a small federal state where the autonomy of the cantons is very high. This has implications for the internal market, as mentioned above. Although there is no systematic programme to address the reduction of administrative burdens in cantons, the revised Internal Market Law and adoption of the “Cassis de Dijon” principle should help. At the federal level, efforts towards administrative simplification have been developed since the mid 1990s. However, evidence of the impact of these efforts is still lacking, given the absence of systematic methodology for measuring administrative burdens.

In addition, specific regulatory tools have been developed to improve the situation of SMEs. The SME compatibility test adopted in 1999 provides a qualitative analysis of the consequences of a new regulation based on a visit to local SMEs. Around five or six tests are carried out in a year. The SME Forum is an advisory body, established in 1998, involving business people, whose responsibility is to analyse draft laws and ordinances with a potential impact on SMEs and to send recommendations to the relevant office or parliamentary commission. However, these regulatory tools are not well integrated in the RIA process, as they are conducted separately.

Improving fiscal management and curbing public spending

Regulatory reform can also be useful to promote a more efficient public sector and also in terms of fiscal management. The application of effective regulatory management to current spending reform plans can help to ensure that policy targets are achieved. More effective budgetary management and control of public spending is needed. The government’s consolidation strategy, which aims at eliminating the federal deficit by 2007 mainly through spending cuts and includes structural reforms of the pension, disability and health insurance schemes, goes in the right direction. But it could be more ambitious, and a further improvement of the fiscal policy framework is needed. Some of the actions needed

Box 1.11. **Swiss measures for administrative simplification**

The Swiss government, led in the main by the Federal Department of Economic Affairs, responding to repeated requests from Parliament, has taken successive steps to identify issues and solutions to streamline the administrative burden over the last decade:

- 1997: a Federal Council report listed a number of areas for attention, including the removal of some formalities, acceleration of procedures, and streamlined contact points.
- 1998: an inventory and evaluation initiative paved the way for some authorisation procedures to be abandoned, co-ordinated, or replaced with simpler mechanisms.
- 1999: a Federal Council report on deregulation and administrative simplification reported on the implementation of the three main rule evaluation mechanisms – RIA, SME tests and the SME Forum.
- 2001: the Federal Council proposed a complete revision of the Federal judiciary organisation, aimed at empowering citizens and cantons, and improving the appeal system. The reform is making progress. The creation of a Federal Administrative Tribunal in 2007 should accelerate appeal procedures.
- 2002: a Federal Council report on Federal authorisation procedures executed by the cantons was submitted to Parliament.
- 2003: a report on administrative simplification measures was approved by the Federal Council. This report proposes specific measures for: better co-ordination among administrative entities, especially as regards taxes and fees, with VAT returns to be put on an annual basis (rather than quarterly) so as to align with social insurance returns; the creation of an Internet consultation system on salary levels and social contributions; broad use of ICT, including the introduction of electronic administrative forms and one stop shops; *ex post* controls to replace compulsory prior authorisations; better integration of federal administrative procedures with those of the cantons.
- 2005: The measures presented in the 1998 report on authorisation procedures were assessed and a mandate was given to ministries to cut down the number of authorisation procedures by 20%. First results are to be released early 2006.

are structural, but rules also need revision to make fiscal policy more comprehensive and transparent. The structural reforms include separation of cantonal and Confederation pension and disability insurance accounts. The rule changes include extending the debt containment rule to medium term financial plans (given numerous projects for additional spending under discussion, and the lack of short term budget flexibility).

Moving forward: regulatory policy, institutions and tools

An effective and coherent use of governance and regulatory mechanisms is necessary for countries to move forward. Switzerland is no exception, particularly if it is to increase the speed with which reforms can be carried through. It is not a question of changing, or even radically overhauling, existing systems. In this, Switzerland has an advantage over some other countries faced with reform, which need to undertake a complete restructuring of their regulatory governance. This section reviews the main parts of a strategy to achieve greater efficiency and coherence, focusing on policies, institutions and tools.

A stronger “whole of government” regulatory policy

A country wide regulatory policy that can act as a motor of reform

Although elements of a common policy have been adopted by the Federal government, this is not yet in place. The experience of other OECD countries is that it takes time to develop broad “ownership” of a consistent regulatory policy at all levels of government and across all the institutions that are engaged in regulation. Important first steps have been taken, mainly through the efforts of the State Secretariat for Economic Affairs (SECO), and most visibly so far in the attention paid to regulatory reform in its Growth Report, but also more directly via the introduction of RIA and other instruments such as tools to reduce administrative burdens on business. But ownership of this vision, strategy and implementation needs to be much more widely spread in order to have a strong and sustained country wide impact.

Communication about reform and the importance of regulatory policy

Governments almost inevitably face opposition when promoting far reaching structural and regulatory reforms. Constituencies for reform are diffuse and often ill organised, whilst vested interests can be extremely powerful in Switzerland as elsewhere. Current consultation processes (including the referendum process) are a strength in making proposals more realistic, better known and more acceptable, as well as a weakness, as they tend to favour the search for a “politically acceptable” solution, instead of a best practice solution. Major efforts have also been made to raise the profile of reform issues, not least communication about the Growth Report. But the co-ordination of a communication strategy that goes beyond this is also important. It will help to reinforce the legitimacy of decisions on reform, as there is a need to balance the perspectives of vested interests and single issue associations, which may be very efficient in serving their specific interests (which is perfectly legitimate in a system of direct democracy).

This process goes beyond ensuring that basics such as the right of access to official documents are covered, the use of plain language, etc., in which Switzerland is generally very successful, and indeed an example of how to make a three language federal democracy work. Trilingualism has been used to encourage clarity of expression. But more is needed, implying a stronger federal voice in communication, in co-ordination with the cantons, which share power and responsibility for key issues.

Raising awareness and understanding of important but often complex reform issues is important. Transparency is an important tool for effective communication but not in itself sufficient. In complex modern societies, and especially in relation to certain sectors such as the network industries and international trade liberalisation, the issues on which policy decisions are based may be technically challenging to understand. Setting out the issues surrounding public services and the management of publicly-owned enterprises in the transition to more open markets is a particular priority in the Swiss context. The Federal Council has made an important effort to renovate the framework for public services. But communication of its work could be developed further, with expanded and systematic efforts to explain the issues to citizens.

Strengthening the regulatory institutional infrastructure

For a small country, Switzerland has a complex institutional landscape. The basic aim should be to use and better co-ordinate key elements of the current institutional

framework to work more effectively in support of reform. With the exception of independent regulators, it is less a question of inventing new institutions, but rather of identifying those parts of the institutional structure that could help the reform process, and ensure they are appropriately connected and resourced.

Adequate resources are needed. The current fiscal context, especially the need for restraint at federal level, complicates the resolution of this issue, but should not be a reason for giving up on it. In any administration, there is usually scope for the redeployment of existing resources. For specific sectors where the establishment of strong independent regulators is a priority, levies on the regulated industry can be considered. The issue of resources for regulatory management is also one of visibility. It is difficult to make a political case for resources if stakeholders and the public do not understand what they are for and how they can improve the functioning of the economy and society. Making the case for regulatory resources is of course easier said than done. However other small (as well as large) countries have succeeded in making room for reasonable resources in this area. The case of independent regulators is especially striking. Switzerland's current plans for the new electricity regulator, for example, would make it the smallest body across Europe,¹⁷ including other small and much poorer countries.

Internal levers of reform: leadership and co-ordination

Switzerland faces a major institutional challenge for the internal promotion of reform. Leadership is dispersed, reflected in a complex set of institutional structures and procedures aimed at balancing interests that carry an equal weight in the decision-making process. The leadership and co-ordination challenge is manifest in the way that decisions are taken within the Federal government; in the important role played by Parliament; and in the fact that considerable powers and responsibilities are devolved to the cantons.

The Federal Council is in charge of broad leadership at the level of the executive. Debates and decision making work their way upward to the Federal Council which co-ordinates the final outcome. The collegial principle means that decisions are taken by coalitions of interest, reflecting the need for consensus. The Federal Chancellery performs a procedural co-ordination role with no rights to vote on the decisions taken by the Federal Council. Promoting reform in the long run requires the setting up of effective and permanent co-ordination mechanisms with clear responsibilities and powers to monitor oversee and promote progress across the public administration. Even if the Legislature Plan¹⁸ goes some way to setting a strategic policy direction, and if efforts have been made through *ad hoc* interdepartmental groups to launch programmes such as the Growth Package, these are more in the nature of *ad hoc* mechanisms. Implementation in practice must be pursued through the complex and diffuse structures of political power and administrative responsibilities. Each layer is working for its own agenda in this process. A big picture strategy is hard to sustain over time, though the Growth Package was one of the more successful efforts.

Reform also needs to take account of the role of the Federal Parliament. The Federal Assembly wields significant influence over the law-making process. It can initiate its own laws, and it has an important role in the development of legislation proposed by the Federal executive, which it may not only accept or reject but rewrite entirely.¹⁹ The Assembly's deliberations, via its active network of legislative committees under which amendments are shuttled back and forth, often take considerable time. The committees can also suggest that a draft be dismissed without debate, or sent back to the government.

The process often leads to important modifications. Simplification of the original draft is as likely as ratification, the ultimate goal being a proposal that can be accepted by a broad range of interests, given the possibility of a referendum, and not only by a slim majority in Parliament. Ordinances may then be needed to flesh out the elements that lack detail. The current electricity reform proposals are an example of this process at work. The original proposals of the Federal government were considerably more detailed and some issues such as the powers of the new regulator will need to be fleshed out in ordinances.

Third but not least, the cantons play a crucial role in law making and regulation. High quality regulation at one level can be undermined or reversed by poor regulatory policies and practices, or even opposition to reform, at other levels; conversely co-ordination can spread the benefits of reform. The cantons are an integral part of the fabric of Swiss governance, so what happens at this level, and its interaction with the federal level, is of critical importance to successful reform. The powers of the Confederation are defined and limited by the Constitution, which gives strong prerogatives to the cantons. The cantons are also inclined to promote and protect their own economic interests because of the revenues which they raise from business. They are not likely to be willing to lose some of their scope to regulate, and this too because of deep rooted democratic traditions. The cantons also exert considerable influence on federal policy making through Parliament's second chamber (there are two deputies per canton most elected by popular vote), and through the need for a majority of cantons to adopt constitutional referendums as well as through the system of "Conferences" (*Conférences*). These institutions (made up of the cantons' decision making bodies on specific issues) aggregate the views of each canton for a given subject, and are thus able to exert a strong influence at federal level. The rejection in May 2004 by referendum of the fiscal package proposed at federal level is one example of this process at work.

Complexity arises within this level too. The cantons may sometimes be effective laboratories for regulatory innovation and experimentation, but this also generates complexity, and far from streamlining regulatory frameworks across the country, moves the latter in the opposite direction. Switzerland is divided up into an unusually large number of political units for its size. There are a large number of cantons relative to the population, and an even larger number of municipalities. The cantons also differ considerably in size and their economies show important differences, with growing disparities which can be linked to low growth and the squeeze on public finances. The municipalities also enjoy significant autonomy over all matters which are not clearly allocated by cantonal or federal law to the other levels.²⁰ All of this generates regulatory complexity on a significant scale, a major factor that may contribute to low levels of labour mobility and differences in economic performance across the country. It also dilutes the strength and pace of reforms.

Despite a number of mechanisms aimed at providing opportunities for co-operation and more,²¹ the dispersed nature of the Swiss governance system remains a challenge. The most important missing link is a permanent,²² visible and influential mechanism that would help to foster a greater coherence in regulatory frameworks, keep the big picture in focus, and ensure that regulations are fit for their intended policy purpose. Other mechanisms could be deployed to provide greater coherence and visibility. SECO's recent initiative to publish an annual report on regulation could provide the vehicle not only for reviewing RIA, but other important issues such as the interface with the EU, and administrative simplification. In the Swiss case, the co-ordination mechanisms should be

supported at the political level and reflect the collegial nature of policy-making. Some federal-level processes may have scope to be deployed country wide without unbalancing the relationship between the Confederation and the cantons. The Price Surveillance Authority's initiatives on price transparency have a country wide impact, for example.

Internal levers of reform: a community of strong and independent regulators

Independent regulators are part of an OECD wide trend to clarify important functions of central government – strategic policy making and regulation, as well as ownership in many cases – and to improve their management. A widely shared aim is to put regulatory functions in the hands of entities that are independent both of commercial interests and of short term political pressures. This does pose a challenge for most jurisdictions. Independent regulators with delegated decision making powers do not fit neatly into traditional structures of executive government, and raise issues of accountability. The evidence, however, shows that the establishment of effective independent regulators and reaping the economic benefits of market opening go hand in hand.

In the Swiss case, potential benefits could be even greater:

- Effective independent regulators can play an important role in consumer protection and the management of essential public services, but in many cases that role is currently underplayed if not non-existent. As the public supports public services, this will also stimulate a more positive attitude to reform. There is a need to strengthen consumer protection in most of the regulated sectors through systematic agreements and co-operation with the consumer protection bodies, which will need to be reinforced.
- They can make their way more easily into influential European discussion groups. They can be a bridgehead for helping to ensure that Swiss voice carries some weight in the future shaping of the EU Single Market (including on the issue of public services).
- They can help in the development of the reform process, if they are correctly set up at an early stage. A strong case can be made for a strong regulator at an early stage, even if the market is not yet fully liberalised. It is important to ensure a correct sequencing of reforms, with an effective and reassuring structure in place to help manage the smooth progression of reform.

Swiss institutional traditions complicate the development of a clear vision for the promotion of independent regulators. There is a temptation to equate the latter with existing structures for Swiss public governance – offices attached to ministries, militias²³ (*milices*) – or at least to build on these home grown models. This needs to be resisted. Current Swiss federal law does not make any clear distinction between decentralised administrations, and independent regulatory authorities with real decision making, own staff and resources, and regulatory powers. The Swiss system of offices puts the accent on delegation of tasks within ministries and a differentiated governance in order to “improve the efficiency and effectiveness of government entities vested with specialised functions”, and to “reinforce the legitimacy and expert basis of decision making”.

As well, the existence of a Price Supervisor means that some of the functions of an independent regulator are treated elsewhere. The picture is further confused by the broader trend – not specific to Switzerland – of New Public Management, which is about decentralising central government management tasks. However independent regulators, by virtue of their powers and independence, are not the same as decentralised agencies.

Absent a coherent framework for regulators, different approaches have proliferated. For example the legal basis of existing regulators is extremely diverse. Some such as ComCom and RACO have been set up as an extra Parliamentary Commissions, a general status which is also used for many other entities with a consultative or quasi judicial remit, and follows the “militias” model. Others – FOCA, FOT, OFCOM – retain the more traditional form of Offices. Most have been established by (different) primary laws, but PostReg rests on an ordinance. Part of these differences reflects a long and specific history – the case of rail regulation for example – but much of the explanation lies simply in the lack of a coherent framework.

Switzerland is therefore at an early stage in the development of genuinely independent sectoral regulators, relative to much of the rest of Europe. Even where the process has been taken furthest, a noticeable gap remains. For example, ComCom’s powers are limited relative to those of many of its peers in Europe. In other sectors the gap is far wider. The postal regulator, endowed with a very small staff, enjoys very limited prerogatives and reports to its ministry. The electricity sector still lacks a regulator of any kind. This lag is damaging to Swiss interests, not only for internal reform, but also for its external interface, especially with the EU.

A more coherent framework would pull together a number of issues that are often inadequately addressed under the current arrangements. These include clearer strategic mandates and objectives, stronger powers, more resources and better accountability and communication.

The negative effects of the lack of coherence are significant. Not only does it undermine the effectiveness of regulation in individual sectors, but it also affects transparency. Swiss consultation procedures and the degree of transparency in public governance are traditional strengths which risk being undermined by *ad hoc* developments in this area. Regulators need to be visible so that the public can relate to them.

Internal levers of reform: the role of the competition authority

Competition agencies have often been prominent in the reform processes of OECD countries. Their contribution can take different forms: well publicised studies criticising regulatory constraints and drawing attention to their effects; behind the scenes persuasion; powers to initiate court proceedings that challenge anticompetitive actions by other agencies, or formal participation in another agency’s public hearings and deliberations; strategic policy co-ordination with potential allies. What is appropriate and effective depends on a country’s particular institutional setting. The competition law framework may also require other bodies or ministries to consult with the competition agency about specific issues, or even about all issues that might affect competition.

The Swiss situation may raise issues in terms of the competition authority’s ability to provide a strong input to the reforms that lie ahead. Comco’s current institutional structure is weak in international comparison (see Chapter 3, Part II). Other structural issues muddy the clarity of the competition authority’s status, such as the close link between Comco’s Secretariat and the Federal Department of Economic Affairs (DEA), despite the formal separation set up under the 1995 Cartel Law. The Swiss competition authority also suffers from a relative international isolation due to a lack of formal agreements to co-operate with other competition authorities over cases with an international reach. The issue is especially acute with the EU, and the European Competition Network. Isolation from the EU

complicates Swiss competition work given Switzerland's central position in the regional European market. Resources are also low in international comparison. Prioritisation is another issue. A stronger role is needed on parallel imports, procurement and patent rights, and dominant positions, as well as in relation to developments in some of the infrastructure networks. As regards the latter, it will be important to ensure that such involvement does not slow up the development, or undermine the authority, of nascent regulators.

Internal levers of reform: the voice of consumers

The consumer voice is relatively weak in Switzerland, and consumers' profile in discussions on the economy is low. Consumer protection is, in legal terms, fairly comprehensive. But it is scattered across several mechanisms, the institutional framework lacks a single strong focal point, and there is some overlap of responsibilities. The competition authority has no direct role in consumer protection (although a consumer representative sits on the decision-making body of the authority, and consumer associations may solicit Comco's views on an issue). The low level of resources given to the federal structures and their low profile imply (and are perceived to mean) that a low priority is attached to this issue in the political system. There is some frustration on the part of the consumer bodies over this and a wish to do more.

A stronger consumer voice could be a powerful one in support of reform. It is a potential rallying point for the whole country, countering the usual fragmentation of interests and the influence of vested interest single issue lobbying. It can also help to counter the general bias toward the supply side perspective in policy making. Concerns about the competitiveness of firms for example do not directly address consumer welfare. Potential may exist on issues such as the general level of household prices and the environment, which has not yet been exploited. Some evidence of this can be seen in citizens' negative reaction to the solar support initiative and emerging responses to the recent initiative on electricity prices launched by the Price Surveillance Authority.

The role of the Price Surveillance Authority appears important. It is solicited on a large scale which suggests appreciation of its existence and potential role, as well as evidence of a consumer voice that seeks to be heard. The Federal government is currently considering its future. A decision has been taken that it should stay as it is, but further studies are underway to consider whether the scope of action, particularly when reviewing prices *ex ante*, could be curtailed, with an increased role for the monitoring by Comco. Other actions to reinforce, as well as demonstrate, the political commitment to consumer interests might be to strengthen the 1991 law on consumer information. Finally, a better link of independent sectoral regulators into consumer issues on a more consistent basis could also help.

External levers of reform: the interface with the EU

Switzerland is a small country and needs to find ways of maximising its influence in the international arena, as well as keeping up with important developments. The EU is its main trading partner. But equally, its position at the centre of Europe gives it a certain advantage, making it an important and necessary partner to the EU for the development of well functioning European regional infrastructures such as the electricity grid and road and rail transport, and more generally for an effective development of the EU Single Market (regional rail and electricity networks, for example, are currently congested, and the EU as well the Swiss regulatory frameworks need further development to address this). The

Box 1.12. Swiss consumer law and institutions

Legal provisions

Article 97 of the Constitution (adopted in 1981) addresses consumer protection. Both private and public law are relevant. Private law covers issues that arise between citizens. Contractual relationships are covered by a federal law, the Code of Obligations (*code des obligations*). The court system only intervenes if a civil action is brought, and operates through the cantons. Each canton has its own procedure, but must establish a simple and speedy conciliation or judicial procedure for smaller cases below a certain financial threshold. Private law (the law on unfair competition-LCD) addresses unfair competition that affects consumer/supplier relationships. The initiative for taking action rests with the parties. Swiss authorities (federal or cantonal) are involved through controls regarding the obligation to indicate prices.

Institutions

A number of overlapping institutions play a role in consumer protection. The Federal Department of Economic Affairs, its State Secretariat for Economic Affairs (SECO), and the Price Supervisor play a particularly important role:

- SECO. SECO is responsible for overseeing the law on unfair competition.
- Price Supervisor (*Surveillant des prix*). This plays an important role for consumers through price monitoring. It is responsible for preventing price increases and abusive price fixing by cartels and dominant enterprises, with a particular focus on public authority price setting (areas that are generally beyond the remit of the competition authority, although there are investigations into the same markets). Action is usually taken with the consent of the interested parties, but if this does not work, fines can be imposed (up to CHF 100 000). The head of the Price Supervisor is political, normally a former member of Parliament. It has limited resources which cannot extend to permanent monitoring so must be selective in its targets.
- Federal Consumer Bureau (*Bureau fédéral de la consommation*). This Bureau and the Federal Consumer Commission (*Commission fédérale de la consommation*) were created by the Swiss Federal government to advise it on consumer issues. Created in 1965, the Federal Consumer Bureau is attached to the Federal Department of Economic Affairs. Its role includes advice in the development of laws and ordinances related to consumer affairs, as well as providing secretariat support for the Federal Consumer Commission. It has a small staff of seven, which includes *stagiaires* (one of the lowest compared with others in Europe).
- Federal Consumer Commission (*Commission fédérale de la consommation*). This is a “non-permanent” consultative body made up of representatives of consumer associations, representatives of key economic players, unions and scientific experts.
- Consumer associations. There are a number of these, with four main ones, reflecting the country’s linguistic divisions. As *organismes de droit privé* they have official recognition and receive some limited financial aid from the Confederation, which is topped up by membership subscriptions.
- Regulatory agencies. Some of the newly established regulatory agencies have consumer responsibilities but there is no consistent pattern, and responsibility is usually weak. The telecoms regulator ComCom is the only current example: it has a duty of consumer protection on issues such as SPAM, and runs a conciliation office (*office de conciliation*). Arrangements for the regulators are vague, non-existent, or developing only slowly. The postal regulator PostReg must ensure that postal services are efficient and close by (“*de proximité*”). There is no special mention of consumers for the rail regulator, given a traditionally well functioning system. In air transport where serious problems have been encountered, there is slow progress towards a consumer protection role.

scope that its political process allow for referenda cuts two ways in the context of international negotiations: a potential brake on agreements that may be important for Switzerland itself, but also a factor for its counterparts to keep in mind in negotiation, where the issue is also important to them.

Switzerland does not therefore start from a position of weakness in discussion with the EU, as the evidence of the agreements which it has negotiated demonstrates. Nevertheless, effective mechanisms are needed for managing current EU agreements, developing new areas, taking a broad strategic view, and generally for ensuring that Switzerland can maximise the benefits of a close relationship with the EU. The fact that Switzerland is not an EU member means that it often does not have direct or automatic access, on an equal basis with EU members, to EU discussion or decision making structures, such as the committees linked to many EU directives, and the regulatory groups for the network sectors that have emerged recently. Switzerland needs, as far as possible, to play an active part in EU debates so as to help promote effective solutions to issues that are still only partly resolved. It is not too late to do this: large elements of the Single Market programme remain work in progress.

Current arrangements appear to work quite well at the practical level: implementation of agreements, etc. Reflecting the dispersed nature of Swiss political governance however, there is an apparent absence of any broad strategic view which may help to define

Box 1.13. **Swiss structures for managing the relationship with the EU**

The Integration Office

The Integration Office (*Bureau de l'intégration*) was created in 1961 (around the same time as Switzerland joined EFTA). It reports to two Federal ministries: the Federal Department of Foreign Affairs (DFA) and the Federal Department of Economic Affairs. It has a monitoring, analytical and co-ordination role across all the areas covered by the Swiss-EU relationship, in close collaboration with the relevant ministries, with which it shares responsibility. Its work includes monitoring the process of convergence with EU law, analysing the consequences for Switzerland, and co-ordinating the negotiation of treaties with the EU.

Management structures for bilateral agreements

The bilateral agreements are managed by joint committees (*comités mixtes*) within which the parties reach unanimous decisions. The air transport committee has a decision making power (set up in the agreement) which enables it to modify the technical aspects of the agreement's annexes, to propose revisions to the agreement, and to decide whether the changes made to legislation are compatible with the good functioning of the agreement. The air committee meets several times a year and has approved the immediate transposition into Swiss law of a number of EU laws related to the sector. A similar arrangement exists for the rail sector.

EU rule compatibility

Reflecting the agreements and other formal agreements (for example the mutual recognition agreements – MRAs in specific sectors) for closer alignment with EU developments that have been put in place, the Federal message (dispatch) attached to draft federal legislation that is submitted to Parliament contains a chapter on the equivalence of the proposals to EU legislation. The process established in 1988 takes into account the review of all new legislation for general compatibility with existing international rules.

objectives such as the deliberate targeting of areas not yet covered by the agreements, or a systematic attempt to secure Swiss participation in relevant EU fora in order to help shape the future of EU developments (wherever possible). Another issue is to keep a watchful eye on the threat of reciprocity clauses in emerging EU legislation. The EU and its member states are testing and implementing new approaches to regulation and regulatory reform, in the network sectors for example, but also in relation to other issues such as the environment (such as different methods of promoting renewable sources of energy). A closer relationship will enable Switzerland to participate in a mutual learning process for improved regulatory quality.

Regulatory tools

Regulatory tools can make an important contribution to better regulatory management. Administrative simplification was addressed under the earlier section on SMEs. The process of mutual recognition of different standards or rules can help to avoid deadlock and long delays in regulatory harmonisation. This underscores the importance of a revised Law on the Internal Market. Two other tools of particular interest in the Swiss context are benchmarking and RIA.

Benchmarking

Benchmarking can take several different forms:

- Benchmarking regulatory practices. This can help to spread best practice in regulatory quality as well as convergence across all the levels of Swiss government. It also uses the fact that cantons are experimenting with different approaches and turns it into an advantage. Benchmarking is likely to encourage regulatory simplification too. A high degree of regulatory transparency is essential for benchmarking to work properly (not least as regards underlying fiscal arrangements).
- Benchmarking competition between firms. Electricity pricing is an example.
- International benchmarking. The OECD's Product Market Regulation database for international regulatory benchmarking is a prime example. It should be noted that the EU is not the only benchmarking "standard" that may be of use, even if alignment with EU developments is important for Switzerland. Australia and the US offer interesting ideas too, for example as regards rail reform.

Regulatory Impact Analysis (RIA)

RIA represents also a challenging process that needs to be built up over time (For more detail see Chapter 2, Part II). Practice varies widely across the OECD but issues encountered in its application²⁴ include omissions (parts of the regulatory structure are not covered, especially at sub central level); the use of evaluation techniques (cost/benefit analysis and other techniques are often not well used); compliance (administrations have an uneven record in the proper use of RIA and poorly prepared regulation often remains unchallenged); complexity and fragmentation (too many checklists, which can cover a bewildering range of issues); targeting (to avoid administrative overload, RIA needs to be targeted at regulations with the largest potential impacts and the best prospects for changing outcomes); and timing and integration with consultation. RIA is often separate from or not included in consultation processes, which waters down its influence on decision making.

Switzerland faces many of these challenges, as well as some others, which will need to be addressed if RIA is to become a useful and influential tool for high quality rule making in the areas where it can make the greatest contribution. As matters stand, RIA is not yet well embedded in the rule-making process. A number of factors lie behind this: the narrow scope of its application (it covers mostly federal laws, and does not cover, for constitutional reasons, most of the cantonal law making); its poor integration with existing consultation processes, and deployment at a late stage in the rule-making process (making it vulnerable to use as an *ex post* justification for a decision that has already been made, rather than contributing to the quality of that decision); resources, both within SECO and in the offices that actually carry it out (which particularly affects the quality of cost/benefit analysis); the scope of issues to be addressed which needs a sharper focus, and does not sufficiently focus on competition and market opening impacts.

Swiss RIA will need to be more closely associated with traditional Swiss consultation processes. It is not a matter of “either-or”. RIA for example can help to determine what goes into the consultation process. It is also important in the Swiss context to communicate what RIA is about. The question may be asked, in a law driven society which already deploys mechanisms akin to RIA such as advanced consultation processes, why it is needed. The answer is that legal quality is not the only issue, and “policy relevant” quality matters too. RIA should be promoted as a tool for strongly anchored evidence based decision making. Another issue is the relative position of the federal level in relation to the other levels of government, which offers scope to encourage experimentation at the cantonal level.

Conclusions

The Swiss economy needs a stronger growth path, based on a sober evaluation of how the future will be if current trends continue. It is proving difficult to persuade Swiss citizens of the importance of this issue, as living standards remain high and Switzerland also scores highly on other measures of welfare. Stronger growth is needed to prevent the further slow erosion of relative living standards, and to ensure that current and future challenges to the economy, not least an ageing population, can be financed. As well as injecting dynamism into the economy, reform will also help to strengthen Switzerland's profile at international and especially EU level.

The OECD experience of reform taken as a whole, and despite well publicised specific failures, is a positive one. Reform policies reinforce each other. Policies for example which increase market openness in one sector and generate positive change may increase the viability of later reforms in other sectors where opposition was initially stronger. Reforms in one industry may have spill over effects to other industries. Another issue from the experience of other countries is that weak or uncertain reforms can backfire. This should encourage current efforts by the federal level to work towards strong new frameworks, even if this will take efforts sustained over time.

Two issues seem to weigh heavily on Swiss attempts to reform in order to meet the growth challenge. The first is the system of governance. The “cost of federalism” has been a focus of recent Swiss internal debate. But Switzerland is and can be expected to remain a federal country with strong and direct citizen participation. Most importantly, it has drawn and continues to draw many of its economic and social strengths from its unique style of federalism and democracy. It is therefore more productive to consider how Swiss

federalism can be made to work more efficiently and effectively, than to consider deeper changes in the Swiss system of governance. Switzerland needs only to *adjust* its regulatory system, unlike some other countries that have needed deep changes. Some aspects of Swiss governance such as consultation and the referendum system allow for pause and reflection, as well as decisive change which is well accepted, when that comes. These are unusual strengths for a modern democracy. A stronger general approach to regulatory quality can also be expected to improve the functioning of direct democracy, through greater transparency, and the engagement of a broader spread of stakeholders to balance the excessive weight of narrow vested interests. However, the need for pause and reflection comes at a price, in terms of the time that is necessary to formulate and implement reforms, particularly when other European countries have made significant progress. This raises the question of how to enact and implement timely reforms combined with robust and thorough forms of democratic participation.

A second issue concerns the future of public services. But Switzerland has one major advantage over earlier OECD reformers in that it can draw on a wealth of different approaches and best practice in reform. Learning by doing is inevitable, as all countries have different characteristics, but carefully managed, reform in Switzerland can avoid some of the pitfalls that affect pioneers. Other countries share very similar concerns over issues such as how to sustain universal service in more open markets, and their experiences can be used to good effect. More simply, reassurance is needed, including communication to explain the benefits of reform beyond the economic benefits measured in GDP growth, aimed at the general public in particular. Switzerland is also a key hub for some core European infrastructure in terms of energy or transportation. This raises the question how to best adapt infrastructure regulation to promote interconnection, cross border co-operation and full engagement in the European arena for Swiss players in this field. This is particularly important for electricity, where the organisation of the sector, in terms of production, ownership, and also system operator and international connections, matter, both for Switzerland and its neighbours.

The real challenge for Switzerland is to accelerate the pace of change, which is often too slow. The case for reform has to be made to voters. Part of this requires addressing difficult issues in a direct democracy, with intense public debates on core social issues, without calling into question either the workings of democratic institutions, or the objectives of environmental and social policies.

A number of actions can be taken. A more vigorous and less *ad hoc* effort at management, co-ordination and communication within and across existing governance structures can be deployed, building on traditional Swiss governance strengths such as consultation. Given the dispersed nature of the Swiss governance system, a permanent, visible and influential mechanism would help to foster a greater coherence in regulatory frameworks, keep the big picture in focus, and ensure that regulations are fit for their intended policy purpose. Policy coherence should be supported at the political level and should reflect the collegial nature of policy making. A clearer strategy for regulatory policy working out from the Federal centre can help.

With the exception of independent regulators, it is less a question of inventing new institutions, than of identifying those parts of the institutional structure that could help the reform process, and ensure they are appropriately connected and resourced. The competition authority is an important internal lever of reform, and a stronger consumer voice would also help. The establishment of genuinely independent regulators with

adequate powers and good visibility is a priority. A more coherent framework for independent regulators would foster policy coherence, thereby aligning the domestic situation with trends observed in neighbouring European countries.

The EU is an important external framework and encouragement for the Swiss reform process. A more strategic approach would be helpful, such as the deliberate targeting of areas not yet covered by the agreements, or a systematic attempt to secure Swiss participation in relevant EU fora in order to help shape the future of EU developments. Switzerland as a medium sized economy that is adjacent and closely linked to large integrated markets, needs to find a strategy to ensure the best opportunities for its citizens and businesses. As host of major multinational companies, operating worldwide, Switzerland has a key interest in gaining access to external markets in Europe and beyond. Understanding the opportunities but also the limits that a medium-size country faces in this context is important when developing a high quality regulatory framework.

A stronger Federal voice in communication to stakeholders, in co-ordination with the cantons which share power and responsibility for key issues, would help to promote reform. An important specific challenge that mainly affects the infrastructure sectors is communication over the future of core public services. Significant efforts have been made to assess and define the scope the “public service in infrastructure sectors” and its performance, following a recent report by the Federal Council. The efforts to renovate the framework for public services need to be better communicated to the wider public, which will help secure reform support.

Reform and the more vigorous application of regulatory quality principles has the scope to make a major contribution to Swiss development, in a wide range of policy areas including internal market competition, a more positive environment for international trade and investment flows, a more efficient and effective public sector, the infrastructure sectors, and stronger SME growth. Seizing these opportunities for stronger economic growth is the policy challenge that faces Switzerland in the years to come.

Notes

1. Economic Policy Reforms: Going for Growth (OECD, 2005). The study develops a cross OECD benchmarking system based on a set of policy indicators (for example employment protection legislation) which are linked to high level performance indicators (such as GDP per capita and productivity). It goes on to propose a number of policy priorities for each OECD country aimed at promoting stronger economic growth.
2. For more detail: OECD Economics department, *Working Paper*, No. 419, Conway, Janod and Nicoletti, 2005.
3. The link appears clearly in the OECD’s Annual Survey of Australia (2004). The survey shows how increased competitive pressures have contributed to good economic performance. These findings generally reflect the projections made when Australia launched its National Competition Policy (NCP) programme in the mid 1990s. Recent work by Australia’s Productivity Commission estimates that the productivity and price changes in key infrastructure sectors in the 1990s – to which the NCP and related reforms directly contributed – have increased GDP by 2.5%. Behind this achievement lie specific improvements such as in the infrastructure sectors, previously dominated by uncompetitive public monopolies, which substantially improved their productivity as they became exposed to competition.
4. See section on Removing regulatory and technical barriers to external competition.
5. In 1870, the influence of outside investors ended internal Swiss disagreements over the route for an Alpine tunnel.
6. State control, and barriers to entrepreneurship.

7. This, for example, is the case for instance for “Rahm” (cream), used in Switzerland and “Sahne”, which is used in Germany (Stoffel, 2005).
8. According to a previous study commissioned by the Federal Council (Plaut/Frontier Economics, 2002), liberalising parallel imports protected by patents would increase GDP by less than 0.1% even though the price of parallel imports is expected to fall by between 14 to 32% in the case of drugs and between 4 and 8% for consumer goods. Such an impact seems low, however.
9. See for instance Kraus (2004), Chapter 4, page 365 for a presentation of various opinions. It is also noteworthy that the legal problems raised by the unilateral adoption of the “Cassis de Dijon” principle proposed by the Federal Council are of a similar nature as those related to a unilateral adoption of the regional exhaustion regime for patent law.
10. The EU takes 60% of Swiss FDI, and Swiss enterprises employ over 800 000 people in the EU.
11. A referendum on 25 September approved the ratification of this agreement. This was an important decision, as rejection could have led to the nullification of the remaining first set of accords, since they stand or fall as a whole.
12. Annual increase of 3% for passenger traffic, 5% per annum for freight across the Alps, plus an increase of freight market share of 1% per annum.
13. The infrastructure or network sectors are sectors which depend on a network (grid, pipeline, rail track or other essential facility such as landing slots for civil aviation) in order for suppliers to be connected to customers. Access to these facilities is not only essential for players in the market, but they are often also natural monopolies, and some in addition have complex technical characteristics which require single central management. The main network sectors are usually considered to be electricity, natural gas, air, road and rail transport, water and sanitation, and telecommunications. Postal services may also be added to the list.
14. Telecommunications is one exception with technical developments through the deployment of satellite and radio that have shattered (though not entirely removed) the natural monopoly core of fixed lines. Some other sectors, however, seem condemned at least for the foreseeable future to just one network technology. Electricity for example can only be transported in bulk and long distances on expensive grids, which also require real time central management (called system operation) in order to remain technically stable.
15. The OECD and the WHO are currently preparing a review of the performance of the Swiss health system. See OECD (2006), *OECD Reviews of Health Systems*.
16. Muller, Christoph A. (1998), *La charge administrative des PME en comparaison intercantonale et internationale*, Rapport structurel, OFDE, Bern.
17. Luxembourg excepted.
18. This is a document presented by the Federal Council to Parliament which sets out the political agenda for the following four year legislature period. It groups the main issues, policy objectives and specific goals for the new legislature. It seeks to promote coherence between the actions of the administration and the (consensus based) wishes of the legislature. The 2003-07 Plan includes the proposals in the growth package to reinforce competitiveness and promote market opening reform.
19. Although the Federal Assembly’s vote is not the final word. A referendum may overturn (or confirm) its decision.
20. One consequence is that cantons, which are responsible for the implementation of Federal policy, find it almost impossible to translate this into a unified regulatory regime at the municipal level. The canton of Neuchatel for example is promoting e-government with a single Internet window for formalities, but this needs a legal anchor if it is to be implemented by the 62 municipalities.
21. Cantons are closely associated in the legislative process at the Federal level. They have a strong direct representation and influence in the Federal Parliament, including representation in both chambers which allows them to put issues directly on to the Federal agenda and to take part in the expert groups that prepare draft laws. They are also important partners in the consultation procedures. Dialogue between the cantonal and the Federal levels of government, as well as between the cantons, is intensive and continuous, supported by a number of procedures including conferences of cantonal directors, the conference of cantonal governments, a biannual Federal/cantonal dialogue, and a recently established tripartite conference that covers the three levels of government, aimed especially at co-ordinating policy for urban areas. Cantonal concordats are often used to take an issue forward.

22. The interministerial working groups set up to launch past reform programmes (such as for the Growth package/Revitalisation programme or for electricity reform) tend to be disbanded once their immediate task is finished.
23. Milices are derived from the approach taken for the military service, which relies on the contribution of each citizen (part time) in support of the wider public good.
24. See assessment in *Taking Stock of Regulatory Reform – A multidisciplinary synthesis*, OECD (2005).

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ANNEX A

Controversies over the GDP Growth Rate and Productivity Growth Rate

The GDP growth rate

The low-growth diagnosis in the 1990s is rarely called in question, but the exact scale of the phenomenon is a matter of debate. Between 1991 and 2004, the annual growth differential with the euro area reached, on average, more than 0.75 of a percentage point, while with the United States it was over 2 percentage points. Because, moreover, the total population was growing faster in Switzerland than in its neighbouring European countries – though not as fast as in the United States – the per capita production growth differential has since 1991 stood at around 1.25 points per year with the euro area and 1.75 points with the United States.

These comparisons, which are based on an indicator of production (GDP) rather than income, are however the target of criticism. The low-growth verdict remains valid, however, even allowing for Switzerland's income on its foreign investment. Growth of gross national income (GNI), which includes net factor income received from abroad, has on average exceeded that of GDP by only [0.4] of a percentage point per year since 1990. These estimates take account of the revised series of national accounts based on the SEC95 system, which have not significantly altered the results.

On the other hand GDP, as calculated by the national accounts, also suffers from a distortion in the event of an appreciable improvement in the terms of trade, which results paradoxically in a fall in real GDP whereas the country gains the possibility of importing more per unit of exported good. The danger of underestimating the trend in real income is particularly great in the case of Switzerland inasmuch as, between 1991 and 2004, the terms of trade improved by some 12%, which was one of the biggest increases among the OECD countries. This distortion can be adjusted in various ways, in particular by calculating an alternative measure called "command GDP" which is obtained by deflating nominal exports by the import price index. The idea behind this concept is to look at exports as a way of financing imports. An improvement in the terms of trade results in an increase in command GDP, in contrast with real standard GDP which will fall. According to this indicator, the real growth differential between Switzerland and the other OECD countries over the period in question is 0.25 to 0.5 percentage point less than that based on real standard GDP. This adjustment, plus the one relating to factor income received from abroad, moves per capita income growth – at around 0.75 per cent per year on average between 1991 and 2004 – closer to the figures for France, Germany and Italy (1.25 per cent per year on average), while remaining among the lowest for the OECD countries.

While the magnitude of the growth deficit may or may not seem significant, depending on the indicator used, the fact remains that Switzerland was systematically bringing up the rear in the OECD area during the 1990s. Its poor growth performance is, moreover, confirmed by the surveys conducted among households and businesses. Those relating to consumption point, for example, to real disposable income growth averaging 0.5% per year between 1990 and 2001, which is confirmed by salary surveys.

The productivity growth rate

The measurement of Swiss productivity growth, and above all the extent to which it remained depressed during the 1990s, has recently been the subject of robust debate amongst specialists. What has given rise to controversy is the measurement not so much of the numerator of the ratio (real production) as of the denominator. In Switzerland, various statistics are used to calculate the volume of work. The main sources are the Swiss Labour Force Survey (ESPA), which is comparable at international level, and the employment statistics (STATEM). ESPA is based on surveys conducted among a representative survey of households, while STATEM uses a survey carried out among businesses to determine the number of jobs.

For the 1990s, calculations based on the above two sources gave average annual productivity growth rates, measured per capita in full-time equivalent terms, of 1.0 and 1.6% respectively. This significant difference is due to the fact that ESPA takes more accurate account of informal jobs and self-employment, especially services provided under contract by suppliers who have not set up an establishment in a formal sense. These jobs, which do not involve the usual work contracts, are liable not to be counted by STATEM, but the fact is that they increased appreciably during the 1990s (“patchwork jobs”). The ESPA employment figures also give a more coherent picture of long-term labour market developments than do those of STATEM, bearing in mind the trends observed in the labour force and unemployment. STATEM does, on the other hand, cover temporary permits and cross-border workers, which is not the case of ESPA. More fundamentally, the ESPA measurement gives a more accurate idea of productivity in the “sheltered” domestic sector which includes public services (health, education, administration where indication of underreporting are present), whereas that given by STATEM is closer to productivity in the sector of industry exposed to international competition. This confirms the two-headed description of the Swiss economy, with an “exposed” sector open to foreign markets, which has no particular productivity growth problem, and a “sheltered” sector turned towards the domestic market, which is lagging behind.

PART II

Regulatory Policies and Outcomes

Introduction

This second part of the report reviews the range of policy areas where the application of quality regulatory principles, including a thorough and focused review of specific regulatory frameworks, can be expected to make a particularly strong contribution to the Swiss economy and society. The following areas are highlighted for attention:

- *Improving regulatory governance.* This includes applying regulatory quality processes to the processing of new regulations and to the management of public sector activities.
- *Promoting internal market competition.* This includes addressing the fragmentation of the internal market through a stronger Internal Market Law, strengthening competition policy as a key tool for the development of an efficient internal market, and opening up public procurement.
- *Promoting a positive environment for international trade and investment flows.* This includes the removal of regulatory and technical barriers to external competition, and pursuing a policy of market and regulatory integration with the EU.
- *Improving the performance of the infrastructure sectors.* These include regulatory frameworks for telecommunications, rail, air transport and postal services, together with a special chapter devoted to the issue of electricity.

PART II
Chapter 2

Regulatory Governance*

* For more information see the background report on “Government Capacity to Assure High Quality Regulation” available on the Web site: www.oecd.org/regreform/backgroundreports.

Introduction and context

Switzerland has a longstanding public governance and regulatory framework which rests on participative democracy which drives a consensus building approach to decision making, and a high respect for the rule of law. This framework has contributed to a well functioning economy and society. However the problem of slow growth now raises questions about the way important decisions are taken, the regulatory framework for policy making and the rate of change to implement structural reform, so that Switzerland's economy can meet the challenge of globalisation, and stay competitive. Switzerland's institutional structure of public governance, made up of three political levels (the Confederation, the cantons and the municipalities) is complicated by the fact that there is no strong centre of authority.

Change is underway but with limited effects. There is a deep general attachment to the main features of Swiss public governance, most notably the power sharing between the Confederation and the cantons, and the importance of maintaining a balance in which the lower levels of government retain their strong influence. But there is also recognition of the need for adjustment. This is reflected in the evolution towards co-operative federalism, which is exemplified in the recent "fiscal equalisation reform", aimed at rationalising the division of labour between the partners in government as well as strengthening the fiscal framework that links the Confederation and the cantons. A clear and strong approach to regulatory management faces significant institutional obstacles. Although considering regulatory policy implemented at the federal level only, efforts have so far been largely confined to piecemeal initiatives based on administrative simplification and reducing the burdens on business. In addition to the federal structure, the system of participative democracy needs to be considered as it shapes regulatory governance in Switzerland. Direct democracy and the spreading of political power across various levels of the State help explain the decision-making process on a wide range of policies, including competition, market openness and sectoral policies, which are crucial to the Swiss economy.

The EU plays a significant role in shaping the development of the Swiss economy and its regulatory framework. Convergence with EU structural and regulatory changes across a wide range of sectors and cross cutting policy areas is essential for sustaining Swiss competitiveness, given the EU's overwhelming importance as Switzerland's main trading partner. Following the rejection by the Swiss people of accession to the European Economic Area (EEA) in 1992, Switzerland has sought to consolidate its relationship with the EU through a series of bilateral agreements aimed at bringing it in line with EU policies. This has resulted in a fragmented adoption of some of the EU legal *acquis*, which is uneven across sectors.

Rejection of EEA membership also encouraged an emerging consensus on the need for reform aimed at reversing slow growth. After the "revitalisation programme" in the '90s, the 2002 Growth Report prepared by the Federal Department of Economic Affairs and the Growth Package subsequently adopted by the Federal Council, include a large number of structural and regulatory reforms to stimulate a better performance.

Regulatory policies and institutions

A key part of the 2005 OECD Guiding Principles for Regulatory Quality and Performance is that countries adopt at the political level broad programmes of regulatory reform that establish principles of “good regulation”, as well as a framework for implementation. Experience across the OECD suggests that an effective regulatory policy should be adopted at the highest political levels; contain explicit and measurable regulatory quality standards; and provide for continued regulatory management capacity.

An ad hoc approach

Current regulatory policy in Switzerland does not, as yet, reflect this broad concept. Rather, it appears in the *ad hoc* pursuit of specific policy areas, including the efforts to build a more open and efficient internal market. Regulatory policy is defined across a range of documents including the Federal Constitution (which is not just the Confederation’s legal foundation, but also contains important rules and political rights); federal Acts and related ordinances; the Legislature Plan (the document presented by the Federal Council to Parliament to agree, for each legislative period); the Legislation Guide and Manual on Legislation Techniques; and the Directives of the Federal Council on the economic

Box 2.1. Good practices for improving the capacities of national administrations to assure regulatory quality and performance

The 2005 OECD Guiding Principles for Regulatory Quality and Performance capture the dynamic and ongoing whole-of-government approach to implementation of regulatory quality. Based on the 1995 Recommendation of the OECD Council on Improving the Quality of Government Regulation, on the Report on Regulatory Reform welcomed by Ministers in May 1997, and on the OECD work of 20 country reviews and new monitoring exercises, the Guiding Principles form the basis of the analysis undertaken in this report:

A. Building regulatory management system

1. Adopt regulatory reform policy at the highest political level.
2. Dynamic dimension of regulatory policy.
3. Establish explicit standards for regulatory quality and principles of regulatory decision-making.
4. Build regulatory management capacities.

B. Improving the quality of new regulations

1. Regulatory Impact Analysis.
2. Systematic public consultation procedures with affected interests.
3. Using alternatives to regulation.
4. Improving regulatory co-ordination.

C. Upgrading the quality of existing regulations

1. Reviewing and updating existing regulations.
2. Reducing red tape and government formalities.
3. *Ex post* evaluation.

consequences of federal legislation (the legal basis for Regulatory Impact Analysis – RIA). These documents are valuable in themselves, but fall short of providing a coherent regulatory policy framework for tackling important policy decisions.

A complex institutional landscape

The regulatory institutional landscape is highly complex, characterised by multi-layered interactions and decision-making processes involving a range of institutions. The resolution of conflicts and decision making works through a process of negotiation called *Konkordanz* (power sharing). The Federal Council is the highest executive authority of the Confederation, and operates on a collegial basis, with seven members who are simultaneously the respective heads of the seven departments. The Legislature Plan helps the Federal Council exercise its co-ordinating role. It groups the main issues, policy objectives and specific goals for the new legislature. (As a result, the 2003-7 Plan includes the draft legislation proposed by the Growth Package.) Under the authority of the Federal Chancellery, the preparation of the Legislature Plan involves a careful process of consultation of all parts of the executive. The four year financial plan and the Legislature Plan are co-ordinated.

Key parts of the executive beyond the Federal Council with regulatory quality responsibilities include the State Secretariat for Economic Affairs (SECO), part of the Federal Department of Economic Affairs, the Federal Office of Justice, the Federal Chancellery, and the Integration Office. SECO promotes a competitive economic environment, and takes the lead to improve the justification of regulation, notably RIA and measures to help SMEs. The Federal Office of Justice, part of the Federal Department of Justice and Police, works closely with the Federal Chancellery on the quality of the legislation from a legal point of view. The Federal Chancellery is the general headquarters office of the Federal Council, and plays a mainly procedural role, co-ordinating Departmental actions and advising on issues such as planning. The Integration Office, which reports jointly to the Departments of Economic Affairs and the Department of Foreign Affairs, monitors and advises on EU matters.

The Parliament is also relevant to law making, as it can initiate laws. It also has an important role in the review of draft Federal laws, although these are subject to referenda, as it can revise or reject these laws. The review process can take time, and sometimes considerably delays the approval of new laws.

Co-ordination between levels of government: federal-cantonal

High quality legislation at one level of government can be undermined by poor regulation at another level. Conversely, co-ordination can vastly expand the benefits of reform.

Switzerland's federal structure is made up of three levels: the Confederation, 26 cantons (six of which are half cantons), and over 2 880 municipalities (*communes* or *Gemeinden*).¹ Swiss municipalities are small compared to those of other countries.

Principles of Swiss federalism

Implementing Swiss federalism is complex and rests on the following broad principles:

- The Confederation is only responsible for those tasks that are clearly allocated to it. The rest is automatically the responsibility of the lower political levels. The responsibilities

of the Confederation are set out in the Constitution. Any matter that is not defined in this way for the Confederation is the policy, legal and regulatory responsibility of the cantons. To this end, cantons may enact their own legislation and regulations.

- While the Confederation has legislative power through the enactment of federal legislation in its areas of responsibility, the responsibility for implementing federal policies rests largely with the cantons. The Confederation may limit itself to setting out broad principles, in which case the cantons may enact their own more detailed legislation (for example on fiscal matters). The Constitution underlines that the cantons must respect federal law, but retain autonomy in its implementation. The constitution sets limits, notably which cantonal regulations shall not interfere with economic freedom, thus limiting the scope for cantonal interventions.

- Responsibilities are shared in some areas (parallel jurisdiction).

Thus, the principle of subsidiarity is applied: a task can only be allocated to a higher level if the lower level cannot take it on.

Policy areas which are the primary responsibility of the Confederation cover customs (reflecting the Confederation's original purpose), central bank matters (the mint), foreign relations and national security. It also has the main responsibility for social security. Confederation authority also extends to infrastructure, especially alpine transit which should use rail (Article 84). It has a general competence for transport (Article 87), as well as postal and telecommunication services (Article 92). As well as the implementation of most federal law (which may require the enactment of secondary rules), the cantons have main policy responsibility for: cantonal taxes (income, property, corporate taxes), building and zoning regulations, regulation of the professions, regulation of leisure activities such as restaurants, bars and hotels, and shop opening hours. They are in charge of individual safety with policy services. Education and health were in the past cantonal responsibilities and are still very important to them from a financial perspective. Shared responsibilities include universities, cultural support, nature protection and monuments. This is also the case for supply services in the field of infrastructure. The cantons are free to organise the sharing of responsibilities for regulation and for ensuring that public missions are met between the respective bodies of the cantons and the communes. The communes have always had an important role to play for social assistance.

Federal-canton fora

The significant role of the cantons in policy and law making is reflected in their close integration in all aspects of the legislative process. First, their role is represented by the Council of States (higher chamber of Parliament), which carries the same weight as the National Council (lower chamber of Parliament), and which is made up of two representatives by canton elected at cantonal level. Second, cantons are also influential partners in the consultation procedures. For this reason, the expert groups, to which the preparation of draft laws is often delegated, include cantonal experts. Finally, the Federal Council must lay out to Parliament the impact of its legislative proposals on the cantons.

A number of fora also exist for federal-canton dialogue, including the Conferences of Cantonal Directors (for co-ordination between cantons as well as with the Confederation); the Conference of Cantonal Governments (for co-ordination as well as collective lobbying by the cantons, for example on cross cutting European matters); the Federal Dialogue (a biannual discussion forum, which, for example, discussed the Growth Package); and the

Tripartite Agglomeration Conference (a recent addition focusing on urban issues). Beyond these fora which are mainly aimed at federal-canton co-operation, a dense network of inter cantonal agreements and conferences services inter cantonal co-operation.

The sharing of tasks and competencies between the Confederation and the cantons is also periodically updated, normally through a revision of the Constitution, or if the constitutional ground is not sufficient, an overhaul of federal legislation. The “fiscal equalisation reform” is a particularly significant recent reform in this direction, which has been steered by a joint federal-canton committee and carried out by a mixed group of Federal and cantonal officials.

Developing the internal market: a continuing challenge

The positive benefits of this intense network of co-operative mechanisms are not always clear. In particular, the effective functioning of the internal Swiss market remains a major challenge. This is for the most part due to divergent and restrictive cantonal regulatory practices for a large number of services, which tend to segment the Swiss market into small geographic areas defined by cantonal boundaries. The 1995 Internal Market Law, which sought to establish general principles for a more open market, suffers from a number of flaws, as it still left significant scope for the cantons to continue to restrict access to their market (for reasons of public interest for example). In 2005 Parliament debated the revision to the law.

Co-ordination between levels of government: national – EU

Although Switzerland is not a member of the EU, its close relationship with the EU has driven a significant amount of the country’s internal structural and regulatory change over the last decade or so. This trend can be expected to develop further, in line with the EU’s own growing programme of legislation which covers a broad front.

Bilateral agreements with the EU

The rejection of EEA membership in 1992 led to the negotiation and approval (by the Swiss people and by the EU) of a number of accords, which either provide for EU and Swiss legislation to be treated as equivalent, or for the transposition into Swiss law of the EU *acquis*. Both federal and cantonal laws need adjustment to reflect these agreements. The accords initially covered seven sectors: Land transport, air transport, free circulation of people, agriculture, research and development, public procurement, and technical barriers to trade. These accords were followed by a further set on nine new areas (this time more focused on political rather than economic subjects); taxation of savings, customs fraud co-operation, co-operation in the fields of justice, police, asylum and migration, trade in processed agricultural products, the environment, education and training, audiovisual and media, and double taxation for EU pensioners.

The lists reflect the wide range of areas tackled so far, but also some important gaps such as electricity, and some agreements are quite narrow in scope. Convergence with EU regulatory frameworks on all the issues that matter is still work in progress. But it is also clear that the agreements so far have allowed Switzerland to progress in important domestic reforms, especially in some sectors such as telecommunications and railways.

Transparency and consultation

Transparency is one of the central pillars of effective regulation, making the regulatory environment more secure and accessible, less influenced by special interests, and therefore more open to competition, trade and investment. It involves a range of actions including standardised processes for making and changing regulation, consultation with stakeholders, effective communication of the law and plain language drafting, publication and codification to make it accessible, controls on administrative discretion, and effective implementation and appeals processes.

The law-making process requires high levels of transparency to sustain confidence in the legal environment, and procedures for this in OECD countries are usually enshrined in legislation. These are covered in Switzerland by the Constitution together with a number of laws, including the Federal Law of Administrative Procedures, the Federal Law on the Organisation of Government and Administration (LOGA), and the Parliament Act. The latter regulates the legislative process, including a requirement on the Federal Council to provide a “dispatch” with every draft law submitted that sets out key information and explanations such as implications for other laws and individual rights, funding, and implications for the economy, society and the environment.

Transparency through consultation: a major Swiss strength

Consultation is a major strength of Swiss regulatory governance, contributing to firmly grounded regulatory decisions that are more fully accepted and complied with, because citizens and business have helped to shape them. Consultation is present in two major forms. The first is the consultation that takes place throughout the legislative process. This is rooted in a Constitutional provision which states (Article 147) that “the cantons, the political parties, and the interested circles shall be heard in the course of the preparation of important legislation and other projects of substantial impact, and on important international treaties”. The collegial nature of Swiss governance and, perhaps more importantly, the threat of a referendum mean that a sufficiently large consensus has to be established. Establishing this consensus does necessarily require consultation. Informal procedures often precede official consultation.

Current rules for the official consultation process are set out in a recently adopted 2005 federal law, which targets the number of subjects that qualify for the process on those that have a significant impact (political, economic, social, environmental, cultural), and puts the main responsibility for triggering a procedure with the Federal Council or a parliamentary Commission. The Federal Chancellery co-ordinates. During this phase of extensive external consultation, opportunities are given for the cantons, political parties, associations and other interested parties to review and discuss major draft legislation proposed by the Federal government. The results of this consultation are made publicly available. They serve to steer the debates in the Federal Council and in Parliament. Before official consultations, but also after official consultations, a consultation process which is internal to the administration prepares the decisions for the Federal Council. This internal consultation involves a two step procedure for a given draft law: the federal offices concerned are being consulted. This is followed by a “co-reporting” procedure (where all the different offices submit their views). The head of the lead ministry has to defend its draft during a session of the Federal Council. The adoption of a draft law by the government requires a majority of the seven Federal councillors.

Besides external official consultations, the interested parties can express their views and make contributions through multiple channels. Interested parties can express their views in special meetings of their associations, popular discussions and public fora, etc. Participation in extra Parliamentary commissions provides opportunities for a wide range of interested parties to help develop new legislation. It allows them to defend their interests, but it also ensures that the Swiss authorities can assess the mood of relevant parties (which may extend to the whole electorate), and the prospects for a successful adoption of draft laws.

The second major form of consultation is the system of direct democracy under which citizens may vote on issues. The referendum process is central in shaping important government decisions, and is directly related to the strength of consultation procedures, which are used to judge public views. Citizens have two rights under this system, the right of referendum and the right of initiative (popular initiative). The right of referendum is automatically triggered under certain circumstances, such as changes to the Constitution, or if a referendum is requested by 50 000 citizens. The right of initiative may be applied by request of at least 100 000 citizens in relation to a Constitutional change. The impact of the referendum system is controversial in Switzerland. It is integral to the strength of Swiss governance, but has also been described as a form of veto that slows up the political process and hence reform.

Transparency through communication

Communication is another facet of transparency. Governments need to communicate regulation effectively to stakeholders, not least to ensure that it is complied with. This, again, is a Constitutional requirement in Switzerland. The Federal Council “shall inform the public timely and fully of its activity” (Article 180). New federal legislation is published weekly in an official gazette in the three official languages. For existing legislation, a new federal law on publications came into force in 2005 which sets out key principles for publishing normative acts and regulatory measures. All the laws and normative acts related to the federal level and to international laws, as well as all regulations in use in Switzerland, are integrated in the “*Recueil systématique*”,² which involves permanent consolidation of laws and ordinances, and which is available on the Internet. Data protection is regulated through a federal law aimed at protecting the rights of individuals as well as public authorities, which sets out key principles, and sets up the Data Protection Commissioner, an autonomous advisory body for citizens and others.

An important new federal law on transparency is expected to come into force in 2006, which seeks to tackle the longstanding issue of Swiss administrative secrecy and sets up a citizen’s right to consult official documents, although there are numerous exceptions and access is not free. Special attention is given to plain language in regulatory procedures, given the need to translate into three languages. Switzerland is, overall, an example of how to achieve effective legal transparency in a three language democracy. The problems that arise have more to do with the underlying complexity of regulatory structures than with the clarity of the rules themselves.

High levels of compliance

Adoption and communication of a law sets the framework for achieving a policy objective. But effective implementation, compliance and enforcement are essential for actually meeting the objective. Compliance levels are high in Switzerland, due to the

intensive interaction between stakeholders that precedes the adoption of new rules and facilitates acceptance of the outcome, as well as a general respect for the rule of law, and the referendum system. Although only 5% of draft laws are submitted for referendum, the possibility of one is also relevant for supporting the legitimacy of law making. Cantons are the main implementing agencies in the Swiss system. A number of mechanisms are in place to monitor this implementation, set out in the Legislation Guide published by the Federal Office of Justice. Some municipalities have systems of citizen supervision. The dense Swiss media network is also active in checking compliance, as are the numerous associations (economic, trade unions, consumer organisations, environmental, etc.). At the federal level the Swiss Federal Audit Office audits the executive. Finally Parliamentary supervision is exercised through committees (the Finance committee and the Control committees) and the Parliamentary Control of the Administration which has an evaluation role.

Public redress: a supportive but complex system under reform

Mechanisms to prevent and redress regulatory abuse should also be in place, both as a democratic safeguard and as feedback to improve regulations. It should be possible to appeal administrative decisions based on a regulation, as well as the regulation itself. Swiss rights and procedures are comprehensive but complex. The Federal Constitution (Articles 29 and 30) sets out a wide range of citizens' rights in this respect, including the right to equal and fair treatment, the right to be heard, and the right to free legal assistance. These rights are backed up by more specific federal and cantonal laws. The administration itself also has rights, notably the right of federal offices to appeal against cantonal decisions that violate federal law. Appeals may go up to the Federal Supreme Court, which takes an average of three months (a reasonable time) to hand down decisions. Procedural complexity arises from the interaction of different levels of government, each of which has its own structures and processes. A full revision of the judicial system is underway, approved by the people and the cantons in 2000, which aims to streamline the legal system, improve efficiency and transparency, and improve legal protection. The creation in 2007 of a Federal Administrative Court that will replace current federal structures will also partly address the issue.

Alternatives to regulation

The use of a wide range of mechanisms, not just traditional regulatory controls, for meeting policy goals helps to ensure that the most efficient and effective approaches are used. Governments must lead strongly on this to overcome inbuilt inertia and risk aversion. At the same time, care needs to be taken when deciding to use "soft" approaches such as self regulation to ensure that regulatory quality is maintained.

Alternatives

Switzerland has clear formal obligations at the federal level to consider alternatives. For example the dispatch attached to draft laws proposed by the Federal Council should include an assessment of this. This is complied with, but the analysis of which regulatory instrument to use is often perfunctory. The burden of authorisations has been a focus of concern for the federal authorities. Alternatives in this area enjoy strong support and have started to be deployed. They include economic instruments to protect the environment (such as eco taxes), information provision, and putting responsibility on enterprises (combined with strong enforcement). An evaluation of progress has been published

in 2005. Voluntary agreements – enterprises taking voluntary action to redress a policy concern under threat of more onerous regulation – are another possibility. Several such agreements have been made in the environmental field, including in waste management.

Self regulation

Self regulation in Switzerland used to be linked to a relatively weak approach to competition policy and corporatist tradition, which allowed associations of enterprises to organise the market without any clear framework for this. Cantonal regulations are sometimes linked to associations' codes of conduct. This type of self regulation is losing ground, and is being replaced with a more competition friendly approach. For example, enterprises are active partners in European regulatory processes such as standards setting. The financial sector is perhaps the most prominent user of self regulation. Regulatory authorities and self regulatory organisations share the regulatory tasks under a clearly defined framework. The Swiss Federal Banking Commission (SFBC) interacts with self regulatory organisations such as the Swiss Bankers Association, and helps to define codes of conduct. An important field for this approach is money laundering. The Swiss Money Laundering Control Authority supervises the self regulatory organisations which fall under its remit, and firms can choose whether to join the latter or be directly subordinated to the Authority.

Regulatory Impact Analysis

Regulatory Impact Analysis (RIA) is one of the most important regulatory tools available to governments. Its aim is to influence policy makers to adopt the most efficient and effective regulatory options, using evidence based techniques to justify the best option. Much of the OECD's regulation checklist relates to RIA good practice.

Challenges for effective RIA deployment

RIA was introduced formally in 1999 with the adoption of Federal Council Guidelines on RIA, in the wake of concerns over rising administrative burdens and their effect on SMEs. It was a controversial decision which raised a debate over the role of traditional Swiss consultation mechanisms and the use of more "technocratic" evaluation techniques. RIA is currently applied to all federal laws, and in a less formalised way also to ordinances. Only two of the 26 cantons – Bern and Soleure – currently apply a federal style RIA process. At the federal level, rules are reviewed according to five criteria: the need and scope for state intervention (what justifies a new rule); consequences for different stakeholders, based on a cost/benefit approach (who are the winners and those who have to adapt); implications for the economy as a whole; alternatives to regulation; and practical implementation (such as administrative implications, co-ordination of tasks). Based not on value judgments, but on any available quantified assessments, distributional and environmental consequences shall also be set out. As in nearly all other OECD countries, the preparation of RIAs is the responsibility of the relevant ministry, guided by SECO. There is no central unit for RIA, as in some other OECD countries. Instead SECO oversees RIA implementation and quality, and provides support to ministries. SECO has recently evaluated progress since 1999, and identified actions for improvement, including a report on regulation that will especially focus on RIA, and identification of specific areas for RIA improvement. A recent Parliamentary report on regulatory instruments has also highlighted weaknesses and areas for improvement.

Switzerland faces a number of challenges which will need to be addressed if RIA is to become a more useful and influential tool for high quality rule making. As matters stand, RIA is not yet well embedded in the rule-making process. Its scope is relatively narrow, but at the same time there is no advice on targeting the most important laws, it is poorly integrated with existing consultation processes, and deployed at a late stage in the rule-making process, more as an *ex post* justification of decisions than an *ex ante* aid to better decisions. It is also under resourced. The scope of issues to be addressed needs a sharper focus too, including competition and market opening impacts. There is a need for more consistent high quality cost benefit analysis, an essential element for evidence-based analysis, which is undermined by the current lack of resources in ministries. Data collection for this is also a current weakness.

Taking a strategic view, Swiss RIA needs to establish a successful “alliance” with traditional Swiss consultation processes. Political commitment at the highest level will be important for progress.

Regulatory Impact Analysis and SMEs

Switzerland has set up two mechanisms specifically targeted at SMEs and the reduction of administrative burdens. The SME compatibility test was adopted by the Federal Council in 1999. It is a qualitative analysis of the consequences of a law project based on a visit to ten different SMEs, conducted by SECO. It is applied in parallel to the regular consultation procedures, and results are published and in some cases integrated into the dispatch sent to the Federal Assembly. An average of five or six tests are carried out in a year. The SME Forum, an advisory body, was created by decision of the Federal Council in 1998, as an extra parliamentary expert commission made up of a dozen of entrepreneurs. It meets three or four times a year to examine draft laws and ordinances with a potential impact on SMEs, and works in parallel with the consultation procedure. It may send recommendations to the relevant office. The results of the SME compatibility test are presented to the Forum.

These initiatives, however, do not currently appear to make much difference to the regulatory process. There is an issue of co-ordination between the SME test and the RIA process, which might be resolved by integrating the test with RIA. This would align Switzerland with the approach that is followed in a number of OECD countries which have integrated SME elements into their RIA. The SME Forum is an important initiative with potential to play a significant role in the regulatory process, if a means can be found of strengthening its institutional status. It could for instance regularly be heard by the relevant parliamentary commissions.

Keeping regulation up to date and reduce administrative burdens

Revising existing regulations

The large stock of regulation and administrative formalities accumulated over time in OECD countries need regular review to weed out obsolete or inefficient material. Substantial efforts have been made by Switzerland to tackle this, on an *ad hoc* basis which emerges from the political process rather than as a systematic policy. Procedures include evaluation clauses, sunset legislation (putting a time limit on legislation), or both combined. *Ad hoc* evaluations are carried out quite regularly by federal offices. The Federal Audit Office examines all financially relevant activities. The Constitution (Article 170) requires the Federal Assembly to ensure that the effectiveness of measures taken by the

Confederation is evaluated, which has been given effect in a Parliamentary law. Dozens of evaluations have been carried out under this approach. The federal executive has also taken the initiative, adopting measures such as plans for evaluation by offices of the laws under their responsibility, the result being reported back to Parliament. Recent reports by the body for Parliamentary Control of the Administration³ also provide a framework for revising existing regulations. The current administrative reform project includes a systematic examination of laws (especially very old ones) to be abrogated.

Reducing administrative burdens

A general increase in legislative activity is a common issue for OECD countries, including Switzerland. The Swiss official compendium for the publication of new laws (*recueil officiel*) can be used as a proxy for measuring the growth in rules: 3 271 pages in 1998, 5 514 pages in 2003. More specifically, this growth adds to administrative burdens, which is especially important for SMEs.

Some administrative requirements in Switzerland (social insurance, permits and taxes) are quite heavy. Regulation starts out necessarily dense and complex in a small federal state where the autonomy of the cantons is very high, so trimming it needs an especially vigorous approach in Switzerland.

Administrative burdens at cantonal level (each canton is different too) are especially unhelpful for the internal market, and for some sectors in particular, such as construction. There is no systematic programme to address the reduction of administrative burdens in cantons, although the revised Internal Market Law and adoption of the “Cassis de Dijon” principle should help.

Authorisation procedures weigh heavily in the Swiss system, accounting for perhaps a quarter of administrative burdens. An Internet database on federal procedures has been in place since 2001, lending clarity to what is required and simplifying the way procedures can be followed (online forms for example), even if it does not reduce the number of procedures. A February 2005 report gave a mandate to the Federal Council, inviting the Departments to suppress 20% of the authorisations for which they carry responsibility.

The Swiss government, led in the main by the Federal Council, has taken successive steps in identifying issues and solutions to streamline the administrative burden over the last decade. Starting in 1997, it led to an inventory and evaluation initiative in 1998; with a removal of some authorisation procedures, it has continued since with further reports and proposals. In the area of law enforcement, the proposal in 2001 for a complete revision of the federal judiciary organisation stands out, aimed at empowering citizens and cantons, and improving the appeal system. The creation of a Federal Administrative Tribunal in 2007 should accelerate appeal procedures.

The overall impact of these initiatives is, however, not clear, and there is little evidence of an overall framework to drive the issue forward. Especially, there is no systematic evidence available on the actual size of current burdens, and no methodology in place to do so. The absence of this first step at measurement makes it hard to establish a high political profile on the issues – either at federal or cantonal level – that would support a more coherent approach to policy, supported by the wider public as well as SMEs. Some other OECD countries, such as the US and the Netherlands, have developed interesting approaches to measure administrative burdens. It is important, however, to avoid establishing a self-perpetuating culture in which codification of existing regulation is seen as an end point.

Use of ICT

The use of ICT for administrative simplification programmes is an important trend across the OECD. Despite the establishment of a number of electronic one-stop shops, both at federal and cantonal level, Switzerland lags many other countries in this area (including Austria, Sweden, Belgium and Italy). However, certain exemplary cantonal initiatives have allowed significant progress: the canton of Neuchâtel has developed a comprehensive concept of e-government, which has been developed in different phases: the first one, mostly internal, tending to the creation of sites to provide information on governmental activities at the cantonal level and ensuring the e-management of files in different areas; the second one corresponds to the one-stop shop (*guichet virtuel*), with an external vision, providing services and information to citizens; a final one that will include secured one-stop shops (*guichet sécurisé unique*), which will allow citizens to comply with a wide range of formalities, even to vote or pay taxes through the Web. The set-up of this initiative required the enactment of a Cantonal Law on the Protection of the Personality (*loi cantonale sur la protection de la personnalité*), the first one in Switzerland. Overall, there is a lag for interactive sites that allow online processing (in contrast to the much simpler information sites). These are less developed in Switzerland than in many other countries, reflecting the fragmentation and complexity of regulatory structures across the Confederation. For example 1 822 municipalities have an information site, but only 493 have an online transactional capability. There is scope for improvement.

Recommendations

1. Adopt regulatory reform at the political level.

Regulatory reform should be adopted at the political level, in order to integrate key elements of regulatory policy – policies, institutions and tools – as a whole, articulating reform goals, strategies and benefits to the public. A key goal is to maximise “ownership” of regulatory reform at the political level.

The State Secretariat for Economic Affairs (SECO) has made important efforts to introduce core elements of regulatory policy and to expand the use of regulatory tools. Regulatory policy elements appear as parts of broader policy sector reforms, primarily focusing on deregulation measures, requirements within law making to assess economic consequences as well as easing administrative burdens for business, especially SMEs. Nevertheless, these efforts could be enhanced if the regulatory policy elements are brought together in a single instrument promoting government-wide regulatory policy. Regulatory initiatives are diffused across federal departments and offices, as well as among cantons. As a result, regulations may not always be enforced consistently across all levels and sectors of government.

2. Strengthen co-ordination mechanisms for regulatory reform.

OECD experience shows that a well-organised and monitored process, with clear accountability for results, is important for the success of the regulatory policy. This can be coupled with effective and credible co-ordination mechanisms to foster coherence across major policy objectives, clarify responsibilities for assuring regulatory quality and ensure capacity to respond to a changing environment. The specific institutional form it takes will reflect the historic and cultural values and context of each country. What matters is the objective. Maintaining consistency and systematic approaches across the entire administration is necessary if reform is to be broad-based and credible.

In the current Swiss system, a wide range of bodies across the federal administration participate in regulatory issues. Efforts have been made in setting up interdepartmental groups to launch programmes linked to regulatory reform, but these efforts have been made on an *ad hoc* basis. However, promoting reform in the long run requires the setting up of effective and permanent co-ordination mechanisms with clear responsibilities and powers to monitor, oversee and promote progress across the public administration. In the Swiss case, these co-ordination mechanisms should reflect the collegial nature of policy-making. This could contribute to strengthen regulatory and management capacities, as a visible sign of the integration of regulatory reform into the decision-making process in all policy areas.

This would bring several benefits to the implementation of regulatory reform in Switzerland. First, it would increase regulatory capacities throughout the administration as a means of systematically ensuring that higher quality regulation is generated. More resources and staff are needed to achieve this goal. Second, it would offer a systematic framework to review new regulatory proposals during the policy development process and to improve their quality. Third, it should improve communications about the benefits of quality regulation, reducing the risks of deadlock. Finally, it could promote long-term regulatory policy considerations, including policy change and development of new and improved tools and institutional change, where timely and appropriate.

3. Strengthen the RIA system with the correspondent capacities, integrating the SME Compatibility Test into it.

OECD experience shows that RIA is a tool that provides decision makers with valuable empirical data and a comprehensive framework in which they can assess their options and the consequences their decisions may have. To fully use the potential of this tool, RIA should be integrated into the decision-making process as early as possible.

In the Swiss case and in its current institutional design, RIA is performed late in the process, which dilutes its effectiveness and importance. RIA could be integrated into the impulsion stage of the consultation procedures, when the administration starts the development of a law proposal.

In order to systematically assess the impacts of regulations in Switzerland, RIA should become mandatory for all kinds of regulatory instruments and not only federal laws and some ordinances. If the use of RIA remains partial, with large parts of the regulatory structure not subject to its disciplines at all, results will not be as effective as they could be. A major challenge is to integrate RIA at cantonal level and this should be encouraged, for example, through improved co-ordination. In terms of the current capacities, however, the scope of RIA should be focused: either the number of “eligible laws” that actually get RIA treatment could be a small proportion of the total or RIA could be implemented with a threshold test.

Some other elements of the current design of RIA should be revised. First, a better structure of the scope of RIA should be proposed. The present understanding in terms of costs is extremely broad and the understanding does not include important elements, such as competition criteria and market openness. A more focused list of questions could help to target RIA in a more effective way. Targeting at regulation with the largest potential impacts and the best prospects for changing outcomes could be an option. Second, data collection has been revealed as a weak point during the preparation of RIA. Improving data collection strategies should be a permanent task of bodies in the administration and

regulators. Third, an inter-departmental co-ordination group should be maintained to improve the effectiveness of RIA. Fourth, increased awareness of RIA inside the administration is needed, not only through training programmes and more visible guidance, but also through the promotion of a cultural change. RIA should be seen as a tool that helps and has an impact in the decision-making process. Finally, human capacities allocated to the RIA system should be reinforced.

The link between RIA and the SME Compatibility Test should be improved. While RIA is intended to provide information on the pertinence of state intervention and which consequences this intervention might have on the economy and the society as a whole, the SME Compatibility Test provides information on how the state has to intervene. The SME Test should be integrated into the RIA, in order to make it more effective. This is used in other OECD countries where business tests are part of RIA, providing invaluable information for the assessment of impacts.

Special attention should be given to the SME Forum as an advisory body. As in other OECD countries, the use of external advisory bodies to government is growing. This institution could become an important actor if it would fully develop its advisory role. An increased visibility could help to increase awareness of the impact of regulations on SMEs. The body should be linked to the regulatory reform process.

4. Strengthen communication mechanisms to inform about reforms.

Given the characteristics of the political system, consensus could be used to deepen the promotion of regulatory policy and to improve the use of tools for regulatory quality. Some substantial elements of regulatory policy, such as RIA requirements and consultation procedures, have been adopted in legislation, which indicates a formal commitment to regulatory policy and the importance attached by the government in a tangible way.

Forward-planning, consultation mechanisms and accessibility to regulations are highly developed in Switzerland. Nevertheless, what regulatory policy is and what it can do are not always clear to stakeholders and citizens. As in many OECD countries, Switzerland is engaged in a real debate on the role of the “regulatory State” and how to manage State-owned enterprises operating in a competitive environment. A communication strategy should explain regulatory quality and its importance.

Communication is crucial to consolidate reform. Consumers are potential winners, but governments need to be honest about expected reform timescales and results, so as not to undermine future support for reform efforts. Governments should also be able to deal with winners and losers because reforms may take time.

5. Improve co-ordination between federal and cantonal authorities to increase effectiveness of regulatory policy.

As in other OECD countries, the sub-national levels of government have important responsibilities for implementation of regulations. The potential for a regulatory policy to achieve its objectives is greatly enhanced if other actors, such as sub-national governments, also take on appropriate roles in implementing the agenda. In Switzerland, cantons are often the main “agencies” for implementation and have their own regulatory capacities. Co-ordination is important not only between the Confederation and the cantons, but also among the cantons, especially in areas where they have responsibilities that are not shared with the federal level.

The OECD experience shows that in some countries, especially federal states, the lack of harmonisation can create unnecessary barriers to the movement of goods and services or generate sterile competition between regions. If co-ordination is lacking, business and people alike can get lost in a maze of contradictory or incompatible standards. The quality of the regulatory framework is a decisive factor of competitiveness today, and will remain so. More co-ordination is thus needed in Switzerland to consolidate an internal market and for preserving the attractiveness of regions.

A major challenge in the Swiss case is to promote regulatory quality at all levels of government, guaranteeing the effectiveness of public policy in a multi-level environment. A useful tool to promote best practice among cantons could be benchmarking. Since cantons are a kind of laboratory where different experiences are put into practice, this could contribute to expand elements of regulatory reform to sub-national levels of government. Benchmarking and regulatory competition among cantons can only be achieved in a more transparent framework, especially in the fiscal ambit and increasing efforts to administrative simplification.

6. Further simplify regulations, procedures and formalities by introducing ICT elements at federal and cantonal level, targeting SMEs.

The Swiss government has followed Parliamentary requests and has undertaken major steps towards administrative simplification and the reduction of red tape. Nevertheless, more intensive programmes to simplify regulations, procedures and formalities are needed, as this strategy can create political constituency, especially among SMEs, to subsequently assist reformers in arguing for the adoption of further-reaching reform initiatives.

The Swiss government should monitor that formalities do not impede innovation and entry, creating unnecessary barriers to trade and economic efficiency. The experience of many OECD countries shows that administrative simplification is key to improving the cost-effectiveness of regulations. Measures tending to simplify regulations and procedures should take into account that if they are poorly designed to achieve policy goals, they can impose substantial unnecessary costs. This is particularly relevant in the Swiss case, as regulations and formalities from multiple institutions and layers of government are of particular importance.

The introduction of different techniques in the context of administrative simplification has not been systematic. They need to consider the whole of existing regulations in order to reduce the cumulated cost of the total stock. One-stop shops targeting certain groups of clients could be extended to other fields at federal and cantonal level. The ICT developed by one canton could be potentially used by other cantons. Evaluation clauses and automatic sun-setting clauses could also be used to force the administration to systematically review texts.

A central challenge for most OECD countries is to enhance the *ex post* evaluation of their regulatory policies, tools and institutions. This is particularly relevant for Switzerland, where the application of regulatory tools at different levels of government should be efficient and effective, in order to support policy makers in improving regulatory outcomes and reduce the risk of regulatory failures. The evaluation of regulatory policy tools can help policy makers of government activities justify their importance and functions on the basis of objective data, to devote resources and efforts to the regulatory reform agenda and to expand the scope and depth of these instruments. The evaluation of regulatory tools and policies should also be seen as an important issue within the broader governance agenda.

Notes

1. Swiss municipalities are small compared to those of other countries. The average population of a Swiss municipality is 2 330, compared to 7 000 in Germany and 30 000 in Sweden.
2. The “Recueil systématique” contains a consolidated version of almost all laws and ordinances. Exemptions are voluminous documents as the tariff code. In these cases, the RS then indicates where the document can be found.
3. Contrôle parlementaire de l’administration.

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PART II
Chapter 3

Competition Policy*

* For more information see the background report on “The Role of Competition Policy in Regulatory Reform” available on the Web site: www.oecd.org/regreform/backgroundreports.

Introduction and context

As in most other OECD countries, Swiss competition policy and institutions have been the subject of a steady development and growing profile over the last few decades. Traditionally, Swiss competition policy has been relatively lenient and low profile, allowing a relatively uncompetitive internal market to remain unchallenged, and playing only a muted role in relation to external competition issues. The development of competition principles which clearly recognise the damage that can be caused by anti-competitive behaviour has been relatively slow.

The impact of competition policy on economic development has therefore been at best neutral. With the emerging issue of slow growth, however, it has been identified as an important factor for improving growth prospects through a more vigorous approach to competition.

Prior to 1985 there was a lenient approach to cartels, although a first law on cartels had been enacted in 1962. A reform was then passed which introduced a distinction between the suppression of efficient competition which could be challenged by the government, and obstacles to competition, which were assessed on a case by case basis. The law was successfully used to dismantle banking cartels, but suffered from a lack of decision making powers and procedural weaknesses.

The Reforms initiated in the 1990s, which aimed at strengthening the competition law, tended to lag those of neighbouring European countries in terms of their extent and speed. The new competition law adopted in 1995, together with the 1995 law on the internal market, sought to lay the groundwork for a stronger competition policy that would, in particular, promote an integration of the extremely fragmented Swiss internal market. The new competition law has brought Switzerland closer to the approach adopted by the EU Commission and many other OECD jurisdictions. These laws have, however, only been partially successful and a revised competition law was adopted in 2003 and entered into force in 2004 (with a period of transition until 2005). The law provides the competition authority with sharper tools, notably direct sanctions and a clemency programme, for pursuing anti-competitive behaviour. The internal market law is currently under revision. Other legal changes are under way to address the issue of protected sectors, under the aegis of the Federal Council's Growth Package.

The new legal framework is quite strong in itself but does not very much address institutional weaknesses for the deployment of the new tools, against a background in which many groups in Switzerland retain an equivocal attitude to competition as a key means of managing market relationships. The structure and staffing of the competition authority does not give it sufficient weight and resources to use the tools that are now at its disposal as effectively as it might. It is also relatively isolated from the network that now links other European competition authorities, which constrains its scope for action on broader regional fronts.

Strengthening the competition law

The objective of the 1995 Cartel Law is “to prevent the adverse economic or social consequences of cartels and other restrictions on competition, and to promote competition in the interests of the market economy based liberal principles”. The law conferred decision-making powers on the competition authority Comco (the power to forbid illicit restrictions on competition), but had weaknesses, notably the fact that sanctions could not be imposed except in the case of a second offence.

A revision of the law was adopted in 2003 which came into force in 2004. Due to a transition period for previous cases, full application started in April 2005. It seeks to address the weaknesses, and to align Swiss competition law closer to the EU (and broader OECD) framework via:

- Introduction of financial sanctions (up to 10% of turnover of the past three years) which may be imposed for the more serious violations of the law (hard core cartels, abuse of a dominant position).
- Introduction of a clemency programme linked to reduced or exempt from fines.
- A new presumption of illegality for vertical agreements made between enterprises regarding prices and the allocation of distribution areas which exclude other suppliers.
- A new approach allowing SME agreements under certain conditions.
- New investigation procedures.
- A requirement on Comco members to declare their interests.
- New provisions that seek to tighten up the institutional scope of the law, which is now applicable to both public and private law enterprises.

Cartels

In contrast to many other OECD jurisdictions, the Cartel Law rests on the principle of determining abuse rather than outright prohibition of agreements. This puts the burden of proof on the competition authorities to prove that there has been abuse. The law in this respect has had a limited effect, compared with a more ambitious reform. Comco has prohibited eleven horizontal cartels, and agreed six “*accords amiables*”. Most have been of limited economic significance. It has also only prohibited a limited number of vertical agreements, although the latter are widely considered to be a main reason behind prices differences between Switzerland and other countries, and a major obstacle to SME competition. Some agreements that have been condemned by the EU Commission, such as automobiles, have been allowed by Comco. For some time now, Comco does nonetheless recognise that vertical agreements raise major issues, notably as regards parallel imports and resale agreements, and promulgated a communication (*CommVert*) in 2002 which is very close to that of the EU on which it seeks to base its approach. The relatively small number of cases may be explained by the fact that – in the absence of direct sanctions – Comco tended to favour “*accords amiables*” before the most recent reform entered into force.

Abuse of a dominant position

The legal framework for this issue is a little weak. Legal provisions are close to those of the EU. But the number of decisions is small, making it difficult to see when there is abuse of a dominant position and what behaviour may be justified for “legitimate business reasons”. The 2003 revisions have sought to tighten up the intent of the law, with specific

reference to the need to consider structural issues (not just the market structure, but also market relationships) and with a more specific definition of a dominant enterprise. It is not yet clear how effective these changes will be in practice.

Mergers

Merger control was first introduced with the 1995 law. The Swiss regime is more permissive than that of many other OECD countries. Comco may forbid a market concentration, but the law also provides for it to allow a concentration which creates a dominant position if it improves the conditions of competition in another market which outweigh these disadvantages. In essence only mergers that may eliminate, rather than adversely affect, competition may be forbidden. Only one merger has been forbidden by Comco so far, although pre notification of mergers has led some firms to abandon their merger plans, while others were subject to conditions.

Unfair competition

Unfair competition is not covered by the Cartel Law but by a separate Law on Unfair Competition (*loi Fédérale sur la concurrence déloyale* – LCD), which concerns unfair commercial practices and unfair competition which affects the relationships between firms as well as the relationships between firm and consumers. As unfair commercial practices are covered by private law, neither the Comco, nor the Confederation or the cantons are in the position to initiate action in this field. However, consumers and their associations as well as firms may bring action. Nevertheless, the Confederation may bring civil and criminal action in the case of unfair commercial practices across borders, particularly when the consumers entitled to take action are residents abroad. The law is especially oriented towards the protection of consumers.

Consumer protection

Effective consumer protection is based as much on relevant regulation as on competition law, including high standards that not only support international competitiveness but also better products for consumers including the EU. Swiss consumer protection is less closely connected with competition issues than many other jurisdictions. Comco has no direct responsibilities for consumer affairs, although a consumer representative sits on its board. Overall, and despite a range of legal and institutional structures, consumer protection does not appear to rank as a high priority.

Private law covers consumer issues that arise between citizens. Contractual relationships are covered by a Federal law, the Code of Obligations (*code des obligations*). The court system only intervenes if a civil action is brought, and operates through the cantons. Each canton has its own procedure, but must establish a simple and speedy conciliation or judicial procedure for smaller cases below a certain financial threshold. Public law puts requirements on suppliers, and the public authorities are responsible for initiating any actions. Two federal entities, the Federal Consumer Bureau and the Federal Consumer Commission, advise the federal authorities on consumer affairs. There is also the Price Supervisor, also attached to the department of Economic Affairs, which monitors prices. A number of consumer associations are active and obtain limited financial support from the government.

Competition policy institutions and enforcement¹

Comco: A structure in need of strengthening

The Swiss competition authority is made up of the Competition Commission (*Commission de la concurrence* – Comco) and its secretariat. Comco takes the decisions and the secretariat investigates. Article 18 of the Cartel Law stipulates that Comco takes any decisions that are not expressly reserved for another authority. Comco is also generally responsible for ensuring that the Confederation, cantons, municipalities and other public sector entities take account of the Internal Market Law.

Comco's structure is based on the Swiss *milice* tradition. Its members devote only part of their time to its work, and have another main occupation. The Federal Council nominates the members, of which there are up to fifteen. Most are independent experts, meaning that they do not represent any particular interest group. Membership is currently fifteen, of which six represent special interest groups (including associations of industry, trade unions, retail, consumer and agricultural interests). Members may have positions on company boards (many do) though they must declare their interests. Comco is divided into three chambers: services, manufactured products and infrastructure. The Comco secretariat has around 45 staff with civil servant status. The Federal Council designates the director of the secretariat, and Comco covers the rest. It is divided into three sections corresponding to the three Comco chambers.

Comco's current institutional structure is weak in international comparison. Its method of staffing which rests on a part time board and especially, on a proportion of board members who represent special interests, has raised considerable controversy for a number of years.² The sanctions and clemency provisions of the amended Cartel Law highlight the difficulties of staying with this approach. Conflicts of interest may arise, for example in relation to the imposition of sanctions which may affect an enterprise that belongs to one of the interest groups represented on the Comco board, as well as in the application of the clemency programme which may require the denunciation of a company whose interests are represented, *e.g.* by an umbrella organisation. The predefined procedure for disqualification of members of the Commission in case of personal interests resolves some, but not all conflicts of interest that can arise. The federal government sought to reduce the number of members, and to remove special interest representatives as part of its proposals to amend the Cartel Law. But this was fiercely resisted, and abandoned in order to assure passage of the reform.

The link between Comco's secretariat and the Economy ministry remains a close one, despite the formal separation set up under the 1995 Cartel Law. For example the secretariat supports the Economy ministry's general secretariat on certain issues such as the preparation of parliamentary replies. This may help with competition advocacy across government, but it also creates a grey zone in which the independent view of the competition authorities may not emerge very clearly. Also, current procedural mechanisms do not clearly distinguish Comco's activities from those of its secretariat, in other words between the investigative activities linked to a case and the judgement made on it, which is not in line with international best practice, and may raise difficulties under the European Convention on Human Rights.

One very positive feature is the openness with which the competition authority communicates decisions and makes information available. Comco's decisions and those of related authorities such as the Price Surveillance Authority are published five times a year

in a review, and their Internet sites are well presented. Comco put significant effort into communicating the implications of the recent Cartel Law revision to enterprises.

Price Surveillance Authority

The Price Surveillance Authority (*Surveillant des prix*) plays an important role for consumers through price monitoring. It is responsible for preventing price increases and abusive price fixing by cartels and dominant enterprises, with a particular focus on public authority price controls (areas that are generally beyond the remit of the competition authority, although there are investigations into the same markets). Action is usually taken with the consent of the interested parties, but if this does not work, fines can be imposed (up to CHF 100 000). The head of the Authority is political, normally a member or former member of Parliament. It has limited resources which cannot extend to permanent monitoring so must be selective in its targets. The federal government is currently debating a reduction of the number of administered prices which fall under its remit.

Enforcement

A distinction needs to be made between procedures related to restrictions on competition, and procedures for merger control. As regards the former, the competition authorities may decide to open an enquiry, which cannot be contested. No distinction is made between foreign and domestic firms. Enquiries may be launched at the request of third parties such as involved firms, and are publicly announced. Comco decides on the course to follow upon advice of its secretariat.

The Comco secretariat may propose a friendly settlement (*accord à l'amiable*) if it considers that there is an illegal restriction on competition. Such settlements were often used before the most recent reform of the cartel law, since direct financial sanctions had not been possible then. For merger control, notifiable mergers that may be expected to create a dominant position are carefully reviewed by Comco. It considers the likely effects on geographic and product markets. A market is considered to be "affected" if the share of the Swiss market held by two or more firms is over 20%, or if the market share of one of the firms is 30% or more. Three criteria are used in the analysis: current competition, potential competition, and the market power of the firms. The methods of investigation and for acquiring information are relatively weak, especially for hard core cartels. The law is a little unclear on the scope of the tools that are available to the competition authorities.

The 2003 revision of the law introduced direct sanctions for the first time. They are applied administratively, as fines, which may be up to 10% of turnover of the past three years. Exemptions may be granted, in particular under the terms of the clemency programme, which is also new, inspired by the practice of other OECD countries. This applies if a company collaborates with Comco to uncover a cartel. It was the subject of considerable controversy because this type of arrangement is not in the Swiss judicial tradition. Appeals against Comco decisions go to a specific competition appeals tribunal in the first place, but may be referred to the Federal Supreme Court. Cantonal civil courts may also be invoked, but cases brought to civil courts are in fact very rare.

International relationships

Comco, as well as SECO, engage in significant international collaboration, including within the OECD and the ICN (International Competition Network). It nevertheless suffers from a relative international isolation, as agreements are *ad hoc* and no formal agreements

are in place to co-operate with other competition authorities over cases with an international reach. Informal collaboration is increasingly inadequate because it usually does not extend to the exchange of confidential information. The issue is especially acute with the EU, whose 25 competition authorities are now in close and regular contact with each other through the European Competition Network.

Resources and priorities

Resources are low in international comparison, which limits the scope for making full use of the amended law's provisions. This is borne out by the evidence of recent Comco activities. Relatively few decisions have been handed down in relation to cartels and abuse of dominant positions. That said, more effective investigations have probably encouraged some enterprises to desist from activities that would otherwise have been formally pursued; and substantial efforts have been made on issues of market concentration, to the detriment of work on anti-competitive practices. A planned increase in staff reflecting the expected greater workload of the amended law has not fully materialised.

The limits of competition policy: exemptions and special regulation

General exemptions

The Cartel Law provides for four types of general exemption:

- General exemptions set out in Article 3 relating to other legal provisions. Legal provisions which do not allow competition in a market for certain goods or services take precedence over the Cartel Act if they establish an official market or price system or entrust certain enterprises with the performance of public interest tasks, granting them special rights. However Comco must clarify, for each case, whether the law allows some competition, and an exemption only applies where the law explicitly rules out competition. In practice this has meant partial exemption for agriculture, healthcare and network industries governed by specific regulations. A recent court case has tested the exemption for electricity, concluding that a general service provision in itself does not preclude the application of the Cartel legislation.³ The Act does not apply to effects on competition arising exclusively from intellectual property law, though the recent reform provides for its application to import restrictions based on IPR, a provision aimed at allowing certain parallel imports of products protected by a patent. In practice, the conditions for application of the Cartel Law must be assessed case by case, so market opening for parallel imports remains patchy. Introducing the principle of international exhaustion in patent law (or at least, regional exhaustion in Europe) would be a more effective measure against restrictions on parallel imports.
- Agreements significantly affecting competition that may be declared lawful if they are justified on grounds of economic efficiency. The conditions for this may be set out in ordinances or communications. Both general forms of co-operation (such as for R&D) or sector specific co-operation (such as in financial services) are possible. Comco has issued four communications to date.
- Abuses of dominant position that may be deemed lawful if they are justified for legitimate business reasons. The Cartel Law does not have any specific provision for this, but the federal message attached to the law sets out the principle of legitimate business reasons. No abuse has yet been found to be justified under this provision.

- Exceptional authorisations by the Federal Council on the grounds of compelling public interests. These can be granted for cartels and abuses of dominant position, and business concentrations. They are of limited duration and may be granted conditionally. The Federal Council has so far only been approached twice for this (regarding a prohibition of the printed music cartel, and a prohibition of an abuse of dominant position in the electricity sector). The cartel was prohibited in the first case, and the parties withdrew their request in the second.

Sectoral exemptions

Electricity.⁴ Reform of this sector to improve efficiency is essential. The market structure is made up of large vertically integrated companies as well as numerous regional and local distribution monopolies, mostly in public ownership and, mostly, *de facto* monopolies. Reform proposals failed to win the popular vote in 2002 and a new set of proposals is currently under discussion in Parliament. These would introduce competition via regulated third party access to the grid, and establish independent system operation and independent regulation. The proposals broadly follow EU provisions for electricity market opening. This is a welcome and necessary development even if some provisions aimed at securing universal service could distort competition. Pending the reform, Comco has been active in this market, notably in setting conditions for the establishment of Swissgrid as a system operator formed out of the dominant grid companies, and in paving the way for third party access via a ruling that found a refusal to allow negotiated access to represent an abuse of a dominant position (the EEF/WATT case).

Gas. A fundamental reform has not yet started in this sector, which is complementary to electricity. The potential to deploy natural gas more systematically has been overshadowed by the efforts to reform other infrastructure sectors. Reform plans were shelved in the wake of the unsuccessful 2002 referendum on electricity reform. The Pipeline Law, dating back to 1963, provides the legal basis for negotiated third party access to the high-pressure gas grid and assigns the Swiss Federal Office of Energy (SFOE) the function of arbitration. On this basis, in 2004, the Swiss gas industry established a self regulation system for third party access. No complaints have been addressed so far to the SFOE. Comco has not to date launched any enquiry into potential abuse of market power in a sector that is characterised by dominant or monopoly structures both for imports and for internal supply. Prices remain significantly higher than the OECD average. Gas already accounts for 12% of energy consumption, but the market is almost exclusively oriented toward large industrial and commercial consumers: there is virtually no gas in power generation and only a small share of household consumption. Switzerland imports it from a range of countries including the Netherlands, Russia via Germany, and Algeria via Italy. It is also a major transit route for gas imports to other European countries. Privately-owned Swissgas accounts for three quarters of imports. The internal market is controlled by *de facto* cantonal and municipal monopolies, which own the majority of gas supply enterprises, including the seven largest which account for 50% of the market. The Swiss gas industry has already taken steps to allow third party access to the high-pressure gas grid, as mentioned above. Reform would be desirable to secure a more efficient performance via greater competition, and to set the scene for a potentially wider use of gas in the energy mix.

*Telecommunications.*⁵ Liberalisation of this sector is fairly well advanced, having started in 1996. Unbundling the local loop, which is important for high speed data transport as well as wireline telephony, is a major remaining issue. The Parliament is currently debating the issue.

*Postal services.*⁶ Reform has divided the market into three segments: reserved services, non-reserved services, and liberalised services. Universal service made of reserved and non-reserved services to be provided by the incumbent on the whole territory is monitored by a newly established regulator, PostReg, but the Confederation owns the Swiss Post and is responsible for PostReg, an obvious conflict of interests. Further reform is needed.

*Rail transport.*⁷ Reform started in 1999, based on EU developments. Significant liberalisation of merchandise transport and on conventional freight traffic has taken place. The next EU reform package, which Switzerland is tracking, provides for complete liberalisation of goods transport, and eventual tendering of passenger transport in regional transport. Infrastructure financing mechanisms are also due to be harmonised. Meanwhile Swiss reforms appear to have done well so far, in terms of competition. Some changes to the regulatory institutional structure are needed.

Financial services. A key competition issue for this sector is the regulatory framework. A plan to introduce integrated supervision of financial services is due to go before Parliament based on the principle “same business, same risks, same rules”. This would replace the current fragmented arrangements which consist of several supervisors. These distort competition because the same financial services may be treated differently depending on whether they are banks or insurance companies for example, and because some sectors are not covered at all. A few exceptions have been justified by a desire to avoid excessive regulation of small entities, though this should be monitored. The most important recent merger case for its effects on banking structure was the 1998 merger of *Union de banques suisses* (UBS) and *Société de banques suisses* (SBS), which Comco authorised subject to conditions. Competition issues in this sector also arise with the publicly-owned cantonal banks, which benefit normally from public guarantees. Comco has made proposals for a tighter approach to this competition distorting issue, many of which were picked in recent legal changes. Finally, fire insurance is a cantonal monopoly in most of the Swiss cantons, and a debate about abolishing these monopolies has continued for some years. Comco’s investigation of private fire insurers did not find any unlawful behaviour by private insurers. The investigation showed however that cantonal monopolies charge lower premiums than private insurers in cantonal markets where competition is possible. This result was explained by lower marketing costs of the cantonal monopolies and the fact that they do not always have to calculate the full costs for their capital at risk.

Health services and pharmaceuticals. Reforms of the legal framework are needed to stimulate more competition in health services. Swiss health insurance consists of mandatory basic insurance and optional additional cover, which may be taken out with private insurers. Under the law, health insurance funds must accept any provider, and there is a premium system for each insurer and region leaving some discretion with the person insured to decide what amount he wants to spend fully out of his pocket in a year. The detailed workings of this system do not encourage competition between health providers, against a background in which health care markets generally are difficult candidates for effective competition. Swiss prices for health care are high in international comparison. Reform proposals are currently being debated in Parliament. Comco has meanwhile proposed abolition of the obligation to contract in the ambulatory and hospital sectors, so

that price competition between providers could evolve. The other major issue is pharmaceuticals. Several proposals have been made for change, given very high Swiss prices in this sector. The Price Inspector has recently queried the practices and rules applied by the Federal Office for Health and has made recommendations to this authority which is in charge of setting maximum reimbursement prices for drugs. In the meantime, Comco has recommended to the Federal Council adoption of the principle of international exhaustion of patent law to favour parallel imports (which was rejected). Comco also prohibited the Sanphar drugs cartel in 2000, which provided for a detailed regulation of prices.

Agriculture. Some reforms are underway in this highly subsidised and relatively closed sector. Swiss aid is the highest in the OECD, and in 2003 state subsidies were equivalent of 74% of gross revenue attributable to agricultural output (double the EU average and almost two and a half times the OECD average). The place of competition is uncertain as Swiss public policy identifies two conflicting objectives for the sector: economic and environment related which need to be reconciled with significant direct payments. According to the Federal Law on Agriculture, the Confederation needs to “ensure that agriculture contributes substantially to a secure supply of the population with a production meeting the requirements of sustainable development as well as of the market, to the preservation of natural resources and landscape, and to decentralised settlement across the national territory”. From a competition perspective, there are differences between sectors. Further reforms are taking place, via the second package of bilateral agreements with the EU, together with some internal proposals (“politique agricole 2011”) to cut internal market support by half through the abolition of all export subsidies.

Competition advocacy for reform

Comco’s role

One of Comco’s missions is to promote competition. It does this in three main ways. The first is through continuous monitoring of the competitive situation, which may lead to recommendations addressed to the different levels of government. The second is through opinions on draft federal legislation that limits or influences competition, delivered in the framework of general consultation procedures. The third is through expert advice to other authorities on questions of principle relating to competition. Comco has made a dozen or so recommendations, mainly to the Federal Council, though most have not been taken up by the relevant authorities. This tool might have been deployed more broadly on key recent issues such as the adoption of the “Cassis de Dijon” principle for market opening, where Comco expressed support in its annual report but did not yet issue a recommendation. Comco will be able to express a position on the draft law during the consultation process. It has also issued a number of opinions, mainly related to telecommunications, energy and healthcare. Finally, it is involved in working groups on the reform of important laws relating to competition (for example the revision of the Internal Market Law).

Internal market⁸

The 1995 Law on the Internal Market seeks to eliminate restrictions on market access introduced by cantons and communes. Comco is responsible for monitoring compliance with the Law and can address recommendations to the cantons or municipalities, as well as provide expert advice. The Law does not give Comco powers to issue binding decisions. The Law has proved relatively weak in practice so far and a revision is underway. This reform might usefully have given Comco a right to intervene actively against restrictions

on market access, rather than a right of recourse which may not be easy to take forward. Still, the reform is progress, when compared with the restrictive interpretation of the initial law by the Federal Court.

Public procurement⁹

Comco's secretariat has played an active part in work to reform public procurement law. Opening up of public procurement does not seem to have gone very far in practice, despite a legal framework based on WTO commitments, a Swiss/EU agreement, and domestic laws, ordinances and agreements among cantons that lay down key principles and detailed rules. An institutional structure has also been established, with the Confederation/Cantons Government Procurement Commission which is responsible for ensuring that Switzerland complies with its international undertakings, and a Government Procurement Appeals Commission to deal with complaints relating to federal contracts. But as complaints relating to cantonal contracts are handled by their courts and may be appealed to the Federal Court, this can give rise to contradictory decisions. As well, there is the problem of not wholly harmonised procedures across the cantons, and differing procedures for tender between the cantons and the federal level. The practical effectiveness of the legislation is based on the right of recourse, and there is the deterrent of high costs in taking this route. Changes are under discussion.

Technical barriers to trade¹⁰

The 1995 Technical Barriers to Trade Law was designed to eliminate technical barriers to trade, but administrative and technical regulations in such areas as production, packaging and labelling still raise obstacles for importers, and help to keep Swiss prices high. A business survey carried out by the Comco secretariat showed the continued existence of many rules in the food and near food (such as cosmetics) sectors. Application of the "Cassis de Dijon" principle would make a significant difference and the Federal Council has approved this in principle as regards imported goods from the EU. The most effective approach to remaining barriers would be a combination of harmonisation and mutual recognition. The Internal Market Law reforms should help as it will give enterprises the possibility to complain about different application of federal rules across cantons.

Recommendations

1. Ensure that Competition Commission members are economically and politically independent.

The financial and political independence of Comco is not now guaranteed, because of the potential for conflict inherent in the current system (in which members can include representatives of interest groups and corporate directors). Sanctions and the leniency programme have compounded the problem. Disqualification procedures and a register of members' interests are only partial solutions that cannot guarantee complete independence. The presence of interest group representatives may also undermine the cohesion of the Commission, in particular when they publicly contest Comco's collegiate decisions on the grounds that they are not in the interests of the groups they represent. The law states that representatives of interest groups must be in a minority. The Federal Council appoints a "substantial" minority of such members. Under the Cartel Act as it stands, the Federal Council could considerably reduce the number of interest group representatives and then propose an amendment to the law that would confine the

Commission to independent members only. A drastic cut in the number of Comco members would also promote decision-making mechanisms. Hence the need to look at the extent to which membership activity should be increased to ensure that it operates on an optimal basis. In addition, a clearer separation between the activities of the Comco Secretariat and the Federal Department of Economic Affairs would also ensure greater clarity as to the competition authorities' powers and activities.

2. Draw up rules of procedure specific to the law on cartels.

Currently, cartel procedures are subject to the general provisions of administrative law. However, these rules are not geared to the specific features of competition law. To ensure that the law on cartels remains effective, it needs its own rules of procedure.

3. Increase the competition authorities' resources.

The competition authorities are given limited resources in relation to their statutory tasks, especially as they have to monitor also compliance with the Internal Market Act. A substantial increase in Secretariat resources would make it possible to intensify and extend investigations, while making procedures as short as possible. This kind of development would be crucial in enabling Comco to assume the powers given to it by Parliament.

4. Develop international co-operation in competition matters.

The Swiss competition authorities are relatively isolated, whereas many anticompetitive practices and many mergers have an international dimension. The relative isolation of the Swiss authorities has increased since the creation of the European Competition Network, bringing together the national competition authorities of the 25 member States of the European Union. The effectiveness of Comco's activities should be strengthened through international competition agreements.

5. Replace the principle of preventing abuse by that of prohibiting cartels.

The principle of preventing abuse means that sanctions cannot be systematically imposed for any breach of the Cartel Act and tends to slow down Comco's investigation and decision-making processes.¹¹ The principle of prohibition, which exists in many other countries' competition law, should be firmly established in Swiss competition law. The introduction of a prohibition system would send a clear signal of a change of paradigm in Switzerland with regard to cartels.

6. Strengthen competition in a number of regulated markets via increased co-operation between Comco and sectoral regulatory authorities.

Comco is now consulted in advance in certain cases concerning the determination whether a firm has a dominant position. It would seem desirable to bring together even more the work of Comco and of sectoral regulatory authorities, with systematic bilateral consultations in cases about competition in these sectors. Moreover, regular informal consultations could improve the overall coherence of the implementation of competition policy.

7. Reconsider the role of the price supervisor and consumer protection.

In the context of ongoing regulatory reform, especially the liberalisation and privatisation of various activities, the issue of price monitoring should be addressed. If

some of the Price Supervisor's activities are deemed necessary, consideration should be given to the appropriateness of the separation between that authority and Comco and the most effective solution in a context of limited resources. The organisation of consumer protection should also be strengthened and the implications of possible integration into Comco should be examined.

8. Ensure an ambitious reform of the Internal Market Act.

The creation of a genuine single market in Switzerland would do much to stimulate actual and potential competition in many sectors protected by various cantonal barriers. This means getting the cantons to realise that it is in their medium- and long-term interest to create such a market even if it means risking short-term disaffection fuelled by the loss of situation rents.

9. Continue to increase competition in public procurement.

The opening up of public procurement has not gone far enough, mostly because of differences in rules, thresholds, awards and appeals that affect the transparency required for competition to be truly effective. Efforts should continue to enforce existing regulations more effectively and to limit the possibilities for splitting up public procurement contracts so as to avoid competitive tendering. The legal protection available through appeals against non-competitive awards should also be improved.

10. Accelerate and strengthen regulatory reforms targeting sheltered sectors.

Reforms could be more ambitious and could be accelerated in many areas, such as healthcare, agriculture and infrastructure (especially the gas, electricity and transport sectors). This could be done through consulting with Comco in advance when planning such reforms, as well as through closer collaboration with sectoral authorities.

11. Open up markets to more international competition.

Although the average import penetration rate in the manufacturing sector is similar to that of comparable economies, the degree of openness for all goods and services is not particularly high given the size of the economy, price levels and transport costs.¹² Moreover, since the early 1980s, the Swiss economy has opened up to international trade more slowly than the smaller EU countries. Adoption by Parliament of the recent Federal Council proposal to introduce the principle of "Cassis de Dijon" for trade in goods between Switzerland and the EU would be a fundamental signal and means of strengthening competition in domestic markets. In addition, increased openness to parallel imports through a modification of the federal patent law, whether internationally (as recommended by Comco) or regionally by negotiating an agreement at the European level, could also significantly stimulate price competition in some sectors.

Notes

1. Regulators are covered in Chapter 5.
2. A 2000 report by the Parliamentary control commission over the administration noted "the situation raises the issue of Comco's independence. It is to be feared that Comco members, acting as representatives of special interest groups, will favour the interests they represent to the detriment of competition considerations".
3. See Part II, Chapter 6, Electricity Reform, for more details on this (the EEF/WATT case).

4. See Part II, Chapter 6, Electricity Reform, for more details.
5. See Part II, Chapter 5, for more details.
6. See Part II, Chapter 5, for more details.
7. See Part II, Chapter 5, for more details.
8. See also Part I for a review of the issues.
9. This issue is also covered in Part I and Part II, Chapter 4.
10. This issue is also covered in Part II, Chapter 4.
11. OECD (2004), *op. cit.*, p. 113 and p. 146.
12. OECD (2004), *op. cit.*

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PART II
Chapter 4

Market Openness*

* For more information see the background report on “Enhancing Market Openness through Regulatory Reform” available on the Web site: www.oecd.org/regreform/backgroundreports.

Introduction and context

An economy dependent on open trade

The link between the domestic regulatory environment and international market openness is a strong one. With the reduction in tariff barriers over time, market access is increasingly affected by national regulations. The impact of the latter on the cross border flow of goods and services is especially important for a country like Switzerland whose economy is significantly dependent on open trade. Swiss international trade in goods was equal to more than half of GDP in 2003, and combined trade in goods and services totalled 81% of GDP. With a trade surplus of nearly USD 4.3 billion in 2003, Switzerland's current account surplus was USD 43.3 billion, equal to 13.5% of GDP. The global competitiveness of Swiss export industries depends in part on a smooth inward flow of goods, services and investment, which is not weighed down by costly regulation. At the same time, Swiss domestic firms need an efficient regulatory environment so as not to be disadvantaged in relation to foreign competitors benefiting from low cost regulation in their own country. An efficient regulatory environment and a strong internal market also act as buffers for limiting the effects of external shocks such as global economic slowdowns.

An important trade relationship with the EU

Switzerland has an intensive trade relationship with the EU, its largest trading partner by far, which has developed quite sharply over the last twenty years. The EU accounted for 63% of Swiss exports and 83% of imports in 2004. The US was the single largest non-EU trading partner (11% of Swiss exports and 4.3% of imports). The rise in importance of the EU as trading partner could be complemented by a more focused effort to develop trade with other partners. The advantages that flow from the preferential trading arrangements with the EU should be balanced by an assessment of the advantages that would accrue from a stronger trade relationship with other dynamic economies.

Swiss trade is dominated by manufactured products. It is mainly an importer of primary and intermediate goods, and an exporter of final goods. Trade in services, which account for nearly three quarters of domestic activity, accounts for just over a fifth of total Swiss trade. This trade, which is in surplus, is overwhelmingly dominated by financial and "other business" services, far exceeding their relative importance in the domestic economy.

Outflows dominate in Foreign Direct Investment

The Swiss market is, overall, hospitable to Foreign Direct Investment (FDI), but it could be improved if internal regulatory and competition issues were tackled. FDI is hampered by the fragmented internal market, which prevents foreign investors from reaping economies of scale, and by anti competitive practices which are difficult to sanction. FDI outflows are stronger than inflows. Swiss accumulated assets overseas are roughly twice those of domestic Swiss assets owned by foreign investors. There is an accumulated net investment outflow (deficit) in respect of every FDI destination. Deficits had continued uninterrupted

since 1987, but there has been a recent reversal of the trend, largely due to a one off surge of investment from the EU. FDI inflows are mainly from OECD countries, especially the EU, and with the US as the largest single investor. FDI outflows are also mainly to the OECD, but with a rapid build up over the last ten years outside the OECD. Inward FDI is highest in the services sector.

Growth problems linked to market openness

Switzerland's current growth problems can be linked to problems with market openness and deficient product market competition. Strong indirect evidence of this can be found in the average 40% difference in price levels compared to the EU. The 2004 World Competitiveness Report (WCR) survey ranked the openness of the Swiss economy a low 50 out of the 60 countries covered based on the question "Does protectionism in your economy negatively affect the conduct of your business?". It also ranked Switzerland among the lower half of surveyed countries as regards relocation of future production as a threat to the future of the domestic economy. The OECD's Product Market Regulation database echoes these findings by ranking Switzerland among the bottom third in terms of regulatory openness to foreign trade and investment. There is, in short, substantial room for necessary progress to ensure that Switzerland's traditional open trade policies continue to bear fruit for the economy.

Reforms to address the slow growth problem centre around a Growth Package of seventeen measures approved by the Federal Council. Much of this package seeks to develop a more integrated internal market and more effective competition, based on internal structural and regulatory reforms. The external dimension of reform is also pursued. The strategy of the Federal Council under foreign economic policy in the years to come rests on three pillars: Securing and extending access to foreign markets based on a set of internationally agreed rules, making the domestic economy more competitive, and supporting trading partners in their economic development. Within the first pillar, it is recognised that small open economies are best served by a firmly established multilateral framework for trade relations and the pursuit of regional economic integration is indicated. The risk of discrimination is identified given the extension of the networks of preferential trade agreements. The recipe here is seen in engaging in similar negotiations. As all these negotiations extend well beyond merchandise trade and cover trade in services, foreign direct investment opportunities and trade in intellectual property rights, and internal reform is considered requisite to a successful conclusion to these negotiations.

The policy framework for market openness: the six efficient regulation principles

Market openness refers to the ability of foreign suppliers to compete in a national market without encountering discriminatory or excessively burdensome or restrictive conditions. With the fall in tariff barriers, the impact of domestic regulation on international trade and investment has become more important. In a global economy, regulations need to be market oriented and friendly toward trade and investment. Six "efficient regulation principles" for building these market openness qualities into regulations have been identified by the OECD in its 1997 *report on regulatory reform*, and further developed in the Trade Committee. They reflect the principles underpinning the multilateral trading system, and are reviewed below.

Transparency¹

Transparency in this context means openness of decision making and of appeal procedures. Market openness requires that all market participants be fully aware of regulatory requirements so that they can base their decisions to invest, produce and trade on an accurate assessment of likely costs, risks and benefits. This is especially important for foreign firms, which have to cope with differences in the business environment, such as language and business practices. Transparency requires access to information on regulations and openness of the rule-making process through public consultation. Foreign parties also need the security of knowing there are accessible and effective appeals procedures. The handling of public procurement and of technical regulations represents an important specific area for transparency.

Well developed access to information

The availability of information on existing laws and regulations is well developed, including through the Internet which is especially helpful to foreigners, and still improving. The 2005 Law on Publications clarifies the situation for the dissemination of existing rules. In Switzerland, procedures for developing new laws are also carefully and comprehensively laid out. An important new Law on Transparency is due to come into effect in 2006, which will improve the right of access to official documents.

Strong and non-discriminatory consultation mechanisms

The practice of consultation is a major feature of the Swiss regulatory governance system. There is no explicit provision for foreigners to be part of the procedures, but this does not appear to be an issue. Foreign businesses with a domestic presence are regularly allowed to join Swiss trade associations that are a key part of the consultation network. A number of bilateral Chambers of Commerce exist and foreign banks in Switzerland have their own organisation. The cantons, which are significant rule makers in their own right, operate their own procedures. As they have strong formal rights of participation in federal law making, this adds to the local perspective in rule making. In the same vein, the system of semi direct democracy via referenda is an important influence on law making, often slowing decision making but also contributing to high levels of compliance with new rules once they are agreed.

Open appeal procedures

There is no explicit general guarantee for appeals by foreign firms, but as with other aspects of rule making and management, they are treated essentially the same way as domestic firms. To start action in court, both have to claim and show that an authority's decision affects them in rights deriving from law and procedural guarantees. If a law in preparation appears to discriminate against foreign firms, the latter may address their concerns to the State Secretariat for Economic Affairs (SECO – part of the department of Economic Affairs), via their government representatives, and directly to the cantons and municipalities. Some important sector specific laws (including government procurement) have provisions that preclude discrimination between domestic and foreign firms based on agreements to which Switzerland is part.

Transparent technical regulations and standards

This is an especially important area for firms facing divergent national product regulations. Under the Law on Publication, all technical regulations at the federal level must be published in print and electronic form, with similar provisions at cantonal level, before they come into force. They are generally available in German, French and Italian, and available on Internet, hence abroad. In addition to its domestic provisions, Switzerland provides information and an opportunity to comment on draft technical regulations to its trading partners, in line with its obligations under the WTO. Swiss notifications under the WTO agreements on Technical Barriers to Trade (TBT) and Sanitary and Phytosanitary (SPS) measures, containing a summary as well as the full text in French and German, appear on the WTO Web site. Foreign firms can offer comments via their national authorities to centralised Swiss enquiry points established under the WTO TBT and SPS agreements. There is no obligation on the Swiss authorities to respond, however. These arrangements take place in parallel with the domestic consultation process.

Public procurement is a weak spot

Public procurement shows a less positive face. Switzerland's ranking in terms of openness as measured by the WCR across 60 countries fell five places to 50th place between 1995 and 2004. The problem is directly related to the existence of 26 different regulatory regimes at cantonal level (one per canton). Aware of the problem, the government has included public procurement reform in the seventeen measures for growth. For now, however, procurement rules are mainly aimed at ensuring conformity with Swiss international obligations.

The current legal framework at federal level is the 1994 Law on Government Procurement, and related ordinance. The legislation reflects Swiss obligations as a member of the WTO Agreement on Government Procurement (GPA), including adjudication processes and appeals procedures for contracts above threshold levels beyond which federal procurement must be open to "GPA covered" foreigners. Several institutions cover procurement issues. The Purchasing Commission of the Federal Government (BKB) is the overall co-ordinating body for goods and services, while the Co-ordination of Federal Construction and Real Estate Services (KBOB) groups the contractors at the level of the Confederation. The Government Procurement Commission-Federal State-cantons (KBBK) acts as a bridge between the federal and cantonal levels. At the level of cantons and municipalities, the Swiss Conference of the Cantonal Directors for Public Works, Land Management and Environmental Protection (BUPK) has set up an inter cantonal government agreement ("concordat") which lays down the essential elements for government procurement legislation for goods, services and construction at the cantonal and communal level. The internal market law also provides guarantees for non-discrimination at sub-federal level.

Government procurement of goods, services and construction accounted for a significant 8% of Swiss domestic consumption in 2000, and some 25% of total government spending (19% Federal government, 38% cantons, and 43% municipalities). There is scope for improving the procedures for tender that has significant potential to improve economic performance. Some reforms have already been made. The ordinance attached to the 1994 Law was strengthened in 2002 consequent to the conclusion of an agreement with the EU on public procurement requiring all private and publicly-owned companies in utilities operating on a concession (i.e. exclusive rights) to make bids above CHF 250 000 public.

Similar steps were taken by a reform of the inter-cantonal agreement, harmonising among cantons threshold values for rendering public calls for offer on the same occasion. Government procurement announcements will soon be more widely disseminated by improved announcements on the Internet (*simap.ch*), as required under the Swiss-EU bilateral agreement.

But more is needed. It is somewhat surprising that at the cantonal and municipal levels, unsuccessful bidders for government procurement contracts may request and receive an explanation for an unfavourable decision, while there is no such provision at the federal level. Appeals processes in particular need to be strengthened. Despite the establishment of a Government Procurement Appeals Commission (CRM) for the implementation of GPA, and cantonal appeals procedures, a 2002 parliamentary study highlighted a number of shortcomings. The cost of appeals processes sometimes outweighs expected benefits and appeals by surveillance bodies are not possible. The government has launched consultations on changes to the 1994 Law aimed at simplification and harmonisation of tendering procedures across all levels of government.

Non-discrimination

The application of the non-discrimination principle in regulation, through Most Favoured Nation Treatment (MFN) under which all firms are treated the same, and National Treatment (NT) under which foreign firms are treated the same as domestic firms, aims to provide equal competitive opportunities irrespective of the origin of products or services and so maximises efficient competition.

As a WTO member Switzerland is bound to apply the MFN and NT principles in its trading relations. The Federal Law on Technical Barriers (THG) does this with respect to technical regulations, and SECO is responsible for its implementation. It does this by monitoring the development of regulations, and ensuring that the federal administration is aware of the requirements. It can take action if there is a problem, such as requesting a change to the regulation, and if the problem persists, it can refer the issue upwards, usually to the Federal Council. It also addresses complaints about a violation of non-discrimination principles, using the same procedures.

Switzerland is among the countries that maintain exemptions on the MFN obligation in the context of liberalisation under the GATS. With such MFN-exemptions, Switzerland seeks to secure in defined services sectors the possibility of maintaining discriminatory measures *vis-à-vis* third countries, in contrast to the general GATS principle of progressive liberalisation of trade.

A generally well viewed investment location

Investment decisions are affected by the extent to which foreign firms consider that non-discrimination is applied in practice. Switzerland is generally viewed as an economy that welcomes foreign investment. The Swiss government has established "Location Switzerland" as a single window to assist foreign investors in entering the Swiss market. Potentially obstructive mechanisms such as pre screening or capital flow restrictions do not exist. Nationality requirements for the purchase of land for facilities, and of homes by foreign managers, have been substantially lifted. Corporate law, however, is still perceived as an issue. The board of a company in Switzerland must be made up of a majority of Swiss citizens residing in Switzerland, and functions such as signing documents must be

performed by a Swiss board member. However, the ongoing reform of corporate law, which will alleviate some of these conditions, is well advanced.

A network of regional trading agreements

Regional trading agreements (RTAs) are necessarily discriminatory and a departure from MFN and NT principles. RTAs have grown globally to such an extent that Switzerland seeks to negotiate them with the trade policy objective of eliminating discrimination faced by Swiss exporters, whilst continuing to support global trade liberalisation. Mutual Recognition Agreements (MRAs), which are allowed under the WTO TBT Agreement, and reduce trade barriers related to technical regulations or standards between the partners to an agreement, are another delicate area which cuts across multilateral trade liberalisation. Switzerland has some of these too, notably an MRA with the EU which is one of the most comprehensive in existence. This MRA is under revision to make it more friendly to third countries. The same basic issue of regional *versus* multilateral approaches to trade liberalisation applies to the Swiss-EU agreement on the free movement of people – which has just been extended to the ten new EU members – and related agreement on professional qualifications. The agreement is very valuable to the Swiss economy but it would be helpful if Switzerland could go further with mutual recognition for third countries.

Avoiding unnecessary trade restrictiveness

Where possible regulators should favour measures that have the least restrictive effects on trade. For example taxes might be used instead of regulations to achieve the same policy goal. Mechanisms need to be put in place to give effect to the principle, including *ex ante* assessment of the impact of proposed regulations on trade and investment, reviewing them after a certain time, streamlining procedures, effective consultation of foreign interests, and access to a dispute settlement procedure. In short, a business friendly environment needs to be created which extends to foreigners as well as domestic interests.

Impact of regulation on trade²

The Law on Technical Barriers to Trade (see above) establishes the principle that technical regulations should not create technical barriers to trade. Exceptions are allowed where legitimate regulatory objectives such as protection of public health or the environment would be compromised. More generally, draft Federal primary legislation must be subject to a Regulatory Impact Analysis (RIA), a statement of compatibility with international obligations, and (in the context of TBT and SPS issues) the results of international notifications to WTO member states. Areas for improvement of the RIA process include, from the market openness perspective, an explicit consideration of trade and investment impacts. Although this perspective and foreign participation in consultation is not precluded, it is not highlighted either. Foreign perspectives can be the source of new and useful ideas for better performing regulation. That said, it is very helpful that SECO is responsible both for RIA and for oversight of international obligations. Thanks to its input, most technical regulations have been amended to reflect SECO inspired market openness concerns.

Unnecessarily burdensome regulation (“red tape”) often impacts foreign firms more than domestic firms, because of the latter’s better local knowledge. Foreign SMEs especially are disadvantaged and it is important that they are drawn into the consultation processes for new regulations, wherever possible. The Swiss regulatory position in international

comparison for start ups is mixed: above the OECD average for minimum capital requirements; average for the number of procedures; below for the cost of the process. Practices diverge considerably between cantons.

Customs procedures need monitoring

Customs procedures attract growing attention, now that tariff barriers in OECD countries are low or non-existent. A reduction in border delays reduces product costs.

The design of the Swiss tariff system is unusual however, and can lead to increased average tariffs over time. It relies on specific tariffs based on the weight of imported goods, whereas the common practice with advanced members of the WTO is specific tariffs for agricultural products, and *ad valorem* tariffs for most other products. With recent decreasing prices for agricultural imports the average implied tariff rate actually increased under this system. The system is also regressive in that heavier and generally less sophisticated goods are taxed more heavily. Gross weight (i.e. including containers) is used, which leaves importers uncertain as to the duties that will be levied. According to the intermediate results of current negotiations in the Doha round Switzerland will have to switch to *ad valorem* tariffs as well.

Tariff system aside, the Swiss customs administration is considered overall to be efficient and modern, though as with most countries there is room for improvement. Rules can be applied with unnecessary strictness: to encourage accuracy in a system relying heavily on self-declaration, the law provides for sizeable fines as well as criminal prosecution for the clerks in charge of completing customs declarations who make mistakes, and these are routinely applied. Not surprisingly the turnover of clerks is high. More generally, resources are a growing issue, with funding cutbacks that may lead to shorter working hours at border points, and hence processing delays.

Encouraging the use of internationally harmonised measures

Compliance with different national regulations and standards can make the cost of operating in different markets significant, even prohibitive, a major issue raised by the international business community. Internationally harmonised standards offer a solution, and their use has gained prominence with the WTO Technical Barriers to Trade (TBT) agreement. This encourages countries to base their technical requirements on international standards where these exist.

Active participation in international standards setting mechanisms

As a member of WTO, Switzerland is bound by the obligations of the WTO TBT and SPS Agreements under which international standards must be used as the basis for domestic technical regulations, and this is given effect in the THG (see above). The vast majority of Swiss standards are already harmonised to international standards, and those remaining are justified as having no international equivalent.

The THG states that Swiss standards should be harmonised to those of its largest trading partners, i.e. the EU member states. The specific Swiss approach to the development of standards is therefore closely linked to the EU. The reduction of standards related barriers to trade within the Single Market has been an EU priority, as is reflected in the new approach which has been adopted. From now on, harmonisation is limited to defining essential requirements, with a reference to the existing standards. The principle

for mutual recognition of conformity requires that public administrations recognise that products made following harmonised standards are presumed to be meeting essential European requirements. References are made to standards set up at the international level, although the EU system inevitably favours trade within the Single Market, and may discriminate against third countries. In practice the EU system means that the development of standards is left to European standardisation bodies, and their use is not mandatory, although they provide a presumption of conformity. The development of Swiss technical regulations follows the EU system not least due to the fact that it is carried out by private standardisation organisations independent of government which are members of the three main bodies in international standardisation work on the continent (CEN, CENELC and ETSI). Membership to these organisations oblige participants to make broad use of standards developed internationally. SECO oversees the process based on its responsibility for implementing the THG.

Streamlining conformity assessment procedures through recognition of the equivalence of regulatory measures adopted by foreign countries

Where international standards are not available, trading partners can mutually agree to accept their standards as equivalent. The existence of differing national standards and the need to use differing national procedures for assessing conformity adds to the costs of producers wishing to sell in different markets. Mutual Recognition Agreements (MRAs), which can cover the standards themselves or the procedures used to assess conformity, can help to reduce these costs. Mutual recognition activities are often left to the private sector so as to ensure that the work is relevant to the needs of evolving markets.

An enthusiastic approach to mutual recognition

Where harmonisation has occurred, goods shipped to the EU that conform with EU standards can also be shipped to the much smaller Swiss market which facilitates trade, provided foreign conformity assessments are recognised. Swiss law provides explicitly for the recognition of foreign conformity assessments even where no formal MRA exists. However, where a Swiss conformity assessment is not recognised in a foreign country, there is a reciprocity provision in that the Swiss authorities may deny that country's conformity assessment results, though this has never been deployed. Swiss conformity assessment bodies participate in private sector led initiatives for mutual recognition. Recognition of the results of conformity assessment based on accreditation is strongly supported by the Swiss authorities. The public Swiss Accreditation body (SAS) participates actively in European and international co-operation schemes.

Application of competition principles from an international perspective³

Anti-competitive conduct can reduce the benefits of market access. From an international perspective, the important issues are commitment to competition principles in law and policy, and the existence of open and effective procedures for hearing and deciding complaints over market access.

Anti-competitive practices are an important challenge for the development of the Swiss internal market, and competition policy needs to play a strong role in tackling this. Enhancing the internal competitive environment will also support broader market openness by facilitating market entry by foreigners. The market openness perspective can also help in the development of a stronger internal competition policy approach. Some aspects of the

current competition policy framework are especially relevant to market openness, notably the issue of the independence of the competition authority, which is crucial for ensuring that the interests of foreign parties are treated impartially. Staff training to understand the relationship between competition policy and market openness is also important.

Market openness and regulations in selected sectors

International market openness and the six efficient regulation principles can also be assessed by looking at key domestic sectoral regulatory regimes: how well do these square up?

Electricity⁴

Although Switzerland has not made any commitments on energy services under the General Agreement on Trade in Services (GATS), it is highly dependent on energy trade to meet its domestic energy requirements. Energy imports account for over 75% of total energy supply and 3.4% of total imports. Switzerland is, in particular, a major trade and transit hub for European cross border power flows, which have rapidly grown in recent years. Swiss electricity firms have also made significant investments with European neighbours, and foreign firms likewise in Switzerland. An efficient and effective regulatory framework supporting competition is therefore essential for securing the long term future of this trade and investment, as well as ensuring a low cost and reliable domestic power market. Plans for reform which failed a few years ago to win the popular vote are now going forward again, with what appear to be greater chances of success. Draft legislation currently before Parliament would align the Swiss regulatory framework with that of the EU in essential areas. Notably, an independent regulator would be set up with authority to oversee cross border trade among other issues. From the market openness perspective the regulator would have authority to prohibit discrimination between market entrants provided they meet relevant Swiss laws, a major step forward.

Telecommunications⁵

Switzerland's market access commitments under the GATS make its telecoms sector "one of the most liberal and competitive environments among the WTO" according to a 2004 WTO review. Reform in this sector has gathered momentum, reflected in lower prices, although some issues remain to be resolved, notably access to the local loop. Over 50 Swiss and foreign companies now offer fixed line services.

Automobiles

Swiss efforts to benefit from cheaper imports is reflected in current efforts to liberalise its domestic automotive and parts market, which, defined in a comprehensive way, is an important sector of the economy for employment and exports albeit Switzerland does not have a wholly indigenous automotive industry assembling cars. Switzerland was party to the 1958 United Nations Economic Commission for Europe (UNECE) agreement on the adoption of uniform technical standards, under which both standards and mutual recognition arrangements have progressed. Market segmentation is an issue, with vertical trading arrangements by major auto producers and importers leading to prices above those in the EU when lower VAT in Switzerland is taken into account (see PPP figures). The competition authority decided in 2002 to take action by making a number of practices illegal, such as the supply of guarantees. This should help considerably in opening up the market for car dealers and auto part producers abroad.

Recommendations

1. Better integrating market openness perspectives within the reform process would benefit growth and welfare, including the establishment of an official channel to receive comments from foreign parties on regulations and administrative practices.

An element of the reform process posing a significant challenge for policy makers is the potential for deadlock due to the rights to popular referenda. In Switzerland, the work of regulatory reform is therefore as much an issue of good communication as it is about good design and implementation. As a result, the Swiss reform process is most meticulous about transparency; current reforms in this sector appear to focus on making it more efficient also. However, although foreign parties are not prevented from learning about proposed legislation, there is no explicit obligation to solicit foreign input within the legislative process.

Swiss legislation, most notably the THG (law on technical obstacles to trade) explicitly seeks to reduce *discrimination* in areas of economic activity that have been liberalised to foreign entry. The State Secretariat for Economic Affairs implements this law by overseeing the development of laws and ordinances and reviewing existing ones over which complaints have been received from the governmental authorities of foreign enterprises. By reducing the number of steps needed to share comments with authorities, positive interactions for reforms would be facilitated.

2. Implementing a standardised process allowing foreign enterprises to lodge appeals would further strengthen market openness.

Formal decisions by authorities usually indicate available means of appeal. It is more difficult to engage action in court when practices by authorities do not give rise to formal decisions.

3. Attention to maintaining transparency within the negotiating process will reduce the discriminatory impact of such agreements on third parties.

The growth in regional trading arrangements (RTAs) over recent years has made the negotiation of agreements a matter of reducing discrimination against own firms competing in foreign markets, rather than seeking preferential access to those markets.

4. A specific obligation for Swiss RIAs to consider market openness implications will help to ensure against mis-assessments of proposed regulatory impacts.

The recent establishment of a mandatory regulatory impact analysis (RIA) at the federal level is an important step towards *reducing unnecessary restrictiveness in regulations* and promoting the emergence of a more liberal economic environment. However, the uneven distribution of analytical capacity across the Swiss regulatory system affects the quality of RIA reports. The lack of formal commitment to consulting foreign parties and the absence of an obligation to consider impacts on foreign trade and investment within RIAs, enhances the potential that market openness impacts (negative or positive) may be overlooked in the assessment of proposed regulations.

5. Strengthening rather than safeguarding market openness towards trade and investment with economically vibrant regions economies outside Europe should become a priority.

Geographic and economic proximity as well as the size of the EU market makes the harmonisation of Swiss regulations to international standards developed in EU bodies a clear approach to increasing trade with its largest trading partner. Rapid progress in alignment of Swiss to EU standards is evident, but attention should be paid to reducing the possibility of *de facto* discrimination *vis-à-vis* third countries. The rules on accepting the equivalence of foreign conformity assessments contained in the THG reduces this possibility. Overall, by engaging harmonisation towards international standards via mutual recognition agreements and by establishing a framework for accepting the equivalence of foreign conformity assessments, Switzerland has adopted an integrated policy approach to market openness in the areas of standards. Continued efforts to develop market openness in a more general sense will go well beyond the approach of standardisation and will become increasingly important.

6. Increase the capacity of competition policy authorities to emphasise the importance of trade rules and market openness principles, as this will enable better consolidation of economic benefits from already implemented liberalisation commitments as well as from future liberalisations.

Competition in Switzerland is affected by the consensus-based culture, the product of a severe environment that has rewarded co-operative behaviour. The consensus-based culture is also reflected in the institutional requirement to consult all interested parties. The complex topography and the long confederate history of the country have further supported the development of distinct regional approaches to regulating a variety of areas in the modern economy. The use of surplus revenue from locally regulated prices to support economic or social activities in other regulatory fields, *i.e.* the existence of cross-subsidisation makes the implementation of effective competition both a regulatory reform and a cause of reform. Yet, the greatest gains to domestic economic competitiveness and market openness will result from further progress in stimulating domestic market competition for goods and services including in areas that remain beyond the remit of strong government interference today. The significance of gains that result from the reform of competition policy in the automotive sector demonstrates the critical importance of market openness considerations in the design and implementation of competition policy.

Notes

1. See Part II, Chapter 2, for a fuller review of these issues.
2. See Part II, Chapter 2, for a full review of RIA and SME related assessments.
3. See Part II, Chapter 3, for a fuller review of these issues.
4. See Part II, Chapter 6, for a fuller review of this sector.
5. See Part I for a fuller review of reform in this sector.

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PART II
Chapter 5

**A Framework for High Quality
Regulation: Air Transport, Rail, Postal
and Telecommunications Services***

* For more information see the background report on “A Framework for High Quality Regulation: Air Transport, Rail, Postal and Telecommunications Services” available on the Web site: www.oecd.org/regreform/backgroundreports.

Introduction and context

The experience of other OECD countries shows that the infrastructure or network sectors¹ are challenging but necessary reform candidates. Reforms are essential to promote more efficient and effective modern infrastructures, and to secure interconnectedness across borders. Reform involves very careful re-regulation to manage complex emerging market structures and interactions. A key challenge of the network sectors is that they have economic and often also technical characteristics which require central management and control. It is hard if not impossible to circumvent this natural monopoly core,² and competition needs to develop around the latter. Many of them are also considered to be a public service, which means that reform is politically sensitive, linked to concerns that social or regional policy functions which have traditionally been secured by a single monopoly incumbent, will be weakened or lost with reform and the advent of new market players. Safety considerations are another feature of some sectors.

The potential efficiency gains from reform are, however, very significant, and international best practice shows that means can also be devised to secure the continuation of public service functions. Achieving efficiency gains as well as other public policy goals involves not least, the establishment of effective independent regulators with clear objectives. The use of regulatory quality mechanisms – notably benchmarking and Regulatory Impact Analysis – can help to ensure that the most appropriate new rules are put in place.

This chapter focuses on the regulatory frameworks in four sectors that are of particular importance to Switzerland: Air Transport, Rail, Telecommunications and Postal Services. Electricity is analysed in a single chapter. The relative size of these sectors is large relative to the Swiss population, in international comparison. The electricity sector plays a significant role in terms of grid density and the existence of major international players in the European power market (alongside a host of very small local companies), reflecting Switzerland's position as a vital European trade and transit route. Most of these play a key external as well as internal role, not only for the closer integration of regional and local economies, but also for the regional market beyond, in Europe. This is important for business but the citizen's expectation of these sectors is high too, across a number of fronts: public service, environment, safety and so on. The issues go far beyond the state of competition.

This makes it all the more important for the regulatory framework of these sectors to be adequately modernised. Switzerland has made some commendable progress in modernising regulatory frameworks. Nevertheless, all the Swiss infrastructure sectors are in need of accelerated efforts to consolidate, complete or even in one case (electricity) to start reform. Part of this means keeping up with related EU developments, in order to ensure that regional connections are smooth and that Swiss business has the same advantages as its competitors.

The extent to which Switzerland lags recent EU developments varies greatly from sector to sector. Rail reform for example is fully in line with EU developments. Telecommunications has made progress, even if certain steps are implemented with a

delay, such as the unbundling of the local loop. However the reform of postal services moves slowly and electricity reform has yet to begin, despite long established reform plans by the Confederation which have so far come to nothing in the face of public and vested interest opposition. The issue is not the lag with the EU, but what this means for Swiss enterprises. The well functioning of these sectors directly affects Swiss competitiveness, within and beyond the internal Swiss market. It is vital for Swiss enterprises to be structurally well integrated with efficient and low cost connections into Europe, their most important market, just as it is vital for the long term development of the internal Swiss market to be efficiently connected.

A warning signal of the need for effective and timely reform is that two important sectors – air transport and electricity – have experienced serious problems. This highlights the dangers of a relatively slow and piecemeal approach to complex sectors facing rapid change. In the case of air transport, the slow adjustment of the institutional framework to a liberalising environment was an important factor in the difficulties experienced over recent years. Electricity has raised problems too. Switzerland's current unreformed institutional structures are contributing to the serious problem of European grid reliability. The absence of an effective independent Transmission System Operator (TSO) is the most important immediate issue.

Switzerland needs to close its reform lag with other European countries, without necessarily becoming a reform leader, although opportunities for this should not be missed.³ Late reformers like Switzerland can reap considerable advantages of the learning process that has been going on with reform pioneers. This provides opportunities, which the Swiss authorities have been seeking to take, of using international experiences to put in place new regulatory frameworks based on emerging best practice. This should not, however, be taken as an excuse for a “wait and see” approach.

Independent regulators: advantages and challenges

Independent regulatory authorities are agencies endowed with significant powers and a degree of decision-making autonomy. They are to some extent part of the broader New Public Management trend, to decentralise central government management tasks, although they stand out from other decentralised government agencies in terms of their regulatory powers and autonomy. They are also part of an OECD wide trend to differentiate between important functions of central government applied to the network industries – strategic policy making, regulation, and often ownership as well. They are typically established following the introduction of competition into these sectors, so that regulation of the liberalised market can be independent both of commercial interests and of short term political pressures. In short, they can make a major contribution to the efficiency of the sectors which they oversee. Such authorities do, however, pose a challenge for most jurisdictions, as they do not obviously fit the traditional structures of government and raise accountability issues. There is a risk that they may be captured, and the relationship with the competition authorities needs to be carefully handled to avoid a fragmentation of policy. To counter these issues, independent regulators must be carefully planned and structured, for example with effective appeal procedures.

Influence of the EU

EU directives have encouraged the establishment of independent regulators in the network sectors, as part of the framework for market liberalisation. Although not part of

the EU, Switzerland is strongly influenced by EU legal developments, and has signed a number of bilateral agreements aimed at convergence with the latter, including in air, road and rail transport. Convergence is essential for these sectors which make little economic sense if they cannot develop within a European framework, given Switzerland's central geographical position in Europe and the small size of its domestic market. It is noticeable that the strongest moves towards regulatory independence have been made in sectors subject to external pressure for reform, such as the WTO and EU for telecommunications, and the EU for the rail sector.

Ad hoc developments so far

Changes in the regulation of the network sectors have been happening more slowly in Switzerland than in many other parts of Europe. The system of direct democracy affects the rate of change that is possible, with popular votes often delaying change against a background of strong attachment to public service which is closely linked to the network sectors. The shift to a regulatory model based on independent regulators exposes a tension with usual practices that rely more on consensus building in which special interests can articulate their view directly. The *ad hoc* character of reforms is another Swiss feature. There is no single approach to the establishment of independent regulators, and the legal basis for many regulators is weak, undermining their effectiveness. They have also developed in the context of distinctive existing Swiss institutions, called "offices", which are part of the central administration with some management autonomy, but lack the independence of true regulators. Some of the regulators are in fact offices, whilst others are more independent, in the form of extra-parliamentary commissions entrusted with some decisional powers. The current legal framework does not make a clear provision for a statute for independent regulatory authorities at the moment.

Switzerland nevertheless enjoys high quality services in the network sectors covered by this review – air transport, rail transport, telecommunications and postal services. Citizens' expectations are high and help to drive this. But a consolidation of reforms is needed to ensure that achievements are not compromised. This includes a strengthening of the overall framework for independent regulation of these sectors, and a more coherent approach to replace the incremental changes so far. This process has started, but is far from complete.

Sectoral perspectives

Air transport

Economic importance

This sector is very important economically to Switzerland, and is particularly developed in international comparison. Its importance was underlined by the Federal Council in a 2004 report. The number of planes registered is half of those registered in France or Germany which have eight to twelve times the Swiss population, and five times more than the Netherlands, with a population only twice as large. Airports are a vital part of regional economies for the relevant cantons. The six main airports account for some 5% of GDP, and provide over 150 000 jobs, when the indirect effects are taken into account. Effective regulation, including alignment with the EU which is the sector's most important market, and safety regulation, is important to ensure the sector's economic health over time. Switzerland has made progress on both fronts, especially in terms of convergence

with EU regulation via a bilateral agreement that provides for direct adoption of relevant EU law. Improvements in the regulatory framework for safety, however, were made following a series of serious accidents.

Reform beginnings

Reform started in North America with market opening in 1978, and spread to Europe in the late 1980s. This has radically changed traditional structures, notably by encouraging the emergence of a new “hub and spoke” market structure, which has yielded significant economies of scale and scope. Countries with more open markets today show a generally more favourable performance across a number of indicators (occupancy rates, tariffs) than others. As with the other infrastructure sectors, the EU has been active in reform, promulgating a series of market opening “packages” since 1987. The third air package, implemented in 1993, took the final steps in the establishment of a Single Market throughout the EU. This has encouraged further change, with the emergence of low cost airlines which challenge the hub and spoke model through the establishment of direct routes. This development has highlighted the issue of regulating the allocation of slots.

EU importance

The EU is the sector’s most important regional market, so its long term health is closely linked to being part of the EU Single Market. Reflecting this, the first bilateral agreement to be signed between Switzerland and the EU, in 1999, was for air transport. This agreement is based on a particularly strong integrationist approach, compared to other bilateral agreements with the EU. It amounts to a partial integration of the Swiss market for air transport with the EU Single Market, based on a Swiss commitment to adopt the relevant EU legal *acquis*, the enforcement and interpretation of which are partly controlled by EU institutions. The Swiss air sector’s sensitivity to links with EU partners has recently been highlighted by the failure to reach agreement with Germany over flying over routes to serve flights landing at Zurich, the country’s main airport. The need for flights to finish over the Swiss territory, flying over a populated area of the City, has sparked environmental concerns with a risk for a possible a popular initiative to curb down the number of flights.

Regulatory authorities

The air transport sector has a complex structure (made up of airlines, airports, air traffic control and ground handling services) and is highly regulated. Regulation reflects the sector’s international characteristics, the technical need for intensive co-ordination and the importance of ensuring safety.

The regulatory framework is based on the establishment of the Federal Office for Civil Aviation (FOCA) as a special division of DETEC under the Federal Aviation Law. FOCA has general responsibility for all aspects of legislation and for monitoring the sector. Slot management – an important part of regulation in the liberalised market – is, following the pattern of other European countries, the responsibility of an association, Slot Co-ordination Switzerland, which has non profit status and is financed through charges collected by the airports and the airlines which use them. This seems to work well, as low cost airlines have increased their presence considerably at some airports.

Performance

Reform has been a politically difficult experience for Switzerland, which started out with a single high cost carrier, Swissair. The 1997 update of the Federal Aviation Law started the reform process with the elimination of subsidies to airports, the abolition of Swissair's monopoly, the withdrawal of the Confederation from Swissair's board, the end of prior approval for air fares and the conclusion of open skies agreements. The combination of the strategy for market opening and the September 2001 attacks, which led to a sharp fall in air traffic, contributed to Swissair's bankruptcy. Swissair's successor, Swiss, is undergoing a slow recovery. It was taken over by Lufthansa in 2005. The safety record has been the other main issue. Several accidents following the crash of a Swissair plane in Canada in 1998 undermined a previously excellent safety record. This put the spotlight on a dysfunctional regulatory system, including inadequate FOCA resources and enforcement powers. The independence of the air accident investigation bureau was also put into question. A significant reorganisation has since taken place.

Rail transport

Economic importance

The railways, like air transport, are very important economically to Switzerland, with a high intensity of use, with 1 900 km per person per year, which puts the Swiss first in the OECD, ahead of Japan; and 128 trains per line every day, the highest number in Europe. The economic importance of rail has its roots in a deep commitment to the promotion of transport that helps to preserve the Alpine environment. This is reflected in the Constitution, following the so called Alps initiative approved by the Swiss people and the cantons in 1994. The Constitution specifies that transalpine freight across Switzerland shall be transported by rail, and that the Federal Council shall take the necessary measures to this effect. The importance of rail is also reflected in the number of laws that regulate the sector. It is considered to be an important public service. Sensitivity therefore runs high on the subject of reform.

Reform history

The best path to reform in this sector is the subject of some debate, against a background of relatively little longstanding practical experience around the OECD, which mainly concerns freight. A key aim of reform is to develop seamless regional infrastructures and services and to promote the efficiency and the competitiveness of this form of transport, especially for freight. New entrants can be more efficient than incumbents by bringing more flexible management methods and they also push for reforms in the already established companies. Poorly sequenced and structured, however, reform can raise costs and hamper investment. Two basic approaches have evolved: a light touch regulatory framework that leaves much of the management to the companies themselves, as in the US, and a more classic regulatory framework that vests an independent regulator with considerable authority over issues such as capacity allocation, as in the EU. The density of utilisation and the structure of the network are of considerable importance in this respect.

The EU has progressively developed a more open rail market, starting in 1991, and pushed in large part by the need to deal with important bottlenecks in the European infrastructure. In a 2001 White Paper the EU Commission identified the railway system as a key factor in sustainable growth. EU legislation aims to strengthen infrastructure

financing, reinforce safety regulation, establish effective conditions for competition from new entrants, and improve regional interoperability. It has been taken forward through three packages, the third of which (proposing competition in passenger transport from 2010) is still under discussion.

Swiss reform of the railways started in 1999, aimed at bringing Switzerland in line with the EU. Infrastructure was separated from transport (accounting); third party (open) access was introduced for freight traffic, which can be considered as liberalised. Access for passenger transport is subject to a concession. Competitive tendering was introduced for local and regional passenger transport in 1996 as an option. The regional transport offer is defined jointly by the public transport companies, the cantons and the Confederation. Non-covered costs for these services are estimated in advance and paid by the public authorities prospectively. Freight traffic competition has also been stimulated through the bilateral Land transport agreement with the EU which has a reciprocity provision enabling foreign companies to establish links for conventional rail with Switzerland and transit through it. The Swiss Federal Railways (*Chemins de fer fédéraux* – CFF), which remains fully owned by the Confederation, were transformed into a public law company and refinanced to give it greater autonomy. Its relationship to the Confederation has been redefined through a four year service contract under which it receives a contribution toward infrastructure costs and must meet productivity targets. CFF retained 87% of the freight market in 2003. Investment is a major issue – two tunnels below the Alps are under construction, as a key policy objective for the sector is to transfer freight from the North to the South of Europe from road to rail. Developments are closely in line with the EU framework and with average progress in individual EU countries.

A second stage of rail reform was presented by the Federal Council in February 2005, partly in order to track and match EU developments. Its objective is to modernise the financing of rail infrastructure (secondary lines), put competitors to CFF on an equal footing with the latter, improve safety regulation, and pursue harmonisation with the EU. The reform has four main elements: a new approach to financing based on service agreements, under which the Confederation finances the basic network and the cantons the branch lines; a new safety service (railway police); guaranteed non-discriminatory access to the network, by creating an independent service for slot allocations and strengthening the arbitrary commission's (RACO) responsibilities; an improvement in interoperability across the national frontier via harmonisation of technical standards; and an extension of the possibilities to submit service concessions to public tendering.

Regulatory authorities

The regulatory framework for taking reform forward shows a fragmented and piecemeal approach. The only independent regulator currently is the very small Railways Arbitration Commission (RACO) which plays a minor dispute resolution role. The long established Federal Office of Transport (FOT) is responsible for safety and policy. Network access is regulated and monitored by FOT, which is also responsible for setting user charges. Given that the FOT is an Office of the ministry, and that CFF is owned by the Confederation, there is a possibility of conflict of interest. Slot allocation is currently managed by an entity controlled by the two largest companies on the market, which raises another conflict of interest. A revision of the supervisory framework is therefore needed. This is to be strengthened under the second reform package, in line with EU standards. The Comco plays a minor role, not least because an exclusion exists for certain rail services under the Cartel Law.

Performance

Performance according to a number of indicators meanwhile is good in international comparison, reflecting the success of the first phase of reform. The key policy objective of moving freight by rail has been achieved: 65% of goods were transported by rail in 2004, compared with 23% in Austria and 22% in France. The productivity of CFF has been rising by about 6% pa, helped by a strong increase in traffic. Service quality in terms of safety and punctuality remains very good. The amount of competition so far to CFF is, however, low, although the market share of competitors is rising steadily. Prices for freight remain comparatively high in international comparison, before an adjustment for purchasing power parity. There is no competition as yet for scheduled-interurban passenger transport and limited competition for regional transport services which remains based on a system of concessions granted by the Confederation and the cantons.

Postal services

A key public service

Postal services in most OECD countries have a traditionally strong link with the notion of public service and in particular, regional policy aimed at ensuring that essential services are accessible even to the most remote communities. Postal reform is therefore very sensitive in terms of its implications for the maintenance of universal service. Switzerland is no exception, and indeed may be more sensitive than most because its postal network is denser and more intensively used than elsewhere, as well as being a vehicle for financial services to local communities alongside mail delivery. The average number of people served by a (stationary) post office is half or even a third less than for other European countries such as Finland, Italy, Denmark, the Netherlands and Belgium. Letter deliveries per person are also far higher than in many other countries, six times higher relative to Spain and Italy, but also up to twice the levels in France and the UK. The story of Swiss reform so far in this sector reflects deep rooted fears over universal service. The universal service provisions had to be reinforced (including rules for post office closures), in the face of strong opposition from the unions and the general public. In the end, the popular initiative organised against the shutting down of postal offices failed to win a majority.

The management of universal service – the provision of services to all parts of the country, including unprofitable communities,⁴ on the same broad terms – needs to be assessed at least partly in terms of the scope for competition in a sector which displays some economies of scale. Mail transport itself does not seem to be the issue, but the final delivery of mail and population density are scale sensitive. Postal operators delivering large volumes of mail, as in Switzerland, enjoy economies of scale associated with delivery.

EU developments

EU strategy from the start has sought to strike a balance between the introduction of competition and the need to preserve universal service. A 1992 Green Paper noted significant disparities in the quality and efficiency of postal services across member states, as well as a lack of co-ordination between national post offices that hampered the Single Market. The 1997 framework postal directive established a distinction between reserved (monopoly) and non-reserved (open to competition) services, the former and some of the latter also being designated as universal service. The 2002 postal directive gave a further push to market opening, by setting timelines for the introduction of competition (full

market opening is foreseen for 2009) and a progressive reduction in the scope of the reserved monopoly area. It also strengthened provisions for regulation that is independent of the main postal operator. The directives set minimum conditions for reform, so member states are free to go faster if they wish. Sweden, Finland and Estonia have already completely liberalised their markets and some other countries plan to open their markets within a couple of years. The pace of change across the EU is uneven, but EU Commission monitoring suggests that since reform started the quality of service has improved and universal service has been preserved.

Reform history

Liberalisation in Switzerland also started in 1997 with reform laws which created Swiss Post from the original post and telecommunications monopoly, and introduced some competition by splitting the market three ways: reserved services (which remain a Swiss Post monopoly), non-reserved services (offered by Swiss Post in the context of its universal service obligations, in competition with other licensed providers), and liberalised services. Liberalisation in this sector has been greatly influenced by the sensitive issue of universal service. Both market opening and related regulatory restructuring has been, in consequence, timid. Another issue on the path to reform is that Swiss Post depends for an unusually large share of its revenues on the provision of financial services (which are included in the definition of universal service). The reserved sector is being progressively reduced but remains larger than in most other European countries, and the rate of reduction is slower. Swiss Post remains the main operator, with just 5% of the market (measured by turnover) in the hands of competitors.

Regulatory authorities

The regulatory arrangements for the developing market are not very advanced. Swiss Post is owned by the Confederation. The regulator, PostReg, is separated from the ministry but still reports to it, as discussed below. The current arrangement is therefore not fully able to resolve the issue of the conflict of interest between the various roles of the public authorities. The market is not yet organised on an even footing, as Swiss Post enjoys a custom privilege which enables it to undercut competitors on customs charges, and enjoys the exclusive right to transport mail overnight and on Sundays. Swiss Post is also consulted beforehand on regulatory changes, reflecting its hybrid status as a Confederation body. Swiss Post appears to be very profitable, with most of its profits (93% in 2004 according to an independent audit) derived from the supply of the universal service. The financing of the universal service, which is a necessary condition for further reform, is therefore more than guaranteed.

Although a regulator, PostReg, has been established, its powers and its independence from the ministry are heavily circumscribed. It was set up by ordinance (not a law). It is attached to the ministry (DETEC) and does not have its own budget. It has a monitoring and advisory role, mainly focused on universal service: monitoring access to and the quality of universal service, and dealing with consumer complaints over universal service. It also monitors accounting separation for Swiss Post activities aimed at preventing the cross subsidisation of non-reserved by reserved services. It advises the ministry on tariffs, and on general policy. Its lack of powers is reflected for example in its inability to apply sanctions on Swiss Post for the latter's failure to comply with requirements to set out the costs of universal service.

The experience of other OECD countries suggests that it is possible to develop both effective competition and effective new management of cost-based universal service, with a stronger regulatory framework that keeps the ex monopoly in its place, and competition-neutral provisions for the financing of universal service which sometimes proves to be unnecessary for it to be sustained. The Swedish experience suggests that even the threat of competition can keep the sector on its toes, given a credible regulatory framework that allows the market to be contested, without specific provisions for reserved services nor specific financing via a compensation fund.

Telecommunications services

Reform history

Reform of this sector has followed EU developments which were highly influential. The WTO Agreement on Basic Telecommunications Services which came into force in 1998 also encouraged change. Telecommunications market opening started in 1992 with the liberalisation of telecommunications terminal equipment. The main impetus came in 1998 with structural change which separated telecommunications from postal services and established Swisscom, which was partially privatised and is now 66% owned by the Confederation. A market opening law was passed at the same time which included provision for universal service, an important issue for this sector. The law includes a broad range of services within the universal service definition, and provides for a five year transitional period during which Swisscom must provide this service without financial compensation.

Regulatory authorities

The regulatory arrangements are complex, and the strongest established so far in any of the infrastructure sectors. There are, in effect, two regulatory bodies, which is unusual. The first step, in 1992, was the establishment of the Federal Communication Office, OFCOM as an administrative entity separate from, but reporting to, DETEC. A new body was introduced with the 1998 law, the Federal Commission of Communication (*Commission fédérale de la communication* – ComCom) to be the independent regulator. Independence is provided for under the law through a number of mechanisms: the seven Board members must be independent specialists, ComCom cannot be subject to any order from the Federal Council or DETEC. ComCom's responsibilities cover interconnection (third party access to the network), the allocation of concessions for service providers, universal service, and radio frequency allocation, and numbering and number portability. OFCOM now reports both to DETEC and to ComCom. A strength of the regulatory framework which is in contrast to other sectors is the existence of formal links with the competition authority. Comco has a formal advisory role to ComCom in relation to dominance in interconnection (only dominant firms can be forced to interconnect).

Current issues

An unusual feature of the regulatory regime is the *ex post* approach to interconnection. The regulators do not have authority to mandate interconnection. They can only intervene if a complaint is made, in which case ComCom can require the interconnection, if necessary. This approach is controversial. It can lead to significant delays in a rapidly moving market, and it stands out against the EU *ex ante* regime.

Unbundling the local loop is the main current reform issue, where Switzerland lags behind most other OECD countries. Not only is unbundling important for competition in

fixed telephony services, but also for competition in high speed data access, which underpins low cost Internet services, especially for the business community. For the moment, Swisscom retains a monopoly over the local loop. A recent interconnection case brought before the federal tribunal has established that a new law is needed to secure third party access to the local loop. To this end, a revision of the telecoms law has been tabled by the Federal Council and is under discussion in Parliament. Like most other issues in a complex sector, unbundling the local loop generates some controversy. It has been argued that it reduces incentives to invest in the network, and at the same time, the observed prices, which impact business competitiveness, suggest that Swisscom needs the spur of competitive forces to bring down its prices.

Performance

A comparatively rapid reform path has been accompanied by a generally robust performance of the sector in international comparison, in terms of competition, prices and service provision. Competition to the incumbent, Swisscom, exists on the mobile market, where two other operators have a combined market share of nearly 40%. Besides, the cable-TV provider Cablecom provides Internet broad band access. Switzerland is high ranking among OECD countries for the number of telecommunication access paths to consumers, with a highly developed cable market. After adjustment for purchasing power parity (PPP), which represents a substantial correction in the Swiss case, prices are among the lowest in the OECD for both businesses and households. Mobile telephony is, however, somewhat less well performing, and the intensity of competition forces on this market has been subject to question, following an inquiry by the Comco over a tacit horizontal price agreement by the three market operators. Prices which fell after the initial market opening have stopped falling since 2001. When the conclusions of Comco's inquiry were about to be released, the three operators announced significant price reductions in June 2005.

Independence and accountability

The institutional independence that forms an integral part of effective sectoral regulators is a challenge for traditional Swiss governance which looks for more direct accountability, as exemplified in the referendum system, and is based on collegial decision making. The small size of the country means a relative scarcity of relevant expertise, which may have to be pooled, as well as a lenient attitude toward dual employment that may raise conflicts of interest. There is a tradition of offices (units of a ministry (department), with some competencies for decision making (according to the laws for which they have responsibility), and independent commissions (based on the militia approach, which means part time, and often without a specific substantive secretariat).

An unclear legal framework for independent regulators

The legal framework for independent regulators is an important support for their independence, but needs to be assessed in its practical context, taking account of institutional and political traditions.

The legal framework for the establishment of independent regulators in Switzerland is diffuse and lacks clarity. There is no specific provision for their creation, and the legal status of the regulators that has been set up therefore varies. Broadly, current regulatory agencies are either offices of a department, or part of the decentralised administration of a department. Offices are much more closely linked to their departments and, for example,

appeals can be made against their decisions to the department. That said, independence works best in the Swiss context with technical issues, and Swiss offices have some autonomy in this regard. A second approach is framed by the Law on the Organisation of Government and the Administration (LOGA). This provides for the creation of decentralised administrative units and for administrative duties to be assigned to external public or private sector organisations. It does not specify the extent of possible autonomy, so the picture varies between agencies set up under this framework. A related ordinance provides more detail, including a list of the units reporting to the decentralised administration. Another ordinance sets out the framework for extra parliamentary commissions under the decentralised administration. These are the only bodies with a real degree of autonomy, although other bodies including offices can enjoy a relatively high degree of administrative autonomy *de facto*. An ordinance on the organisation of the Federal Department of Environment, Transport, Energy and Communication (DETEC) sets out the tasks of the offices attached to it.

The powers and other attributes of regulators can also be set out in specific legislation for market opening in that sector. Pressures from the referendum process mean that many laws leave many of the details to be fixed in ordinances. But ordinances cannot increase powers that are deficient in the primary legislation, which has often been the case.

The Federal Communications Commission (ComCom), the Arbitration Commission for Rail Traffic (RACO) and the Air Accident Commission and bureaux of investigation into rail and air accidents, as well as the competition authority (Comco) are part of the decentralised administration. ComCom and RACO are extra parliamentary commissions under this approach. The Federal Offices of Civil Aviation, Transport and Communications are part of the central administration of DETEC. PostReg, the postal services regulator, is a special case, set up under an ordinance, though its independence falls short of what might be expected of an independent regulator, as it is closely attached to the ministry. In international comparison, other EU countries display a range of approaches, with a clear move toward independent regulators. Developments toward independent regulation in Switzerland are slow, reflecting the political and governance culture.

Independence and accountability

A balance needs to be struck between independence and accountability, which means ensuring that appropriate governance and appeals structures are in place, and that there is an effective dialogue between regulators, Parliament and citizens.

Governance structures

The collegial approach to regulatory governance has proved its worth across a range of other countries, though some have a single head. The collegial approach can help to resolve conflicts of interest in decision making, and may strengthen the regulator's legitimacy. It allows for the appointment of a diverse set of people. Overlapping terms of office support stability. In the Swiss case, extra parliamentary commissions are collegial but nominations are not staggered, and part time membership does not help their institutional standing.

Appeals procedures

Effective and transparent appeals procedures⁵ against regulators' decisions constitute an important democratic right, as well as supporting a more effective regulatory system. A

major issue with the current Swiss system is that it fails to provide for a single jurisdiction of first instance for decisions taken by sectoral regulators and those taken by the competition authority. This has the effect of creating a degree of disparity between regulators and sectors. The current far reaching reform of the federal legal system aims to introduce subsidiarity into the appeals process to lighten the load on the Federal Tribunal, and provides for the creation of a Federal Administrative Tribunal. The extent to which this will help jurisdictional unity for sectoral regulators is not clear yet. The ideal would be for rulings to be handled the same way for all economic decisions relating to regulation and competition.

Dialogue with Parliament and citizens

Dialogue between regulators and Parliament is an important feature of accountability in many OECD countries. It underlines the regulator's independence from ministers and reinforces direct accountability. Most Swiss regulatory authorities publish an annual report, mainly aimed at their parent department. It would be helpful to encourage discussion of these reports in Parliament. Direct dialogue with citizens is another important part of accountability, as well as visibility, for regulators. Such dialogue is a general Swiss strength given its political system and popular votes. All the regulators maintain well furnished and up to date Internet sites. Some issues which are highly relevant to regulators, such as the future management of public services, have not been sufficiently disseminated with the wider public.

Resources

Adequate human and financial resources are important for securing independence. The technical expertise of regulatory staff is key in ensuring that an independent view can be taken on the issues that arise. As in other OECD countries, Swiss regulators are funded either out of revenues from the federal budget or by charges levied on the regulated sector. The FOT in the rail sector stands out for its large and mainly publicly financed budget, which reflects its role in investment as well as regulation. Elsewhere budgets are more or less in line with those in other OECD countries. The budget rules appear to provide offices with a certain degree of financial autonomy. As regards human resources, these seem quite low for FOCA and PostReg. The part time militia approach to staffing, whilst reflecting the shortage of specialised skills in a small country, does weaken the status of regulators relative to those in many other OECD countries who are full time and well paid. The lack of rules to prevent conflicts of interest with the private sector is another issue.

Horizontal institutional architecture

It is important to view regulators in a "whole of government" perspective. This includes looking at the sectors and functions entrusted to regulators. A wide ranging sectoral coverage assigned to a given agency can help to provide a consistent economic approach. However too many functions for a single agency can blur the clarity of regulators' objectives, in a context where they are not democratically empowered to make political trade offs between equally desirable objectives, such as safety and efficiency.

Sectoral responsibilities

In telecommunications the dual existence of OFCOM and ComCom, which cover between them the same ground as other OECD regulators, is original, and generates some

complexity. The rail sector is also particular. FOT has all the relevant powers as well as for the transport sector as a whole, akin to ministries in other OECD countries. RACO, the independent regulator, plays a marginal role. In the postal sector, PostReg has limited powers that are mainly defined in relation to universal service. Postal regulation in some countries has been merged with telecoms regulation, which immediately promotes a high level of independence and responsibilities. In the air transport sector, FOCA has wide ranging competences as in many countries.

Functional responsibilities

All the Swiss agencies covered by this review have an economic function, with the addition of an important safety role in the case of the FOT and FOCA. The objectives of PostReg, OFCOM and ComCom are the most clearly defined from an economic perspective. The objectives of FOT and FOCA are couched in general terms and are less clear. The specified objectives of OFCOM and ComCom include ensuring effective competition, a reliable universal service at an affordable price, and the general availability of well priced quality services. PostReg's objectives are also clearly defined, in terms of universal service delivery, and competition development.

The objectives of FOCA reflect the history of the air transport sector over the last 50 years or so and the significant legislation that has built up. FOCA is generally charged with "surveillance of aviation over the entire territory", which masks a tension between two different objectives: economic development and support for the sector, and the safety of passengers. An internal reform has allowed these objectives to be more clearly separated. In the rail sector, RACO's clear objectives imposed by EU packages contrast with the FOT's much vaguer objectives, which reflect a number of issues, not least the Swiss public's support of rail rather than road transit through the Alps. The FOT's presentation of itself covers infrastructure, technical issues (safety) and traffic management. The first of these is linked to investment and cannot easily be dissociated from political decision-making. The FOT's organisation is similar to that in other European countries, but could be adjusted to strengthen independent regulatory oversight of rail paths. Similarly, FOCA has both safety, regulatory and economic functions embedded in a loose mandate. The need to identify more clearly the safety function was revealed by a recent audit following a series of serious accidents. However, the regulatory functions, ensuring the well-being of citizens through lower rates and better services, and the economic function, supporting the economic development of the sector, are still intertwined. The functions of overseeing prices for certain services, such as handling and airport services, are exercised jointly with the Price Supervisor.

Co-ordination with other agencies

Co-ordination of regulators with other relevant agencies – the competition authority not least – is important for minimising regulatory burdens. Three basic approaches can be applied: a common doctrine for the implementation of regulations; co-ordination of decision-making timetables; and co-ordination of compliance schedules. It helps to have an overall review of relationships, which in the Swiss case would involve the Price Supervisor, the Competition Commission and the Federal Consumer Bureau.

The role of the Price Supervisor, which enjoys strong popular support, is to prevent excessive price increases or unwarranted price maintenance by cartels and dominant firms. To this end it monitors prices, and seeks an amicable settlement in the first place if

it finds a problem. Except where prices are set by political bodies, it can forbid a price increase or the maintenance of an excessive price, though this can be appealed. The Price Supervisor's opinion must be sought by political bodies before they increase prices. There are mechanisms for close co-operation with Comco.⁶ The Price Supervisor framework differs from that of many other OECD countries in that its price functions are more usually placed with the sectoral regulators, and on an *ex ante* basis rather than *ex post*.

Its recommendations in the network sectors are generally followed, at least in part. Its specific role varies between sectors and over time. It does not cover air transport tariffs, but focuses on tariffs for ground infrastructure and air safety. CFF (rail) tariffs have been reviewed and amicable agreements have been reached. There are plans for a more sustained monitoring. It can recommend prices for reserved postal services, which it has done several times. It has regularly intervened in relation to cable subscription taxes and made a number of recommendations to ComCom on interconnection prices and universal service.

Effective co-ordination between sector regulators and the competition authority is essential to ensure even handed regulatory treatment. A clear division of tasks and harmonious co-operation are essential to this end. But this can be a challenge especially when sectoral regulators have objectives that are unrelated to competition (such as safety or universal service). At this early stage in the evolution of its regulatory oversight structures, Switzerland does not have any overall framework for the relationship. Very broadly, however, it usually applies a mix of two approaches. The first is the application of competition law if there is no sectoral economic regulation establishing a market order satisfying certain qualifications (an example is mobile telephony where Comco's competence was upheld by the courts; see also the decision by the Federal Court in the EEF/WATT-Migros case). The second is a general division of labour by mandates *i.e.* competition law is the sole preserve of Comco and regulation that of the economic regulators (an example is Comco's advisory role to ComCom for deciding whether a dominant position exists that would warrant regulatory intervention). So far the only formal co-operation procedures exist in the telecoms sector. A more systematic approach to the relationship, drawing on the experience of other OECD countries, would be helpful.

Consumer protection is fairly embryonic and the main link so far with regulators has been in telecommunications.

Co-ordination at the international level is also important, to promote learning by others' experience, and to avoid being circumvented by firms across national boundaries. Swiss regulators have often made important efforts to join European regulatory groups, despite the difficulties of not being an EU member.

Powers for high quality regulation

The powers granted to regulatory authorities are important for their effectiveness. They may allow regulators to issue opinions, set out rules, monitor and inspect, enforce regulations, grant licences and permits, set prices and settle disputes. The picture varies considerably between countries, and relevant powers may be divided between the regulator and the ministry or other agency. Powers may be granted by law or other regulation. The powers of the Swiss regulatory authorities vary depending on factors such as their legal basis, but are generally weaker than those of many other OECD countries. In the postal sector, PostReg has more limited powers than many other European regulators. Telecommunications regulation is much stronger in international comparison. For rail,

most powers are with the office not the regulator, at least so far, and no independent safety regulator has been set up, as in some other countries. In air transport, the overall framework that links the different parts is not strongly integrated.

Looking across the sectors, specific powers, such as powers to obtain information, can also be weak. Transparency is a general Swiss strength, and important for the independence and effectiveness of independent regulators. Decision-making processes and explanations of often complex regulatory decisions are usually very clear. Swiss regulators put considerable effort into making themselves transparent and clear. But their relative lack of independence raises the risk of opacity because decisions are not all their own. Consistency and predictability of decisions is another important factor. The Swiss civil law system means that the laws define very precisely the context in which decisions are taken. The main difficulty is in judicial review, which can lead to unpredictable results as well as long delays for decisions. This should be helped by the current reform of the legal system. Finally, compliance with procedures, and consultation with interested parties, are other confidence building factors for regulatory systems. Switzerland has a very positive tradition in this respect.

Powers relevant to the sectors in this review can be divided into the following:

- *Safety related inspection, surveillance and sanctions.* In the rail sector, FOT has strong powers (for example it can withdraw safety certificates). In the air transport sector FOCA has specific monitoring and inspection powers, and can apply sanctions, but has been found to adopt a lenient approach for Swiss aircraft, and apply less regular inspection schedules than other countries.
- *Economic licensing.* Economic licensing is a crucial aspect of an independent regulator's powers. This power is delegated to the telecoms regulators. A concession regime has been introduced for non-reserved postal services, but licences are granted by DETEC, not PostReg (which advises DETEC).
- *Economic licensing related inspections and sanctions.* Licensed telecoms operators must supply the regulators with relevant information, and OFCOM may conduct inspections, but does not have the power to impound documents. ComCom may take measures including withdrawal of the licence, and a fine.
- *Access to networks and infrastructure.* This is another crucial power for regulators, which ensures that third parties have access to the incumbent's infrastructure for the supply of their services. There are major differences between sectors. With rail, a licence is the key to accessing the network. FOT specifies the criteria for path allocation and minimum path prices. Path allocation is managed at the moment by a consortium involving the two main domestic operators. Access in the telecoms sector is on an *ex post* basis. If this fails to work within a specified time, ComCom lays down the conditions for interconnection. In the postal services sector there is no access as yet to the final distribution of post, which would involve possibilities for competitors to receive mail and give it for distribution to Swiss Post. In air transport, slot allocation is key to market access and is carried out by a non-profit association, as is the case in other European countries.
- *Price regulation.* This is another essential regulatory power. Swiss arrangements are unusual because of the existence of the Price Supervisor, which limits the regulators' powers. None of the regulators for the four sectors covered in this review have significant powers in this context. Decisions on (ceiling) prices are normally taken by the Federal Council, on the basis of a proposal by the department in charge, and of public advice by the Price Supervisor.

- *Universal service surveillance powers.* This is especially important in the telecoms and postal services sectors. It is one of PostReg's major tasks, although it has no powers of sanction. In telecoms, universal service guarantees everyone access to a minimum range of services. ComCom awards universal service concessions, and monitors the situation together with OFCOM. The Federal Council determines what constitutes universal service, which has recently been revised.
- *Settlement of disputes.* This power has been granted to several regulators. For rail, FOT monitors but RACO is the main dispute resolution body. It has no sanctions for non-compliance. ComCom has the power to resolve interconnection disputes.
- *Development of regulations.* The development of general rules is usually the prerogative of a political entity such as the ministry, but in implementing these rules regulators have to make individual regulatory decisions, which leads in effect to binding second level rules. The Swiss regulators for this review have varying powers to draft such rules, but none to issue them, a power which remains in the hands of DETEC or the Federal Council. But there is often a close relationship between the regulators and DETEC for taking this work forward.

Assessing performance

Assessing regulatory performance is a complicated task. But it is an important aspect of ensuring effective and enhanced performance over the longer run. It can be carried out either *a priori* or *a posteriori*. The former involves a Regulatory Impact Analysis (RIA) at the time that a regulator is being set up, using the law or regulation to set it up as a basis for the analysis. The latter entails an assessment of the regulator's objectives against its achievements. A balanced approach to evaluation is important, neither too strong which would undermine the independence of the regulator, nor too weak which would undermine its legitimacy. Performance assessment also calls for a clear definition of regulators' objectives, although this can be hard to achieve in practice, as many regulators have multiple objectives. If so it can help to rank objectives by order of priority.

Evaluation is a widespread Swiss activity, carried out through the medium of official evaluations, self-assessments and independent appraisals. The wide variety of approaches means that quality can vary, and the impact of evaluation in terms of changes that are carried through can be uncertain.

There are two central official evaluation bodies. The Swiss Federal Audit Office (SFAO) is strongly independent and assists Parliament and the Federal Council in monitoring the federal administration, including the offices. The Parliamentary Control of the Administration (PCA) is the Federal Assembly's evaluation body and also plays a role. The SFAO has been active in recent years with evaluations relevant to the sectors under review. In particular it has carried out a broad analysis of the evaluation practices of ten offices in the federal administration, including FOCA and FOT. The study found a number of shortcomings with FOCA, noting that FOCA has only recently become aware that its mission consisted in part of monitoring and regulation. FOT came out distinctly better.

Self-assessment is prevalent, though quality levels vary. Annual reports are standard practice. As well, economic and statistical units have been set up, and independent expert appraisals have been commissioned. Some regulators have gone further. For example FOT has created a special internal auditing function. OFCOM probably goes furthest, with numerous studies and analyses of different aspects of the telecoms market and regulation.

Switzerland is also part of assessments carried out by the EU, where a bilateral agreement exists. Where there is no agreement, Swiss initiatives can be launched to fill the gap by reviewing the relative development and liberalisation of a sector in a European context. This has been done for example by the regulators for the postal and telecoms sectors. Independent evaluation by academics may also be used. OFCOM for example commissioned a comparative study of regulatory performance across eight countries. Although this measured regulatory performance according to outcomes which were not wholly within regulators' power to influence (given the limits of their powers), it found that dilution of powers was an issue with regard to dual telecoms regulation and price supervision, and the framework for appeals was unclear for the exercise of the regulator's responsibilities.

Modernising the regulatory framework for the Public Service

Reform of the regulatory institutional framework also needs to be considered in the context of a broader debate on public service and its future.

The Federal Council has presented a report "Public service in the field of infrastructure" to Parliament, which examines the main challenges raised by market opening for postal and telecommunication services as well as transport. This has led to new guidelines that set out some important principles, including the need to distinguish between the regulatory function and other functions in order to provide clear and neutral support for public service; the need for core public services to be self financing (except public transport); and the need to stay in broad line with the EU even if some aspects may need to be handled in a "Swiss" way. A definition of public services is also provided. They are characterised as:

- High quality basic services defined at a political level accessible to all categories of the population.
- Offered uniformly throughout the country, with quality control.
- Prices that are affordable to everybody.
- Uninterrupted service.

Efforts have also been engaged, with varying enthusiasm, to set up new means of making core public services available and of financing them. For example, service contracts have been established for the rail sector. Progress has been made in telecommunications and postal services, however, the regulatory framework has so far been quite weak in tackling transparency to reveal underlying costs (and profits).

A recent Parliamentary initiative by a commission of the Council of States proposes a possible constitutional article on public service. The experience of other OECD countries suggests that this could be too constraining, at least as to the means by which public services may be delivered. A more open market requires some flexibility as to the way in which these services are provided.

Recommendations

1. Improving the consistency of the regulatory framework in the sectors concerned through clearer mandates and objectives.

A high-quality regulation approach calls for a coherent framework of governance to be put in place for regulatory authorities. This framework is designed to achieve public policy objectives and to develop market activities in regulated sectors while taking account of their specific characteristics. Regulatory authorities cannot function properly without a

clear reference framework and without precisely defined objectives. The decisions taken by such authorities must be based on clear principles that can be understood by all parties. A precise definition of the responsibilities of the various actors is needed to implement an efficient governance framework. Experience shows that institutions pursuing a large number of partially contradictory objectives are often less able to fulfil their various missions satisfactorily.

The authorities addressed by the present study reflect contrasting situations. While the mandates of ComCom or PostReg are precisely set out within the framework of recent legislation, the mandates and objectives of longstanding authorities discharging their responsibilities within a very broad framework are defined more generically. This is the case for FOT and FOCA in particular. However, in the field of transport, the Constitution sets precise goals for rail policy, thereby defining the practical role and responsibilities of the FOT. In the air transport sector, the framework is less clear. Under current arrangements, safety functions as well as economic promotion are entrusted to FOCA. Recent reforms have modernised the regulatory framework with the aim of improving safety. The reorganisation of FOCA made it possible to clarify the internal procedures used to meet safety and economic development objectives. However, it might be desirable to explore the possibility of making an even greater distinction between the various services in charge of safety, perhaps starting on a geographical basis. This might make it possible to adopt a more autonomous approach to safety, before considering the possibility, where appropriate, of performing that function more independently.

FOCA likewise continues to perform functions aimed at developing the sector at the same time as regulatory functions aimed at providing the best level of service at the lowest cost. The Federal Audit Office noted this ambiguity in its assessment. FOCA only has a general regulatory function and does not have the power to regulate regarding airport charges and taxes, this function being jointly exercised with the Price Supervisor. Perhaps it might be possible in the future to see whether it would be feasible to clearly identify the nature of the economic regulation functions that FOCA is, or might be, called upon to perform, and then to consolidate them. Air control functions and missions could likewise be clarified. A start could also be made on analysing the way in which the Confederation's interest are represented in Skyguide's Board of Directors in order to clarify the nature of the public service duties assumed by this body, while at the same time providing it with adequate financial resources.

Possibilities for clarification and potential restructuring might also emerge in the rail sector. The regulatory framework is currently evolving. Some economic regulation functions are performed by the RACO, as well as by a path management body administered by the operators. As part of the Railways Reform Programme II, there are plans to set up an independent path management service. The Swiss authorities might well consider the option of setting up a separate regulatory authority consolidating all economic regulation functions in the rail sector. This would allow clarification of some of the functions of the FOT, which is also responsible for infrastructure development and safety management, as are comparable Ministries in other neighbouring countries.

A complex institutional architecture is also apparent in the telecommunications sector. ComCom can call upon the services of the Communications Office, while the latter can also receive instructions from the Department. There would still seem to be room for further progress to be made in clarifying the separation of roles and competences between ComCom and OFCOM.

2. Strengthening regulatory structures in Switzerland in the sectors concerned through increased independence and resources.

The growing internationalisation of activities in a number of infrastructure sectors has highlighted the need to provide uniform and predictable market conditions for operators and to guarantee the general neutrality of the regulatory framework. In return, this calls for consideration to be given to regulatory structures, and to the independence of the latter, that are needed to support the changes in progress. This is particularly the case with regard to telecommunications, air transport, rail path management, and postal services. The experience of a number of OECD member countries that have adjusted their regulatory environment in recent years, notably in Europe, can serve as examples in the work of institutional analysis, even if individual structures and statutory status may differ. The design of the institutional framework must take account of the structures in place in each country and the regulatory context.

In Switzerland, the current regulatory framework comprises authorities with differing status, and also with very unequal resources. The bodies which currently enjoy genuine independence take the form of a decentralised administration, with ComCom and the RACO having the status of extra-parliamentary commissions. However, there is still room for further reform, primarily because of the relatively short term of mandates, the conditions under which members serve, and the fact that bodies do not have their own Secretariat.

The Swiss authorities might consider the option of redefining a general statutory framework for regulatory authorities in cases where independence proves necessary, perhaps through legislation. This could be derived from the framework for extra-parliamentary commissions, after some adjustments. The term of commissioners' mandates could be lengthened. Experience shows that staggered appointments of commissioners tend to lend greater stability and consistency over time to decisions made by regulatory authorities. Restricting the scope for renewing mandates also tends to enhance the independence of bodies, even though this must be balanced against the need for experience and technical expertise. The regulator's function often requires a major personal commitment on the part of commissioners, which in turn calls for attractive remuneration. The appointment of regulators at a high political level can also be a means of reflecting the status of their functions as well as their independence. In Switzerland, this could be achieved by making appointments at the level of the Federal Council. The independence of authorities means that no instructions are to be given to those authorities by the Department to which they might be administratively attached. The search for independence also calls for specific provisions to ensure the integrity of the regulator's functions with regard to private interests. Some countries have decided to place restrictions on commissioners subsequently working in the regulated sector concerned. In other cases, commissioners must declare any prior activities relating to the sector.

The regulatory authorities, even though in many cases small, need a high level of technical expertise on which to anchor their authority and underline their independence. The Swiss authorities might therefore explore the possibility of systematically allowing regulatory authorities to have their own secretariats, whose size would be proportionate to the responsibilities entrusted to them. This is not the case for ComCom at the moment. Funding is another attribute that can influence independence. One means of enhancing independence is to introduce charges whose means of calculation would be stipulated in the legislation, or to use budgetary funding in accordance with special procedures designed to make regulators' resources secure.

The postal sector is also an area where a need for independent regulation is starting to be felt, given the outlook for the opening-up of this market. The current institutional framework is aimed at making a start on clarifying the functions of the State as regulator compared with the State as stakeholder and owner of the Post Office. However, the current authority PostReg, established under an Ordinance, does not have the status of an independent regulatory authority, an approach similar to that adopted in a number of neighbouring countries. This particular point was stressed in the 2005 WIK report. It also has a role in the design and drawing-out of policies which usually is not the task of an independent regulator. The Swiss authorities might consider allowing this authority to evolve towards greater independence as part of the reforms currently in progress. Lastly, from the standpoint of an independent authority, size is a practical constraint which might suggest giving consideration to organising competences on a multi-sectoral basis. It is for this reason that other European countries, such as Germany (see the new organisation in Germany with gas and electricity sectors) or France, have decided to consolidate regulatory functions in the communications sector.

3. Increasing the capacity of authorities to be accountable and strengthening communication with the public.

An approach based on high-quality regulation means that consideration must be given to introducing procedures to guarantee accountability. Such an approach is also aimed at making it easier for both firms and the public to understand regulatory decisions and objectives. This is all the more important in that regulatory authorities do not operate in an institutional vacuum and therefore need to find channels for dialogue with not only political decision-makers but also the general public and citizens. This allows them to ensure that their message has been properly understood and that their actions are consistent with the objectives they have been set.

The transparency and consensus that characterise the Swiss institutional framework offer major guarantees in terms of accountability. The practice of assessment, the quality of the information available, the will to consult and seek a consensus, allows all the various market actors to be involved in the process.

However, perhaps a more incisive communications policy might help the population gain a better understanding of the strategic challenges involved. The regulatory authorities might give thought to participating more actively in the public debate. At this stage, the situation varies from one sector to another and according to the relative degree of autonomy of bodies. Stepping up the institutional dialogue can also involve communicating with Parliament more actively through specialised commissions and publication of annual reports. Direct dialogue with the public, NGOs and opinion leaders might also be developed. This would lead to a better understanding of certain messages at a time when public service issues are attracting a lot of interest, as well as arousing a certain degree of apprehension, among the population.

Lastly, performance assessment is also an important instrument through which regulatory authorities can account for their actions. This has already been developed in Switzerland through self-assessment, the work of the Federal Audit Office and the role of European assessments. However, it might be advisable to base self-assessment on a more sophisticated statistical system in which systematic use is made of international assessments, notably at the European level.

4. Increasing the powers of regulatory agencies, notably in terms of tariffs, inspections, investigations and sanctions.

The regulatory authorities need to have sufficient powers to accomplish their missions. If not, they run the risk of being denied the leverage they need to implement decisions.

To date, the delegation of powers to regulatory authorities in Switzerland has remained fairly limited in terms of both access to information, through on-site inspections, and the power to impose sanctions or the power to regulate tariffs when necessary. In terms of tariffs, it might be beneficial to explore the possibility of increasing the *ex ante* powers of intervention of sectoral regulatory authorities after consultation with the Price Supervisor and Comco, where appropriate, in cases relating to monopolies or strong market power.

As a general rule, the effectiveness of the actions of regulatory authorities could be enhanced by giving them the power to conduct investigations and inspections on-site, as in the case of the powers currently granted to Comco. Likewise, increasing the punitive powers of regulatory authorities would make it easier for them to take action in the event of failure by regulated firms to meet their obligation. These powers should include in particular the power to fine in order to modify the behaviour of regulated firms. Moreover, the institutional process should be adjusted to ensure that when the regulatory authorities prepare and impose sanctions for unfair behaviour or failure to comply with regulations, the regulated parties are granted the full benefit of the guarantee that their procedural rights will be respected.

This could be achieved, for example, in the telecommunications or postal services sectors. While admittedly the independence of ComCom is recognised, and its existence accepted by market actors, it does not at present have *ex ante* powers relating to interconnection and local loop unbundling. These are part of the ongoing reforms discussed in Parliament in 2005. ComCom does not have any powers to investigate regulated firms either. In terms of tariffs, it does not have its own *ex ante* powers. Extending ComCom's powers to intervene might allow it to act more effectively. This could in addition include extended powers with particular regard to sanctions. Similarly, PostReg does not currently have any powers to sanction the Post Office to ensure that the latter meets its obligations with regard to the presentation of accounts and respect for the universal service.

5. Strengthening competition and consumer protection in the telecommunications, air transport, postal services and rail sectors through systematic agreements and co-operation with the competition authority and consumer protection services.

High-quality regulation requires achieving a coherent competitive environment throughout the economy. This calls for full collaboration and good co-ordination between sectoral regulatory authorities and the services in charge of competition.

Existing provisions in Switzerland have made it possible to guarantee satisfactory collaboration in the telecommunications sector. It would be desirable for such provisions to be extended, where appropriate, to cover the relevant aspects in other sectors, by ensuring cross-consultation between Comco and the sectoral authorities with regard to matching cases. Furthermore, the resources attributed to consumer protection in the sectors concerned remain inadequate. The role of the regulatory authorities in this area should be developed and should be matched by similar development of the role of consumer protection services.

6. Improving the legal framework for appeals regarding regulation through a unified framework.

A high-quality regulatory system includes procedures for appealing against individual decisions which will not cause delays in the decision-making process within firms. The existence of effective and consistent appeals procedures is a prerequisite for creating an environment favourable to investment and the development of economic activities.

The current system of appeals commissions in Switzerland reflects an uneven approach across sectors and agencies, and also includes a separate appeals procedure for decisions relating to competition policy. In some cases, as in the telecommunications sector for instance, this legal framework has hampered some of the efforts made by regulatory authorities. This system will be fully overhauled as part of the ongoing reform of the legal system. One might wonder to what extent this system will in the future offer a unified legal framework for appeals against the decisions of regulatory authorities, including those taken by Comco. It would be advisable to consider merging the jurisdiction for appeals against decisions taken by sectoral regulatory authorities with that for appeals against decisions by Comco. It would also be advisable to ensure that the legal services can benefit in their procedures from the provision of adequate technical and economic expertise with regard to high-tech sectors.

Notes

1. The infrastructure or network sectors are sectors which depend on a network (grid, pipeline, rail track or other essential facility such as landing slots for civil aviation) in order for suppliers to be connected to customers. Access to these facilities is not only essential for players in the market, but they are often also natural monopolies, and some in addition have complex technical characteristics which require single central management. The main network sectors are usually considered to be electricity, natural gas, air, road and rail transport, water and sanitation, and telecommunications. Postal services may also be added to the list.
2. Telecommunications is one exception with technical developments through the deployment of satellite and radio that have shattered (though not entirely removed) the natural monopoly core of fixed lines. Some other sectors, however, seem condemned at least for the foreseeable future to just one network technology. Electricity for example can only be transported in bulk and long distances on expensive grids, which also require real time central management (called system operation) in order to remain technically stable.
3. In electricity for example, there may be scope for Switzerland to become a technical leader in regional grid management issues (as it was after the Second World War) and in benchmarking techniques (given the large number of distribution companies).
4. These are usually remote areas of low population density where prices charged cannot cover costs.
5. See Part II, section on regulatory policies and outcomes, for a fuller review of the Swiss appeals system.
6. See Part II, Chapter 3, for a fuller review of this.

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PART II
Chapter 6

Electricity Reform*

* For more information see the background report on “Electricity Reform” available on the Web site:
www.oecd.org/regreform/backgroundreports.

Introduction

Electricity* reform features prominently in Swiss proposals for promoting stronger economic growth, and is on the list of actions to strengthen the Swiss internal market and improve competitiveness identified by the OECD. In contrast to best practice, the current Swiss legal framework does not yet make specific provision for competition in this sector. There is, as yet, no independent regulator or independent system operator, and no competitive wholesale market underpinned by specific rules for third party access to the grid. The market remains closed to effective competition, despite attempts by some market players to test the limits of what is possible under the competition law.

The structural and legal development of the Swiss electricity sector started in the early 20th century with the adoption of important framework laws, including an electricity law and a law on the use of hydropower resources which remains on the statute book. The topology of the country was a key factor in the development of a large number of distributing companies, most of which still exist and often operate under their own legislation and rules. A dense electricity network later evolved. Switzerland also became a key participant in the rapid development of an integrated grid across Europe after the Second World War. This period also saw the construction of large new hydro and nuclear plants. Switzerland is also a significant part of the European high pressure gas grid, for which negotiated third party access has been allowed since 1963. The more recent policy history of the sector has seen a growth in the importance of environmental issues, including a growing emphasis on renewables, and the roll out of significant energy efficiency programmes.

As well as supporting a stronger internal market and growth performance, reform is needed to catch up and converge with developments in the EU, where market opening is considerably more advanced. Switzerland's central geographic position in Europe as a major electricity transit and trading hub requires this. The 2003 Italian blackout has raised issues about the European and Swiss regulatory framework for securing reliable supply.

The Swiss Federal authorities have been aware for some time of the need for reform, and a first project for a new law was launched a few years ago, but was narrowly defeated in a popular referendum in 2002. A new reform package has been proposed by the federal government and is currently being debated by Parliament. This time round, there is room for cautious optimism about reform prospects.

* The assessment in this chapter is based on the proposal the Federal Council submitted to Parliament at the end of 2004 for electricity market reform. The project was still being debated in Parliament at the time of the review. The proposed legislation is also characterised by its slimness. The outcome of the reform will therefore strongly depend on provisions laid down in ordinances that will follow adoption of the reform law. These two factors complicate a clear evaluation the reform proposals and, to some extent, the articulation of recommendations at this stage. Equally, the recommendations should be helpful to the process of further refining and developing the proposals through the remaining stages of the reform process.

The federal proposals are broadly on the right track and identify all the main elements of an effective reform, although some aspects need strengthening. Some elements, such as the establishment of a genuinely independent regulator and system operator, as well as regulated third party access to the grid, are essential for progress to be made towards a more effective and competitive market structure, stronger price performance, and more robust system reliability. Managing the transition to a new framework will also be important, as well as continued communication, especially to the general public, of the reasons why reform is important. This implies ongoing federal government co-ordination to keep the reform process on course, and to prevent the disintegration of an initially well conceived plan under political pressure.

Main features of the sector

A large number of very diverse companies

The Swiss power sector is characterised by the large number and structural diversity of its electricity companies. There are currently over 900 companies, which also vary considerably in ownership and legal form, size, and activity, and there are marked differences between regions as well. Very broadly, the sector is made up of a small number of large utilities, which generate and distribute most of the electricity sold, and a large number of very small utilities, which distribute electricity to their communities (and are often interwoven with municipal budgets). Five very large vertically integrated companies dominate the value chain. But there are also about 200 vertically integrated regional companies, as well as a vast number of small distribution companies. There are important cross linkages within and between the various categories (for example, the distribution utilities purchase power mainly from the five big companies, which themselves share a close relationship). Most companies are partly or wholly publicly-owned. An evolutionary process is underway, partly in anticipation of market opening, toward consolidation, partnership and co-operation, and sale of public equity.

Generation dominated by hydro and nuclear

Swiss power generation is dominated by nuclear and hydro (the latter accounts for nearly 60% of generation). Generation reflects the structural diversity of the industry, with some 2 300 generating plants, the 25 largest accounting for almost 60% of generation, along with a multitude of micro hydro plants. The nuclear/hydro mix is well balanced and has been efficiently exploited in order to secure efficient and reliable generation across the domestic load curve (nuclear for baseload and hydro for peak load demand).

System operation in transition

A joint subsidiary of the five largest companies (which between them own and operate the grid), called Etrans, co-ordinates system operation across the high voltage grid. Today, the five companies propose to replace Etrans with a legally separate company, Swissgrid. This is currently held up by a dispute with the competition authority over conditions attached by the latter, aimed at strengthening the new company's independence from its owners. In any event, the proposal would be displaced by the system operator proposals under the new reform law, modelled on requirements in EU legislation.

Highly developed transmission and international trade

The combination of its central geographic location in Europe and the opportunities afforded by its hydropower to store electricity have made Switzerland a major trader as well as a major hub for the transit of electricity in the European market. It accounts for some 11% of electricity trade and nearly 20% of cross border transmission capacity within the UCTE area. Overall, it is a net electricity exporter. Two main factors underlie Swiss power trade: exploitation of hydropower's storage capacity, and the seasonal fluctuation of electricity production and demand. Cross border physical flows have increased considerably over time. The contractual basis for the trade has also been changing, towards short term contracts and trading on the European power exchanges.

Reflecting this situation, Switzerland has a dense and highly developed transmission network, with some 6 500 km of high voltage lines. Even so, the network is struggling to cope with trade developments. The interconnection with Italy is a major bottleneck, and there can also be congestion in the interconnections with France and Germany. Some new interconnections will ease the problem somewhat, but not wholly.

Distribution and supply on a local basis

Distribution companies typically supply and sell to a demarcated distribution area either with direct sales or with indirect sales through partners or shareholders. The supplier usually owns the local grid. The accounts of many small distribution companies are often bundled into municipal finances.

Demand and renewables

The largest consumers are industry (34%) and households (30%). Electricity consumption has risen slowly but steadily over the last couple of decades, outpacing economic growth (a factor that can be explained by demographic growth and economic activity). Objectives of the energy programme until 2010 (SwissEnergy) are to limit the increase of electricity consumption and to raise the share of new renewable energies in power generation.

The current legal and regulatory framework

The current framework is best described as *ad hoc* with regard to market regulation and competition. It was not designed to promote competition, and there is no independent regulator. The strong role played by the cantons means that they will also have a crucial role in securing change aimed at developing competition.

Strong cantonal influence

Broadly speaking, the federal level legislates on strategic issues, and the cantons implement this legislation, with near total autonomy over the way they do this. The legal system also grants significant law making and regulatory powers to the cantons in their own right on electricity matters. Switzerland does not currently have an agreement with the EU on electricity, which would be needed under the proposed reform. The main current federal laws relating to electricity include two that date back to the early 20th century, and mainly focus on energy efficiency, the promotion of renewables and technical and safety issues. Specific regulation is largely though not exclusively in the hands of the cantons and municipalities, and broadly covers market entry (for power plant licences), end user prices (regulated by the cantons or municipalities and approved by local political bodies), and end user supply and public service (distribution concessions or through the local authority's own utility).

Regulatory authorities

All three levels of government (federal, cantonal, municipal) play a regulatory role. At the federal level two ministries and related offices and authorities are relevant. The Federal Department of Environment, Transport, Energy and Communication (DETEC) through its Swiss Federal Office of Energy (SFOE) has the main responsibility for energy policy. The State Secretariat for Economic Affairs (SECO), part of the Federal Department of Economic Affairs examines the impact of energy policy on the economy.

Relevance of the competition law and price surveillance

The lack of any competition provisions in the electricity specific laws has put the spotlight on the Cartel Law as the main law, in practice, that has the scope for dealing with competition issues in the electricity sector. This law has proved effective at opening important breaches in the current unliberalised framework. The competition authority has made use of its powers to launch a number of investigations, mainly linked to abuse of dominance. The most important such case, which opened the way to negotiated third party access to the grid, was the 2001 EEF/WATT decision. Comco's conditions for the establishment of Swissgrid are another example of efforts to use the competition route for improving market conditions. Contestation of these cases is ongoing, however, which highlights the weakness of relying solely on the competition law for market opening.

The Price Surveillance Authority, which is attached to the Department of Economic Affairs, monitors prices charged by dominant enterprises and can take action if it determines that prices are abusive. It too has played an increasingly significant role in the power sector in recent years. Specifically, it has launched an initiative on end user price transparency and benchmarking via the Internet. It shows that end user prices can vary enormously between localities.

Performance of the sector

There are two main issues for Switzerland. The first is efficiency, and the second is system reliability. Reform is the only way to deal with both issues. There is a fundamental lack of transparency in the sector (the Price Surveillance Authority's price initiative is very welcome in this regard). Improving transparency through such mechanisms as price monitoring and benchmarking is a priority. A more difficult long term goal would be to review the structural basis for local market distortions and find other ways of supporting local economies than via power pricing. Reliability of the transmission network and power technologies for the longer term are the issues for attention in relation to security of supply.

Price levels may not reflect true costs

Price levels are overall relatively high for industry in international comparison, although the picture varies by category. Prices are especially high for SMEs which pay about 50% above the EU average. The main issue for households is great price variability across the many distribution zones of the country. These differences and the fact that power generation is largely based on depreciated hydro and nuclear plants suggest that prices do not currently reflect true costs.

Cross subsidisation, monopoly rent, costs and taxes – an opaque and complicated picture

Part of the gap between costs and prices can be explained by excess profit. This is either recycled into municipal revenues or pocketed by companies as monopoly rent. The former is sometimes justified by the claim that the rent goes into local budgets for development and public works. Since there is no cost information, it is hard to judge how much excess profit and cross subsidisation is involved. One indication is that average industry prices dropped by 25% in 1998-2003 in anticipation of the first proposed electricity reform law. It is also, for the same reasons, hard to judge the extent to which there may be inefficiency in the sector which is raising costs. A complex structure of taxes and fees (levied at all three levels of government) further complicates the task of analysis. A range of taxes is levied by the cantons and municipalities, the extent and level of which varies significantly. The most important is the royalty tax on water use, for cantons that have hydro plants. Local taxes provide significant revenue for mountain regions.

Transmission system reliability – a major issue

The 2003 Italian blackout crisis has been carefully analysed for its causes. The Swiss report on the blackout notes that the underlying cause was a chronic and worsening mismatch between scheduled and actual power flows on the grid between Switzerland and Italy, against a background of rapidly growing trade due to higher production costs and prices in Italy. But the effective exchange of information is a major issue too. Switzerland has been largely excluded from relevant developments and discussions in the EU, with capacity allocations increasingly ignoring Swiss concerns about capacity limits. It is, however, accepted by the Swiss federal authorities that there is an urgent need to apply the EU transit regulation and set up an independent regulator and system operator that can join the relevant EU fora as equals.

Switzerland's current set of generation technologies serve it well, but there is a need to consider the longer term, given constraints on further large hydro development, and difficult decisions on the future of nuclear power. Decisions have to be taken against the background of the likely adoption of a CO₂ tax. Natural gas is a promising possibility given the existence of high pressure transit pipelines. A measured assessment of the contribution which new renewables can make to the future generation mix will be important.

The European dimension

European market and regulatory developments are extremely important for Switzerland given its central position. Both the EU and the UCTE (Union for the Co-ordination of Transport of Electricity) are key institutions in this regard. Over the last few years the EU has adopted framework legislation for market opening and cross border grid management, and more legislation to reinforce security of supply aspects is on the way. The UCTE has been active in updating technical system security rules in the wake of the Italian blackout. Efforts are being made to strike the right balance between commercial freedom, and the security needs of a densely meshed regional grid system which leads to a high degree of interdependence between European countries. The developments have some way to go still.

Market opening

The aim of the 2003 Directive is to push the EU electricity market opening process to an end point in 2007 when all consumers will have a choice of supplier, and to strengthen

the necessary regulatory and institutional apparatus for this. The content of the Directive can be viewed as a template against which market opening reforms may be assessed and which determines the market context to which Swiss firms will be exposed.

Cross border congestion management

This was not a major issue until increased trade from market opening put traditional grid structures under pressure. The 2003 transit Regulation seeks to address some of the issues by putting capacity allocation under the oversight of national regulators, emphasising transparency and market friendly approaches. It defines a new framework for capacity allocation, with a strong preference for auctions. Compliance and enforcement, however, are not directly covered, and the framework needs fleshing out, a process that is being carried forward in relevant EU fora. Europe is currently working through a messy transition from the old, opaque capacity allocation arrangements between system operators and the new approach which puts national regulators in charge of a more efficient and transparent system.

Security of supply

This was highlighted by the Italian blackout, which showed up the vulnerability of the European grid under present operation and trade practices. Of importance in this context are the rules for short term system reliability, the institutional frameworks to promote reliability, and regulation to promote reliability via appropriate investment. The UCTE's report on the blackout underlined that the immediate causes were reliability rules and institutional relationships that failed to meet the test, and a broader issue of pressures on the grid from increased trade. As regards short term system reliability rules, the UCTE has taken the lead in reviewing these. The N-1 rule (used worldwide) is a key issue, given the risk under this rule. An updated security package including security standards is being adopted, and the issue of effective compliance is being addressed. The UCTE has also made a number of recommendations for an effective European regulatory framework, emphasising the importance of setting up independent system operators under the approach taken in the 2003 EU Directive, to avoid incompatibilities that could endanger security. Lastly, national as well as European regulations are important, both of a technical nature such as grid codes, and to ensure adequate investment in transmission. The UCTE has made recommendations, and the EU Commission has tabled a new directive on electricity infrastructure and security of supply.

The proposed reforms and their assessment

The Federal Council reform package

The Federal Council has tabled a second reform package which is currently being debated by Parliament. It is made up of three main elements: international transit reforms aimed at aligning the Swiss legal and institutional framework with the EU transit Regulation, much broader and more comprehensive reforms for the internal market aimed at alignment with the EU Directive on market opening, and proposals to support renewables. The first two elements of the package are necessary and important, and the first is especially urgent given system reliability concerns.

Market opening

In order for competition to take root in a market that has been effectively closed and tightly controlled by local and regional monopolies across the whole value chain, a number of elements are critical: a strong and effective regulator, effective regulation of access to and use of the grid, effective unbundling of the grid from other activities, and the development of an effective wholesale power market that supports competition between generators and facilitates the development of new links between suppliers and customers. In this regard, large parts of the package cover the essentials and are strong in principle but some parts need to be reinforced, which may be through the ordinances that would follow adoption of the reform laws. Regulated third party access is covered, as well as the establishment of an independent regulator. The framework for the new regulator needs some attention. The two stage approach to consumer choice is reasonable so long as there is effective regulation to avoid abuse by designated network operators of their right to supply households in the transition (and beyond).

Network unbundling

The unbundling requirements distinguish between the distribution and transmission grids. The stronger form of legal unbundling is proposed for the transmission grid. Accounting unbundling is proposed for the distribution grid. This is the weakest form of separation as it can reduce the ability, but not the incentive, to discriminate, and can act on the former only if it is implemented effectively. It requires, in essence, a strong independent regulator with the necessary powers of enforcement, and a linked requirement on the incumbent to provide necessary information. If this route is followed, best practice for making it work (including from other sectors such as telecommunications) can help to define what is needed. Although cross financing between network and other activities is prohibited under the draft law and community related payments must be identified in invoices, the proposals do not address separating the accounts of the utilities from the political bodies to which many of them are attached. It would also be useful to set up a framework or checklist for ensuring competitive neutrality between players, and to carry out a review of corporate governance, using the OECD's checklist. Benchmarking distribution performance (including with other countries) can also help in efficient market development at this level.

System operation

The proposals include the establishment of an independent system operator, and set out its duties. These are a major and essential step forward from the current unsatisfactory situation under which Etrans has no formal powers of control and is best described as a system co-ordinator, and are a major potential reinforcement of system reliability. They will enable Switzerland to play a much fuller part in relevant European fora. The new entity's independence is clearly set out, and could be further reinforced if the new regulator (ElCom) were explicitly allocated the task of overseeing it.

Network use pricing

The proposals reflect many of the best practice principles that are emerging from experience elsewhere. The important cost reflective principle is firmly embedded at a general level, and the proposals also tackle two other main issues appropriately: the overall revenues that network owners will be allowed to recover, and the way they should charge

network users. There is also a strong and helpful emphasis on the need to provide incentives for investment as well as minimising charges for use of the network. Benchmarking might be considered as an additional tool, taking due account of its resource intensiveness. This possibility is provided for in the draft law.

Cross border congestion management

The proposals closely track the EU transit Regulation and (alongside the proposals for an independent system operator and independent regulator) should enable Switzerland to play a full part in the EU management of cross border flows. As staying on the sidelines of these developments carries both security and commercial risks, not adopting the proposals is no longer a realistic option.

Public service

These provide for the cantons to define network zones and to designate network operators for these zones on a non-discriminatory basis; put an obligation on the latter as regards delivery and pricing; and give households the right to stay with their existing supplier (if there is full market opening) i.e. they set up a supplier of last resort system. The proposals echo what has been put in place across a number of other European countries for universal service. The principle of cost reflective tariffs will have to be firmly enforced, but risks being undermined by the network zone approach. Much depends on how these zones are drawn up. Continued cantonal price regulation is another issue. Service quality standards would be a useful addition to the proposals.

Independent regulation

The proposals for an independent Electricity Commission (ElCom) are another major step forward. Its independence is a major issue in the Swiss context, which has no tradition of independent regulators, yet will need one in order for reform to be effective. The proposed collegial structure is positive, as such a structure generally helps to ensure independence. Resources and staffing are another important aspect. Anticipated staffing looks very low in international comparison, even allowing for Switzerland's small size. Staff competences will also need careful attention, with a mix of expertise that will allow the new regulator to establish itself firmly and rapidly in a complex market. The links to other institutions are important too. The new regulator will need a clear identity and place in the institutional framework, including its link to the oversight ministry, if it is to function with authority. The proposals helpfully assign the Price Surveillance Authority the task of advising ElCom on prices. ElCom also needs a clear relationship with the competition authority, given that the latter remains responsible for tackling abuses of market power. It would be useful to give ElCom a list of strategic objectives (including regulatory oversight of the new system operator), beyond the specific duties and responsibilities that are already laid out. The proposals assign ElCom a monitoring role, but its powers to obtain information are not yet clear. Prosecution and sanctions for non-compliance with rulings issued by ElCom are the responsibility of the SFOE, as the office is in charge of applying the general penal code in the sector. This introduces a complex setting.

Renewables

The basic aim of this part of the reform is to meet demand for a large increase in the share of renewables in the future power mix. The latest proposals suggest a specific growth

target to be achieved by 2030. Several policy instruments are being debated in Parliament to achieve this target, including an increase of feed in tariffs, a quota system and auctions (for the renewal of existing hydropower plants and efficiency programmes). This is a difficult debate in Switzerland, in which the realistic future contribution and costs of renewables are highly controversial. In the Swiss context, the prospects for new large hydro are effectively non-existent so this leaves reliance on “new” renewables to meet potential targets, which can be costly, as some other European countries have found. International best practice and experience should be used to guide the best approach. A strong stand should be taken in favour of market-based approaches, avoiding feed in tariffs if possible as these offer little scope to bear down on costs. Ensuring that Swiss approaches are aligned with EU developments will help to ensure that Switzerland can be part of EU renewables promotion mechanisms such as emissions trading and green power exchanges.

Taking reform forward

Focusing on essentials and sustaining coherence

An important lesson of past difficulties with electricity reform in other countries is the failure to ensure that the essential building blocks of an effective new regulatory regime are firmly anchored. The strategic essentials are clear for Switzerland, partly because there has been no market opening reform so far. These are: the specific proposals for congestion management based on EU legislation; for domestic reform, a strong and independent regulator to regulate and encourage change, an independent transmission system operator to promote grid reliability and facilitate access to the grid, and effective management of third party access to the grid; and the effective and transparent development of a wholesale power market to encourage competition. A strong cross cutting focus on transparency and benchmarking would help to pull the distribution sector forward.

This is not a limited approach, but rather the reverse. Tools such as benchmarking require adequate resourcing. The ordinances that will flesh out the primary laws on the main issues need to be clear and complete, for example as regards the powers, resources and institutional place of the new regulator. Another lesson of reform failures elsewhere is the specific failure to master technical details effectively.

Maintaining effective communication

Maintaining effective communication is important. The details of electricity reform are often technical and difficult to convey. These are important for certain stakeholders such as market players, but the broad picture, objectives and expected results also need to be laid out for users and the wider public. For this second attempt at reform, there are some positive aspects to build on. There is likely to be a better understanding of the issues, reflecting the communication that has already taken place. Lessons have been learnt in other countries that Switzerland can use. There is still a need to address justified fears and worries, as well as to focus on benefits. It is important to target the general public because of the Swiss tradition of direct citizen participation in law making, and the fact that households account for nearly a third of electricity consumption. Consideration should be given to setting up a broad institutional support mechanism, perhaps modelled on the committee of experts that advised on the current reform package.

Managing the EU dimension

A formal mandate is essential to progress an agreement with the EU, and an agreement with the EU is essential to secure recognition of Switzerland as a full participant in EU developments. If domestic reform is effectively handled, there is little cost attached to following the EU path, and considerable domestic advantage to be gained once competition develops. There are major opportunities to help shape the EU framework even without being formally part of the EU. Switzerland should in particular press for participation, formally and on equal terms as far as possible, in the European electricity discussion groups, committees and fora. These groups are developing the details of EU rules as well as debating new approaches to regional market and reliability issues. They are also a way of keeping in touch with best regulatory practice.

A long term vision

The debate about reform in Switzerland often looks at the negative side. But there are important opportunities too. These include commercial leadership, given Switzerland's existing role as a major trader and supplier of peak electricity; regulatory leadership, by seeking to develop a strong voice on issues such as benchmarking; and technical leadership, by making a much fuller contribution to regional grid development and stability (echoing the Swiss role after the Second World War in the initial development of the European grid).

Recommendations

The recommendations below are based on the reform package submitted at the end of 2004 by the Federal Council to Parliament. The status of the package as of September 2005, following debate in the National Council (lower chamber) was:

1. Revision of the 1902 Federal Electricity Law: establishment of ElCom the TSO (the latter with a clause to ensure that the majority of Board members are independent) and regulated TPA for cross-border transmission lines.
2. New Electricity Supply Law: two phase market opening, with the aim of market opening by 2007 for consumers above 100 MWh consumption, and full market opening five years later, with the option for households to remain captive. Full market opening no longer to be subject to an optional referendum, but to a Parliamentary vote.
3. Revision of the 1998 Energy Law: renewables to be increased by 5.4 TWh by 2030, to be promoted through feed-in tariffs and other incentives. Total additional costs generated by feed-in tariffs would be capped at 0.3 Swiss cent/kWh. Modalities are yet to be defined.

The proposals now go to the upper chamber for debate, probably in spring 2006.

A. General recommendations

Reform of the domestic market as well as addressing cross border issues is necessary and increasingly urgent. At the time of writing these recommendations in September 2005, the prospects for moving forward on both fronts at the same time seemed reasonably positive. That said, if it becomes clear that the alternatives are no reform at all, or acceptance of the cross border proposals, the urgency of the reliability issues, highlighted by the Italian blackout, suggests that it would be better to have the cross border proposals than nothing at all.

1. Anchor essential changes firmly into place.

Essentials need to be anchored firmly into place. These are an independent regulator, an independent system operator, and regulated third party access to the grid. The development of an organised wholesale market should also be formally encouraged. This will provide the foundations for future progress toward a more effective and competitive market structure, stronger price performance and more robust system reliability. An important lesson of past difficulties with electricity reform in other countries is the failure to provide firm foundations of this kind. The role of ordinances to flesh out the primary legislation is also crucial in this context. Another lesson of reform failures elsewhere is the specific failure to master technical details effectively. Ordinances allow scope for fine tuning, but there is also a danger of weakening original intent, which may generate investor uncertainty. The Federal government needs to sustain a strong co-ordinating role among political actors to ensure this does not happen.

2. Set the scene for a self sustaining evolution of the market.

Promote transparency and benchmarking

Transparency and benchmarking can be valuable allies in the development of a competitive market. The aim should be to promote greater transparency wherever possible, including end user and grid access prices, and clear unbundling of the networks. The initiative of the Price Surveillance Authority to collect and disseminate information on end user prices and grid access tariffs should be supported with the necessary resources. A regular flow of reliable information is needed to sustain popular support. It would also be useful to extend the work to wholesale prices, in order to encourage the development of a transparent and well functioning wholesale market and to discourage gaming by market players. Benchmarking retail prices across regions can be expected to encourage voluntary change, as consumers become more aware of prices, and producers or suppliers seek to maintain (or increase) their market share.

Engage and sustain the support of the cantons and municipalities for reform

The cantons play a major role in defining public service obligations and in the management of the electricity sector. They will also have a major role in securing change aimed at developing competition. Areas in which they need to be particularly engaged include benchmarking, transparency, new forms of company governance that are compatible with a more open market, and competition friendly management of their responsibilities for enforcing the public service aspects of the reform to ensure that local designated network operators do not abuse their position.

Fiscal change will be needed in the long run, to help extricate the distribution sector from local public budgets. A long term goal should be to review the regulatory and structural basis for the distortions to local distribution markets, and work toward a less market distorting and more transparent means of supporting local economies.

Promote a level competitive playing field, including stronger corporate governance

This is especially relevant to the distribution sector. Best practice can be found in the competitive neutrality frameworks set up elsewhere in the OECD such as in Australia and the Netherlands. The OECD Principles for effective corporate governance can also help to define helpful changes in this area.

Ensure that Comco and the Price Supervisor have the means to continue supporting the reform process

Comco and the Price Supervisor have crucial supporting roles in the transition to competition, even after a reform law has been enacted. Comco will need to continue to deploy its powers through the Cartel Law, to act on abuse of dominance and on mergers and acquisitions, both of which will need careful monitoring in the foreseeable future. The latter does not necessarily mean opposing mergers. The Swiss industry structure is currently very disaggregated, and further mergers in the distribution sector especially may help the reform process. Comco will need a strong and defined relationship with ElCom. The Price Supervisor's initiatives in the promotion of price transparency and benchmarking have already started to have an effect on the companies, and it should be adequately resourced to continue this work.

3. Manage the transition to a new framework.

Managing the transition to a new approach will be as important as getting the technical details right. This implies ongoing political co-ordination at the federal level of all important players at all levels of government and across key institutions, which does not lose sight of core needs, effective and continuing communication with the public as well as other stakeholders, and close attention to the way reform will unfold in practice over coming years, so as to take corrective action if this is needed.

Maintaining effective communication is crucial. This means, especially, addressing justified fears and worries, focusing on the benefits of reform, and targeting the general public.

Consideration should be given to setting up a broad institutional support mechanism, perhaps modelled on the lines of the committee of experts that reviewed the Federal government's draft proposals. This *ad hoc* committee or commission would have the specific purpose of addressing electricity market development, and could draw in representatives of the cantons and municipalities as well as federal administrations, and business and consumer representatives. Periodic evaluation of progress to check that reforms are moving in the right direction should be considered.

4. Ensure that security of supply in generation remains on the strategic agenda.

A clear vision of the way forward will be important. This should, especially, consider the potential of natural gas. It should also ensure that the scene is set for timely decisions on nuclear power. The contribution that new renewables can make to the generation mix needs a sound assessment.

B. The EU dimension

The combination of its central geographical location in Europe and the opportunities afforded by its hydropower to store electricity and to provide peak power have made Switzerland a major trader as well as a major hub for the transit of electricity in the European market. It is an important peak electricity producer for the European market. But at the same time, imports are needed to cover domestic winter consumption when hydro production is at its lowest and demand greatest. Switzerland therefore needs to be able to influence the regulatory setting in which its electricity sector will operate in future.

5. Secure an equitable agreement with the EU.

An agreement with the EU is essential to secure recognition of Switzerland as full participant in European grid management at least, preferably more.

Aim to participate on equal terms, as far as possible, in the EU and other European regulatory and technical groups

For this Switzerland needs a recognised independent regulator and an independent system operator. Participation is important because these groups are developing the details of EU rules as well as debating new approaches to regional market and reliability issues. They are also a useful way of keeping in touch with emerging best regulatory practice.

6. Play a strong and positive role in the development of a new European framework for system reliability.

The Swiss transmission grid is under growing pressure from increased international trade. Capacity allocations increasingly ignore Swiss concerns about capacity limits, and Swiss exclusion from key European discussions and negotiations has both overloaded the Swiss grid and also promoted an inefficient use of the grid. But the ongoing European discussions also represent an opportunity to shape developments. Switzerland should continue to work with the UCTE on developing better reliability standards and compliance mechanisms, as well as taking as active part as possible in the EU fora (which should become much easier once there is an independent regulator and system operator).

7. Participate in the discussions on new commercial market ideas.

Some of the ideas under discussion in Europe, such as market coupling, are of considerable potential interest to Switzerland as a major trader.

C. Specific reform issues

8. Establish a fully independent regulator.

A strong independent regulator is essential for the EU as well as the domestic context. The reform proposals are a good start but some issues need more careful treatment.

Strengthen the provisions for independence

This matters especially in the Swiss context because there is no tradition of independent regulators. Given the current non-competitive structure a strong and independent regulator is essential to act as a motor for the development of competition. The proposed collegiate structure is positive, as such a structure generally helps to ensure independence in decision making, especially when the board is made up of independent experts. But specific areas such as selection procedures, conditions to promote independence such as a prohibition on having a financial interest in the regulated sector, or rules to protect the board from politically inspired dismissal, are also needed. Open decision-making procedures, such as posting the record of Board meetings on the Web site, also help to reinforce independence (as well as strengthening accountability).

Ensure that ElCom can exert its proposed powers, and highlight its key strategic responsibilities

ElCom's powers are potentially broad, as defined in the draft law which underlines its role in ensuring that the provisions of the new law are complied with. It will be important

to ensure that it can deploy these powers effectively in practice. Also, its strategic responsibilities are not clearly defined. These should be clearly earmarked to include strategic responsibility for the oversight of the new TSO, the oversight of public (universal) service obligations and protection of the consumer, and for the enforcement of grid access, network tariffs and accounting separation.

Strengthen the provisions for resources

Anticipated staffing looks very low relative to the work that needs to be done. Switzerland's small size may not allow for a much larger entity and may require some sharing of expertise with and technical support from the ministry, but the costs of a new regulator (even a slightly larger one) will be low relative to the benefits which can be expected from a successful reform of which a strong regulator is a central component, and other small countries have larger regulators. A levy on the industry, as proposed in the draft federal law, is one way of raising funds.

The competences of the staff also merit attention. Industry and consumer experts are certainly needed, but specific competences in economics, law, and accounting are also essential. A knowledge of costing and accounting, for example, will be invaluable in the work that lies ahead to master unbundling in Switzerland's highly complex network of industry relationships.

Address relationships with existing institutional structures

The new regulator will need a clear identity and place in the institutional framework in order to function effectively and with authority. This place is not yet wholly clear. Horizontal institutional relationships should also be covered. The most important ones are with Comco and the Price Supervisor. The proposals assign the Price Supervisor the task of advising ElCom on prices, which should help any problem of capture as it provides for a second opinion. There is no direct reference to the relationship with Comco. Based on the existing competition law, Comco remains responsible for tackling abuses of market power, an important issue for the healthy development of the Swiss electricity sector. Co-ordination mechanisms with ElCom need to be put in place through ordinances or formal agreements. One option is to have a Board member of Comco sit on the ElCom Board and *vice versa*. The relationship with the cantons and municipalities should also be covered.

Strengthen the provisions for accountability

Countries are deploying a variety of approaches to secure accountability, including compliance with requirements for high quality regulation, consultation, publicising regulatory decisions, and systematic reporting to interested parties. Performance evaluation is another approach, which requires the establishment of clear objectives against which performance can be measured. Giving ElCom a list of strategic objectives and responsibilities against which it might be judged, beyond the specific duties and responsibilities that are already laid out, would help with this.

Ensure that ElCom has adequate powers to ensure that its rulings are respected

The ability to obtain information, so that it can be verified, from what are likely to be recalcitrant regulatees is especially important *e.g.* for checking that there is effective separation of activities. The proposals assign ElCom a wide monitoring role, whilst

prosecution and sanctions for non-compliance with rulings issued by ElCom are with the SFOE, reflecting the latter's responsibility for applying the (non-electricity specific) penal code. The way that this split of responsibilities works in practice may need attention.

9. Establish an independent system operator.

Etrans, a co-ordinator rather than a proper system operator, is an unsatisfactory stopgap. It is essential to move toward a proper system operator, for the EU as well as for the domestic context. The proposals are in the right direction but some issues need to be strengthened.

Secure the TSO's full independence

The TSO will need strong regulatory oversight and carefully designed corporate governance. These are important because it will not be a wholly separate company vested with ownership of grid assets. The governance proposals are well conceived and should not be weakened. The TSO Board must be wholly independent of its owners. The independence of the Board's CEO should be secured through appropriate rules covering recruitment and terms of appointment.

Ensure an effective evolution of the new system operator that will address the needs of short term system operation and long term investment planning in a balanced way

The proposals assign the TSO responsibility for the operation of the transmission network. Ownership of transmission assets remains with the existing owners. All network managers need in particular to establish multi-year plans to ensure the safety and efficiency of the network. In the event that the owners fail to take due account of long term system needs such as investment in network maintenance and extension, the TSO may request ElCom to take the necessary measures, at the owners' cost. Allocating and achieving the best balance of responsibilities for short and long term transmission management issues is not an easy task. A variety of approaches – asset-owning and non-asset-owning system operators – have been deployed across the OECD. The proposed Swiss legislation assigns the duty of long term grid planning to all network operators and vests the authorities with supervising and sanctioning powers. The approach proposed by Switzerland will need monitoring for its effectiveness over time.

Ensure an appropriate regulatory framework for other important issues

Issues such as rules for system dispatch, quality standards, procurement of reserve capacity, need to be transparently laid out and approved by the regulator, whether through grid codes, licences or other processes consistent with transparency and the promotion of competition. Reliability standards and incentives need to be put in place.

10. Promote consumer choice and separate the issue of market opening from the provision of public service.

Separating the issues of market opening, and ensuring a defined public service under conditions of competition, is important and not wholly achieved in the proposals. Full consumer choice would be desirable in the longer term, and if provisions for its achievement can be agreed now, so much the better. A measured approach, as proposed by the Federal Council, would allow the new regulatory and institutional apparatus for competition to evolve and be tested. It should be noted that stability for local suppliers is not a good argument in support of this approach.

11. Ensure regulated and ex ante third party access to the grid.

Market opening with the Cartel Law is an unsatisfactory case by case and *ex post* way form of market opening. Disputes on network access on this basis would have to be settled individually, probably in the courts. The time this takes would be a major disincentive for all but the most determined competitors with deep pockets. There is also some legal uncertainty over the position reached in relation to third party access via this route. A regulatory approach does not mean that there will be no challenges, but it provides for a more consistent approach and may generate a test case that will ease subsequent challenges. It will also provide for a more consistent approach.

12. Unbundle the grid effectively.

Effective unbundling is essential both for the transmission grid and the distribution network. If it is not adequately secured, it may compromise both balanced system development and commercial efficiency by increasing the difficulty of market entry. Unbundling is also important for transparency. It will help to highlight costs and help to pinpoint cross subsidies and inefficiencies. It will be important to ensure the effective and accurate monitoring, enforcement and compliance with new regulatory requirements.

Strengthen the provisions for distribution reform

The principle of ensuring that there are no cross subsidies is strongly articulated, but not given sufficiently strong effect in the proposals. This is especially important given that households will remain captive to existing suppliers for at least five years (and possibly beyond). Accounting separation is the weakest form of separation and it would be better to have legal separation of distribution companies too. But if not, best practice approaches to make the most of accounting separation have been developed elsewhere and should be considered. The proposals should also be strengthened to separate the accounts of utilities from the political bodies to which many are attached, as well as separating them down the supply chain. Provision should be made for reviewing the arrangements with a view to stronger unbundling in due course.

13. Encourage the development of a transparent wholesale power market.

A wholesale power market can be expected to develop out of the TSO's activities in buying and selling power for system balancing purposes. It is crucial that the market which develops is organised according to clear and transparent rules. The draft law provides the basis for the Federal Council to assign ElCom or the TSO additional duties *e.g.* to improve market conditions. The development of a strong Swiss power market could act as a powerful lever for the furtherance of Swiss interests in the European market which counts a growing number of power exchanges.

14. Minimise distortions to competition from public (universal) service obligations.

The proposals set a policy which echoes what many other European countries have put in place for universal service. It is important that the distinction between security of supply and basic supply (the Swiss term for universal service) is made, so as to sustain a clear vision as to the aim of this regulation. Provisions for cost reflectiveness in tariffication are important and the principles are soundly articulated but risk being undermined by the network zone approach. One challenge will be to determine the size of the supply area in which price solidarity through uniform tariffs should apply. The more differentiated the

costs of supply across this area, the more cross subsidisation this implies. It would be better to have a more direct form of subsidy for supporting remote areas. If there is limited market opening, the implementation of the proposals for public service needs particular attention in order to minimise the inevitable distortions to competition.

Service quality standards should be addressed and provision made for their enforcement. In a competitive market, consumers (not just the vulnerable ones) need to know what they can expect of their suppliers, beyond price.

15. Monitor the development of transmission (network use) pricing.

The proposals reflect much of the best practice that has been emerging around the OECD. The cost reflective principle is firmly embedded and the two key issues – overall revenues that network owners will be allowed to recover and the way they should charge network users, are addressed. The regulator should be in charge of implementation once the broad principles are agreed, in accordance with best practice elsewhere.

Include benchmarking

There are no explicit proposals for benchmarking transmission prices. The Swiss context lends itself to this approach, given the large number of companies at least in distribution. It would enhance prospects of “getting it right”, given present non-transparency and weak unbundling proposals for information to the regulator, which is essential for the rate of return calculations. There is also scope to consider international benchmarking for distribution with comparable regions such as the Nordic area. For transmission benchmarking the Finnish approach (a procedure based on negotiation) offers a way forward worth considering. However the resource intensive nature of benchmarking needs to be taken into account.

Provide for an adjustment mechanism for the calculation of recoverable costs

The proposals are basically sound. It will be important to ensure that they are not too generous to network owners, and it is not clear what mechanism will be available for making any necessary adjustments to the methodology. Provision of adequate and accurate information to the regulator is essential, as is the means of enforcing the provision of such information.

Ensure that provisions for user charging do not distort the market

It will be important to ensure that there is no implicit cross subsidisation of the more costly user groups. The solidarity principle raises some doubts, as does the reference to helping the mountain regions. Such subsidies should be transparent and should not be provided in a manner that distorts cost reflective pricing.

16. Promote market-based instruments for renewables support.

The voluntary first phase is a positive approach. The main issue lies in the second phase. If the feed in tariff option is chosen, which offers less scope to bear down on costs than more market-based instruments such as quotas and trading, the proposal could prove to be very costly.

International (and especially EU) developments should be used to help guide the best choices. Alignment with EU developments would help to ensure that Switzerland is not excluded from useful mechanisms such as emissions trading and green power exchanges.

There is growing international experience with cost effective mechanisms for renewables support, such as the quota style approaches.

Further efforts should be made to communicate the advantages of quotas and trading over feed in tariffs, and the disadvantages of the latter, to a wider audience than those who are already engaged in the debate.

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OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(42 2006 06 1 P) ISBN 92-64-02247-3 – No. 55007 2006

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ISBN 92-64-02247-3
42 2006 06 1 P



9 789264 022478