COMPETITION AND CHANGE, Vol. 15 No. 4, November, 2011, 315–35

Preventing the Retrenchment of the Welfare State: Switzerland's Competitiveness in the World Market for Protection

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Most welfare state typologies still characterize Switzerland as a liberal welfare regime. However, recent research shows that its welfare state did not retrench but instead moved towards the conservative type. Nevertheless, higher social expenditure has not been accompanied by increases in taxation. Moreover, Switzerland managed to overcome the so-called trilemma of the service economy. After analyzing the shift of the Swiss welfare state from a liberal to a conservative welfare regime, we argue that the Swiss economic success story of the twentieth century is based on a favourable policy mix (tax system, labour market, financial sector) used to compete successfully in the world market for protection. We conclude that, as a political entrepreneur, Switzerland has the capability to receive taxes and investments from foreign individuals and enterprises, wealthy residents and high-skilled and well-paid immigrants to finance the welfare state and to overcome the trilemma of the service economy.

KEYWORDS Welfare state, tax competition, world market for protection, Switzerland, global

Introduction

> Our country has only very rare natural advantages that make it attractive to investors. As a country with difficult topographic conditions, without access to the sea, without natural emporia and without considerable amount of raw materials, we are more dependent on an attractive tax climate than other nation-states that profit from a huge domestic market. (Hans-Rudolf Merz, Minister of Finance, St Gallen, 31 August 2007)

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DOI 10.1179/102452911X13135903675697

In the last 20 years, the question of rising national debt and growing social expenditure has become a major topic of public debate in most countries. Switzerland, alongside other advanced capitalist countries, was confronted with a deep economic crisis in the early 1990s. The unemployment rate rose to 5 per cent and gross domestic product (GDP) shrank (see Figure 3 below). As a result, the revenues of the Swiss welfare state (social insurance contributions, taxes) diminished while social expenditure grew continuously. As in other Western countries, the crisis in Switzerland paved the way for the rise of a radical economic liberalism, which strongly supported the deregulation of labour and financial markets and a lean state. A major aim was to relieve companies and individuals from the burden of heavy taxes.

Some time after the year 2000 the following question arose: 'Who pays for social justice?' (*Neue Zürcher Zeitung*, 2005). The rationale behind the question is how the growing social expenditure of the Swiss welfare state can be financed without massively raising taxes and social security contributions. Moreover, with the global financial crisis of 2007 and the euro crisis that brought into focus the national debt of Greece, Ireland and Portugal in 2010, the question of how to finance the state, especially the welfare state, has become even more of a major concern for governments.

In what follows, we argue that Switzerland has managed to overcome the so-called *trilemma of the service economy* by skimming the world market for protection. The trilemma of the service economy is a concept posited by Iversen and Wren (1998), who argue that out of the three desirable objectives for economic policies (fiscal discipline, earnings equality and employment growth), at most two can be satisfied simultaneously. We define protection as all measures provided by the state to protect enterprises and individuals, and the assets of foreigners as well as domestic citizens, against the violations of their property rights and claims on privacy, against violations of physical integrity and against social insecurities. Our hypothesis is that its favourable mix of a strong financial sector, low taxation and migration policies helps Switzerland to compete in this international market. These competitive advantages enable Switzerland to disproportionately gather productive resources and economic rents from foreign countries. These gains from increases in GDP and from taxation of foreign companies and individuals help to finance the welfare state, which massively expanded its social expenditures without raising taxes or social security contributions to the same degree.

In the next section, we show that the Swiss welfare state neither retrenched nor has it been trapped within the trilemma of the service economy. In the third section, we outline a concept of the world market for protection, which focuses on policies promoting locational advantages. The impact of a strong financial sector, fiscal and migration policies, particularly suitable for small states, helps us to understand the Swiss economic success story of the twentieth century. In the fourth section, we focus on three major policies used to compete successfully in the world market for protection: policies concerning the financial sector, the tax system and labour migration. In consequence, we argue that Switzerland's position in the global division of labour is consolidated by its locational policies skimming global economic rents as well as other productive resources (holding companies, high-skilled immigrants, investment capital and tax exiles). Therefore, as a result of its large public revenues derived from

its privileged position in the global economy, the Swiss welfare state has fewer financial difficulties than liberal, social democratic or other conservative welfare regimes.

The Swiss welfare state: Budget discipline without retrenchment

Esping-Andersen's (1990) typology of welfare regimes differentiates between three types of regime. The liberal regime is characterized by low decommodification, high inequality, means-tested social services, modest transfers and social insurance. The conservative type is characterized by average decommodification and inequality, a moderate role for the state, but significant social insurance that strongly links social provision to occupational status. The social-democratic type is characterized by high decommodification, extensive public services and low inequality. Social provision is high and does not fully depend on the former contributions of individuals.

Most welfare state typologies still place Switzerland close to the Anglo-Saxon model of liberal welfare states. Indeed, if we look at Esping-Andersen's (1990) typology of welfare regimes, Switzerland was characterized by low social expenditure, a medium level of income inequality and a low protection of workers' rights. However, in the last three decades Switzerland has been transformed from a liberal to a conservative regime (Nollert, 2007). In contrast to liberal welfare regimes such as the UK or the United States, its welfare state did not retrench in the 1990s. Not only was there no substantial decline of net replacement rates concerning sickness, work accident and unemployment insurance (Korpi & Palme, 2003; Moser, 2008), but social expenditure actually grew in the 1990s. According to the Social Expenditure Database of the OECD (SOCX), public and mandatory private expenditure rose from 15.5 per cent of GDP in 1980 to 23.8 per cent in 1995 and to 25.7 per cent in 2007. This increase in expenditure was primarily the result of unemployment, health care and disability insurance. In comparison, over the same time period rates in the USA rose from 13.5 per cent to 14 per cent and to 16.5 per cent. In Sweden, a social democratic welfare regime, the rates of public and mandatory private expenditure rose from 27.2 per cent of GDP in 1980 to 32.4 per cent in 1995 and then decreased to 27.7 per cent in 2007. In terms of social expenditure, Switzerland reached the level of social democratic welfare regimes. Moreover, the Swiss welfare state is now characterized by high social expenditure, a high level of decommodification, a low poverty rate and moderate income inequality (Förster & d'Ercole, 2005).

It should be noted that Swiss mandatory private expenditure is responsible for 7.2 per cent of all social expenditure. This is by far the highest value of all OECD countries.[1] The most important mandatory private expenditures are the occupational pension (second pillar of the pension insurance) and the health care insurance. Moreover, the redistributive effect of the social insurance system is even smaller than in the US. The post-tax and post-transfer decline of the Gini-Index is lower than in all countries classified as liberal. According to Bradley et al. (2003), the Gini-Index (pre-tax and pre-transfer) value of Switzerland decreased by only about 8.8 per cent between 1967 and 1997. In the US and UK, the proportional reduction of the Gini-Index was about 17.8 per cent and 22.7, respectively, while in contrast, in Sweden the reduction was 37.9 per cent.

However, although Switzerland expanded its welfare state, it did not suffer from severe budget constraints. We argue that, in contrast to most other countries, it could manage the so-called *trilemma of the service economy*. As we have discussed, Iversen and Wren (1998) argue that out of the three desirable objectives for economic policies (fiscal discipline, earnings equality and employment growth), at most two can be satisfied simultaneously. Referring to Esping-Andersen's (1990) ideal types of the welfare state, social democratic regimes are assumed to prioritize earnings equality and public sector employment growth, but place less weight on fiscal discipline. Liberal regimes emphasize fiscal discipline and private sector employment growth, but place less weight on earnings equality. Conservative regimes put more weight on budgetary restraint and earnings equality than liberal regimes, but less on employment growth.

Figure 1 shows four indicators of the desirable objectives defined in the trilemma of the service economy concept for different countries for 2009. Employment growth is measured by the standardized employment rate (Eurostat Labour Force Statistics). Budgetary restraint is measured by two indicators of the OECD: tax revenues (the average tax burden in OECD countries, calculated as the ratio of tax to gross domestic product (GDP)), and national debt as a percentage of GDP. The indicator of earnings equality is a reversed Gini-Index (Eurostat, 100 = perfect equality, 0 = perfect inequality). Figure 1 gives insight into the profile of the welfare regimes as described by Iversen and Wren in 2009 (ibid). Sweden, as representative of the social democratic welfare regime, had the predicted strengths in terms of equality and employment, but the weakness of the regime is perceived as being the high level of taxation. Germany, a conservative regime, had a lower tax burden compared with Sweden, but had a higher national debt. In line with the arguments of Iversen and Wren, the employment rate and earnings equality are significantly lower than in Sweden. The UK, as a liberal regime, had high earnings inequality, but also comparably low employment. The national debt was comparably high and tax revenues were modest. It has to be stated that the UK does not have the predicted strengths of a conservative regime. In contrast, the Swiss case disproves the *trilemma* concept. Thus, Switzerland combines the highest employment rates with a high level of earnings equality, low tax revenues and a modest national debt.

At first sight, it is puzzling that Switzerland has managed to overcome the trilemma of the service economy despite the expansion of its welfare state. In the following, we argue that Switzerland has been in a better position than other OECD countries in so far as it attracts a significant proportion of global economic rents as well as several productive resources (holding companies, high-skilled immigrants, investment capital and tax exiles). In widening the analysis from a national to an international perspective, we are able to understand how Switzerland uses the world market for protection and international inequalities to overcome the *trilemma of the service economy*.

The world market for protection

We argue that financing the welfare state is linked to comparative advantages of location in, what we refer to as, the world market for protection. In so doing, we draw on Chase-Dunn's statement from a world systems perspective:

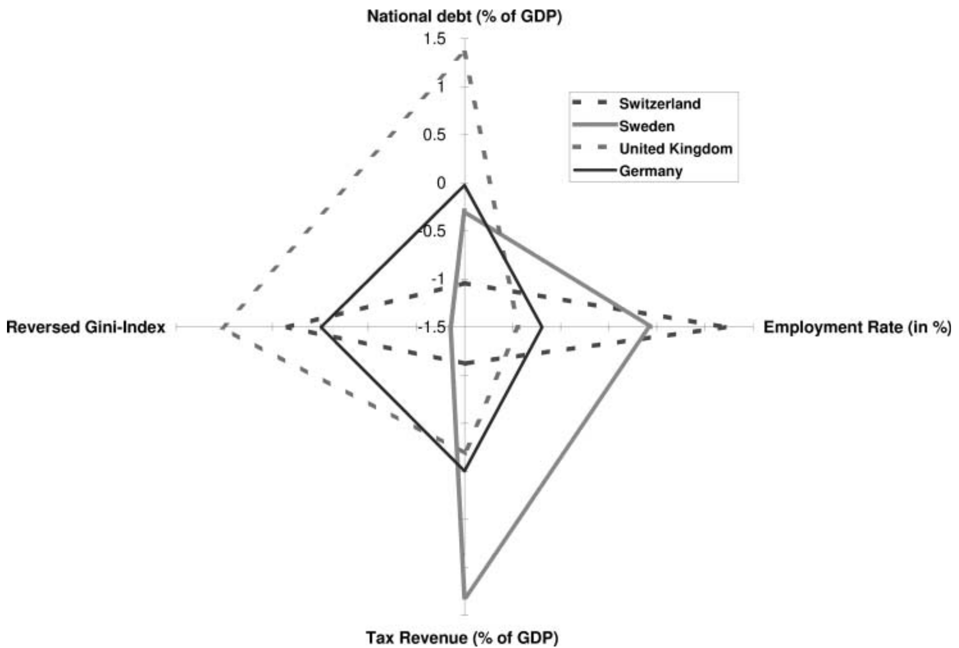

FIGURE 1 Indicators for the desirable objectives concerning the *trilemma of the service economy* concept, Income Gini-Index, national debt, tax revenue, employment rate, selected countries 2009, z-transformed variables.
Source: Eurostat, OECD.
Notes: Reversed Gini-Index (100 = perfect equality, 0 = perfect inequality), employment rate of persons of working age (20–64), tax revenue in per cent of GDP 2008, total central government debt in per cent of GDP. All variables are z-transformed for reasons of comparability.

> It [the world systems theory, Michael Nollert, Sebastian Schief] challenges the assumption that national societies (or tribes or city states) constitute independent units whose development can be understood without taking into account the systematic ways in which societies are linked to one another in the context of a larger network of material exchanges. (1990: 2)

According to Chase-Dunn (p. 107), 'the interstate system of unequally powerful and competing states is the political body of capitalism, and [. . .] capitalist institutions are central to the maintenance and reproduction of the interstate system, as well as vice versa'. However, within the capitalist world system it is not only political-military power, but comparative advantage which states rely on.

In line with arguments derived from the concept of states as ideal collective capitalists (Engels, 1878), political entrepreneurs (Hintze, 1929), the theorem of protection rent (Lane, 1979) and the arguments of Weber (1923) and Bornschier (1996), we presume that states are political entrepreneurs which produce and sell legitimate protection. By protection, we mean all measures provided by the state to protect enterprises and individuals and the assets of foreigners as well as domestic citizens against the violations of their property rights and claims on privacy, against violations of physical integrity and against social insecurities.[2] Thus, protection includes

the maintenance of civic, political and social rights (see Marshall, 1950) but also the guarantee that foreign states neither get information on administered financial assets nor can claim for their repatriation. It is important to note that this understanding of protection is broader than the understanding of conventional economics, which only refers to the idea of government regulations designed to prevent or restrict the imports of foreign companies from, and the takeover of, domestic companies.

Selling legitimacy in the world market for protection

In contrast to early Europe where merchants either organized their own protection or engaged private protection-producing enterprises (for example, the Italian *condottieri*) and few regions in which mafia-like organizations still prevail (e.g. Somalia), most states successfully maintain a monopoly on the use of force to protect its population within a contiguous territory and recompense its service with taxes (Tilly, 1985). In consequence, there is now a global competition between governments as providers of protection.

In line with Bornschier and Trezzini (2001), we point to the importance of legitimacy in the Weberian sense in creating an effective economic order. Therefore, in contrast to Lane or Tilly, we emphasize that protection is not only ensured by armed forces or the police but by legitimacy.[3] In fact, a social order which protects parts of the population against the claims of others would boost violence. While protection only based on violence turns out to be a competitive disadvantage, legitimate protection is an indispensible prerequisite for economic success.

Although most protection is a collective good, its provision must be financed and, therefore, states have to levy taxes. The modern state is also a tax state (Goldscheid, 1917), which can decide about the tax burden and the purposes for which its revenues are spent. In addition, it can force their population to join and fund social insurance. However, a democratic government must take their citizens' and corporations' opinions seriously (voice) (Hirschman, 1970), otherwise they will cancel their loyalty or even leave the country (exit) if they consider the price of protection to be too high. States depend on taxes and, therefore, have to compete for enterprises, capital, skilled employees and wealthy residents in the world market for protection by offering them protection for a low cost.

A look at economic history suggests that, in the era of protected national economies during the twentieth century, the high transaction costs for corporations and individuals to shift their production and wealth to other countries enabled most states to prevent the exit option. Hence, in the golden age of the tax state most states could increase their tax revenue through progressive income, wealth, corporate and value-added taxes. As a result of the facilitation of transnational capital mobility, this era ended in the late twentieth century. In addition, new communication and transport technologies and the liberalization of economic cross-border transactions meant residents, high-skilled employees and investors now can increasingly choose where they want to live, work and produce.

However, it is not the level of taxes and social security contributions *per se*, but the protection–cost ratio that affords locational comparative advantage. A state which provides low taxes and social security contributions but hardly any public infrastructure, political and social instability or high administrative burdens is not

attractive for foreign investors and migrants. That is to say, on the one hand, neither states which combine low protection with low taxes nor states which combine high protection with high taxes are successful. Only states with similar protection–cost ratios are assumed to have similar economic success.

In addition, we have to be aware that small states are more prone to competition in the world market for protection than large states such as the US (Palan, 2002). As a result of the comparatively high tax revenue from foreign sources, small states would suffer more from increasing taxation than large states because the foreigners would withdraw their capital and/or emigrate. In the case of decreasing taxes, the taxes from immigrant residents, foreign investors and corporations in contrast to the loss of taxes from domestic sources are higher in small states (see Bucovetsky, 1991).

To summarize, our theoretical approach is firstly premised on the assumption that states without power to control their economic environment must offer legitimate protection for their domestic enterprises and workers. Therefore, legitimate and democratic states are more successful than states which forcibly protect the rights and claims of privileged groups against the rest of the population. However, it is not the extent of protection benefits or the level of taxes *per se* that are relevant for firms and workers to take residence in another state, but the protection–cost ratio. Secondly, investors and residents prefer to choose those countries where the protection–cost ratio is best. Thirdly, from a world systems point of view, we suggest that low costs of protection in receiving states are linked to higher costs in those states from which capital and residents come. Thus, it is not the receiving state but the state of origin which finances the education of high-skilled immigrants and in addition may suffer capital flight and tax evasion.

The Swiss state in the world market for protection

Switzerland, as a small state, competes very well in the world market for protection. As a late industrializing country it started without natural resources or the possibility of imperialist policies or military interventions. Its strong export industries and its financial sector paved the way for integration with the world economy. In the twentieth century, Switzerland also successfully produced and sold protection. The high level of satisfaction with life (see White, 2007) and its social and political stability (Kriesi & Trechsel, 2008) suggest that this protection is based on legitimacy rather than on violence. Thus, the reason for its success was a beneficial combination and concentration of capital and labour interests (Katzenstein, 1984), but also a high level of legitimate protection in combination with low taxes.

Similar to other small states not pursuing imperialistic policies, even in the golden age of the tax state, Switzerland attracted many investors, transnational holding companies, big non-profit organizations (Union of European Football Associations, Fédération Internationale de Football Association, International Olympic Committee, United Nations, World Health Organization, International Labour Organization)[4] and wealthy and skilled people from all over the world. This remarkable position in the world economy compared to its size is still based on a favourable protection–cost ratio.

However, since the 1990s, cartels and price fixing in the financial sector have been contained and the agricultural, energy and telecommunication markets have been

deregulated, which meant the loss of protection of economic rent for many enterprises, workers and farmers. In order to finance the increasing protection costs and to stabilize the protection–cost ratio, the government had to develop new political measures. Following the assumptions of the Laffer curve (Henderson, 1981; and see Edwards & Mitchell, 2008, for the US) tax rates should not be raised because state revenues would shrink after the tax rates reach a certain threshold.[5] In line with this argument, the federal government and most governments of the Swiss cantons decided to attract investors and wealthy people by offering even lower tax rates. A frontrunner was the canton of Zug, which was transformed from a poor agrarian canton into one of the richest cantons of Switzerland on the basis of tax reforms in the 1920s. In other words, Zug competed extremely well in the market for protection.

As in liberal regimes, these policies are justified by a functionalist and trickle-down orientation towards income and wealth inequalities. According to this line of argument, those on lower incomes would benefit from an increasing concentration of income and wealth. Thus, the Swiss government supported the policy of employers' organizations (for example, Economiesuisse, 2007) in avoiding high tax rates because this was supposed to lead to a loss of enterprises and the exodus of rich residents. In addition, the headquarters of huge enterprises, such as the Union Bank of Switzerland, Credit Suisse and Novartis, or transnational non-profit organizations, such as UEFA or FIFA, threaten from time to time to leave the country if regulations are tightened.

Therefore, we argue that Switzerland is a political entrepreneur which was able to manage the trilemma of the service economy without retrenching its welfare state thanks to the profits which have arisen from locational competitive advantages in the world market of protection. Because legitimate protection is provided by the state, we focus in the next section on three policy areas which are of particular importance for corporations, rich individuals and highly-qualified workers.

Three pillars of competitive strength

Since the mid-1990s policies have been implemented that strengthen Switzerland's attractiveness as a location for the headquarters of holding companies, as a workplace, as a place of residence or a holiday resort for high-skilled migrants and wealthy tax exiles. Thus, it is no surprise that Switzerland ranks fourth on the present World Competitiveness Index provided by the International Institute for Management and Development in Lausanne (IMD, 2010), behind Singapore, Hong Kong and the US. Indeed, it managed the financial crisis better than most of the other 58 countries covered by the index. A look at the key dimensions of the index further shows that Switzerland even ranks third in terms of robustness of governmental institutions (measured by public finance and fiscal policy) and public infrastructure (measured by technological, scientific, educational and health indicators).

Financial sector policies

Switzerland attracts and accumulates financial resources within the world economy in various ways. It is a major player in the financial sector, especially when it comes

to fund management banks. Switzerland is still listed as an offshore financial centre (OFC) by the International Monetary Fund (IMF, 2000), in guidebooks for offshore finance and tax havens (Merkl, 1996; Merten, 2009), and is considered as one of the most traditional tax havens (Doggart, 2002). Further, Switzerland ranks third in the Tax Justice Networks' present Financial Secrecy Index,[6] behind Delaware (US) and Luxembourg, but above the Cayman Islands and the City of London. Moreover, a look at the dimensions considered in the index shows that Switzerland is the only entity besides Labuan (Malaysia) and some small islands with a maximum opacity score of 100. In contrast to other OECD countries, the disclosure of ownership, corporate transparency and readiness to cooperate is assessed as extremely low.

Moreover, according to the independent Financial Stability Forum (FSF), Switzerland belongs to a group of about 40 offshore financial centres in the world which support tax evasion (Baumeler, 2007; Baumeler et al., 2009). The publication of the FSF report released a storm of indignation in Switzerland and the Swiss government protested against this classification, wanting to dissociate themselves from dubious financial centres such as the Cayman Islands and the Bahamas. They preferred to compare the Swiss financial centre to respected financial centres such as London or New York (EFD & EDA, 2003).

Although the Swiss banking system is formally independent of the state, historically Swiss politicians have defended the idea of banking secrecy as a fundamental principle of a Swiss culture of independence and neutrality (Donaghy & Clarke, 2003). The Swiss government defines the protection of the Swiss financial centre as one of the most important tasks of Swiss foreign policy (EFD, 2003). This comes as no surprise because the financial sector contributes to a considerable proportion of state revenues. In 2007, Swiss financial service providers (including pension funds) generated 8.5 per cent of GDP (SwissBanking, 2009: 9), twice as much as in the US or Germany. Furthermore, in 2009 the financial sector accounted for about 6 per cent of employment, which corresponds to more than 200,000 above-average paid employees (in full-time equivalents) (SwissBanking, 2010). Depending on the level of profits, the financial sector (including employees and shareholders) contributed between 12 and 15 per cent of the entire tax revenue of Switzerland (SwissBanking, 2010).

The Swiss financial centre attracts a high proportion of financial activities of non-residents. In 2004, 61 per cent of the wealth administered in Switzerland originated from other countries (Swiss National Bank, 2004: 5). According to SwissBanking (2009), Switzerland remains the most important financial centre in the field of international offshore private banking. Thus, Switzerland is still the global leader in international private wealth management (dealing only with high net worth individuals), with a market share of 27 per cent in 2007, followed by the UK (24 per cent), Luxembourg (14 per cent) and the Caribbean (12 per cent). This refers to US$2.0 trillion out of the estimated US$7.3 trillion total in worldwide offshore private banking. Switzerland also had 9 per cent of global assets under management in 2007 (ibid). Only the US (39.9 per cent) and the UK (10.9 per cent) had higher figures. Its biggest banks (Union Bank of Switzerland and Credit Suisse) are responsible for about half of the market share in Swiss private banking; a fourth of the market share belongs to foreign private banks that took residence in Switzerland because of the favourable legal conditions (Missbach, 2009: 102). Despite the OECD's attack on

bank secrecy and the crisis of the Union Bank of Switzerland – clients withdrew more than US$120 billion in 2009 – the Swiss financial sector preserves its position in the world economy. In fact, thanks also to the migration of numerous hedge funds from London to Geneva, the cities of Zurich and Geneva are still number 8 and 9 in the 2011 ranking of 75 Global Financial Centres behind the cities of London, New York, Hong Kong, Singapore, Shanghai, Tokyo and Chicago (Long Finance, 2011).

Tax policies

Switzerland also profits from its particularly good protection–cost ratio in terms of taxes. It affords domestic, as well as foreign, residents and companies legitimate high quality protection at very low cost. In the following, we focus on particular features of the Swiss tax system.

Low progressivity and low levels of individual tax rates

For rich individuals the progression of tax rates is just as important as the mean tax rate. Surprisingly, the unequal liberal welfare regimes have more progressive taxes than the less stratified conservative welfare regimes (Wilensky, 2002). Kato (2003) argues that regressive taxation was among the factors enabling the expansion of the welfare state in the twentieth century. The argument is that the wealthy accept the expansion of social security if the burden of its financing falls on the shoulders of the middle and lower classes. According to Prasad and Deng (2009), Switzerland's tax regime cannot be classified as liberal because both its progressivity of income, wealth and property taxes and its regressive consumer tax are low. This small net progressivity of Swiss taxes is accompanied by a very regressive lump-sum taxation of rich immigrants.

As in most other countries, individuals with and without citizenship who are deemed resident for tax purposes are subject to income tax on their worldwide income regardless of source. The exception to this rule is the possibility of so-called lump-sum taxation (*Pauschalbesteuerung*) for a small part of the foreign population. Similar to the taxation on remittance basis in the UK, the lump-sum taxation is feasible for residents who are not Swiss citizens, have not earned any income and have not worked for at least ten years in Switzerland. If all requirements are fulfilled, the tax is not levied on the basis of their income and wealth, but on the basis of their standard of living (approximately five times the annual rental value of their housing; see *Bundesgesetz über die direkte Bundessteuer*, Art. 14[7]). Although most politicians support this tax, in 2009 the citizens of the canton of Zurich voted for the abolition of the lump-sum tax.

The value-added revenue for Switzerland of the 5,445 non-Swiss residents (*Neue Zürcher Zeitung*, 2011) who are subject to lump-sum taxation in 2010 is enormous. The canton of Vaud has by far the highest number of foreigners with lump-sum taxation (1,397). In 2008, they accounted for 1.8 per cent of the tax revenues of natives of the canton and communities (ESTV, 2010). The highest percentage of tax revenues of native persons paid by foreign residents with lump-sum taxation is to be found in the canton of Valais, with 1.9 per cent. The average for Switzerland is 0.7 per cent. Geneva has the highest average tax amount per subject with about US$230,000. It is important to note that Swiss politicians expect these subjects to also

support the economy by their generous spending, and that many wealthy foreigners as well as wealthy citizens pay regular taxes.

The outcome of the lump-sum tax is documented in the Forbes list of world billionaires for 2009 (Forbes, 2009). Thus, the figures of foreign billionaires (in US dollars) show that, compared to Switzerland, there are only more foreign billionaires in the UK (UK: 15 billionaires; Switzerland: 13), with a slightly higher average net worth of billions of US dollars per foreign billionaire (UK: 73.1; Switzerland: 70.1). Even more striking is the difference of the net worth of foreign billionaires per capita; the figure of Switzerland (9.6 million US dollars per 1,000 inhabitants) is eight times higher than that of the UK, in second place (1.21 million US dollars).

Swiss citizens are explicitly excluded from the lump-sum taxation.[8] They can reduce their taxes by utilizing the tax competition between the Swiss cantons. Taxation occurs at three levels: Swiss Federation, cantons and communities. The share of total revenues is about 50 per cent for the Federation, 30 per cent for the cantons and 20 per cent for the communities. While Swiss federal tax is equal throughout Switzerland, personal taxes vary among the 26 cantons and among the 2,600 communities. Thus, individuals can compare tax rates and take residence in the canton and community of choice. Of course, this choice not only depends on the tax level, but also on other factors such as the distance to the workplace and the public infrastructure.

In line with our argument that political entities compete for wealthy taxpayers, many cantons use their capability to set their own tax rates as an instrument to attract rich residents. Obwalden, a small canton in the centre of Switzerland, even tried to introduce a regressive income tax. Since the Swiss Federal Tribunal overturned this law in December 2007, Obwalden became the first canton to implement a flat-rate tax for individuals; 91 per cent of Obwalden citizens opted for the new tax system in a cantonal referendum.

A study carried out by BASS (2006) underlines the increase of tax competition within Switzerland. In fact, the differences between cantons as to average direct taxes are much larger now than 20 years ago. Moreover, cantons with low tax levels decreased tax rates more than cantons with high levels. While some cantons provided tax relief for households with low incomes (for example, Berne, Fribourg, Basel-Land, Vaud, Neuchâtel and Jura), other cantons relieved the top income quintiles (for example, Zurich, Schwyz, Glarus, Basel-Stadt and Appenzell Innerrhoden).

Moreover, tax competition between cantons is increased by the lack of federal inheritance or gift taxes, which means that cantons can levy inheritance and gift taxes at their own discretion. The canton of Schwyz, for example, does not levy any inheritance or gift taxes at all. Most cantons do not levy inheritance taxes between parents and children at all, and levy only a very modest tax for spouses, parents and siblings. Further, there is no capital gains tax in Switzerland, except for professional equity and real estate traders. Whereas all interests from bonds or savings are assessed as income, gains from stock exchange business, up to a certain threshold, are not taxed. In June 2001, the Swiss parliament voted against a proposal to establish a more general capital gains tax within the Swiss tax system. In December 2001, 70 per cent of the citizens also voted resoundingly against a 20 per cent tax on capital gains of more than US$6,500.

Figure 2 underlines the low tax burdens for well-paid employees and the variety of tax burdens within Switzerland. In the left lower corner (with the exception of Slovakia (SK), Hong Kong (HK) and Singapore (SGP)), there are only Swiss cantons, for example Obwalden (OW) and Zug (ZG). It is hardly surprising that the level of taxes for well-paid employees correlates with a classification of cantons according to Esping-Andersen's (1990) typology of welfare regimes (Armingeon et al., 2004). While high tax cantons mostly belong to the group of cantons classified as social democratic, most low tax cantons are classified as liberal.

Low company taxes attracting foreign investment

In addition, Figure 2 indicates that cantons not only compete for wealthy individuals but also for companies and investors. The extremely low tax burden of companies in

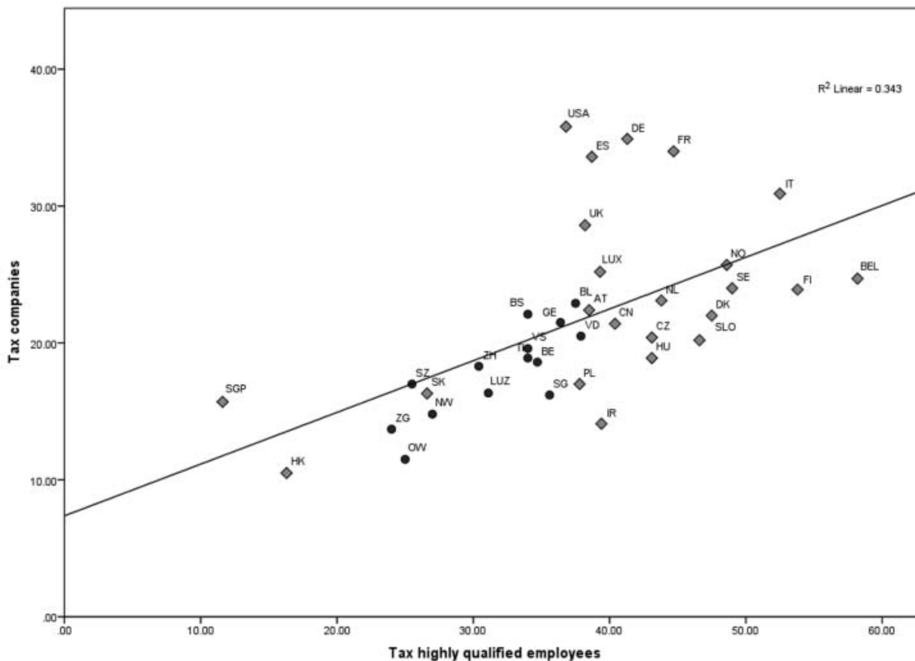

FIGURE 2 Tax burden of highly qualified employees and companies and on the basis of the IBC Taxation Index 2007.
Source: BAK Basel Economics (2007: 8).
Notes:
Countries: AT = Austria, BEL = Belgium, CN = Canada, CZ = Czech Republic, DE = Germany, DK = Denmark, ES = Spain, FR = France, FI = Finland, HK = Hong Kong, HU = Hungary, UK = United Kingdom, IT = Italy, IR = Ireland, LUX = Luxembourg, NL = The Netherlands, NO = Norway, PL = Poland, SE = Sweden, SGP = Singapore, SK = Slovakia, SLO = Slovenia, USA = United States of America
Cantons: BL = Basel Land, BS = Basel Stadt, BE = Bern, GE = Geneve, LUZ = Luzern, NW = Nidwalden, OW = Obwalden, SG = Sankt Gallen, SZ = Schwyz, TI = Ticino, VD = Vaud, VS = Valais, ZG = Zug, ZH = Zurich

some cantons has been widely discussed in public since the European Union criticized Switzerland for its tax practice towards foreign companies. It was criticized for the fact that, alongside the federal taxes on foreign income, some cantons only have minimal tax rates on top of federal taxes. The EU argues that this is a contract violation of the Free Trade Agreement, while the Swiss federal government claims that it has never been subject to it. Both parties agree on the fact that the Swiss corporate tax system is a massive locational advantage for Switzerland.

However, the tax burden of companies in the European Union has strongly converged with that of Switzerland. The difference in direct corporate tax rates between Switzerland and the mean of EU countries has declined continuously since the 1990s. It should be noted that tax rates within the EU still vary considerably; while the corporate tax rate in Belgium, France, Italy and Malta was higher than 30 per cent in 2010, it was 12.5 per cent in Ireland and 10 per cent in Bulgaria (KPMG International, 2010). Hence, there are more and more countries within the EU, especially in Eastern Europe, that now undercut the still low tax rate of Switzerland (21.17 per cent in 2010). However, Switzerland still imposes the lowest national value-added tax in Europe (8 per cent since 2011).

The number of foreign holding companies and the amount of foreign direct investment capital (FDI)[9] suggests that the strategy of low company taxation has been successful for the Swiss state. The *Frankfurter Allgemeine Zeitung* (2007) estimates that the EU's criticism of Switzerland's low taxation of foreign companies refers to 20,000 companies with 150,000 employees and revenue from taxes of up to US$ 1.9 billion. In some cantons there is, in addition, a special taxation on holding companies. For example, in Zug there are very low tax rates on capital and no taxes at all on profits for holding companies. According to Dun & Bradstreet (2008), the number of holding companies in Switzerland has grown by 75 per cent since 2000. By 2007, 2,113 holdings had been established. Altogether, those holdings have a capitalization of more than US$6 billion; the amount of effective administrated capital of all holding companies in Switzerland (20,520; Register of Companies, 2008) is – depending on the valuation – about US$650 billion. The share of foreign capital as a proportion of all holding companies in Switzerland was estimated at about 55 per cent in 2007 (Dun & Bradstreet, 2008).

A closer look at the development of foreign direct investment stocks in Switzerland confirms the importance of foreign finance and holding companies. By direct investments, the Swiss National Bank means investment that 'is to exert a direct and lasting influence on the operations of a company abroad' (Swiss National Bank, 2007: 16). Since 1997, the FDI stock of finance and holding companies rose from about US$52 billion to about US$156 billion in 2006 (Swiss National Bank, 2003, 2007). The FDI stock of finance and holding companies is higher than the FDI stock of all other services and industrial sectors put together. This clearly proves the importance of foreign companies for the financing of the Swiss state.

High quality of protection at low cost

For both investors and residents, the attractiveness of Switzerland derives from its institutional framework which provides high quality protection at low cost. Although some Eastern European countries have brought down their company tax rates, as a

result of their favourable public infrastructure most of the Swiss cantons still have more attractive protection–cost ratios. In addition, especially wealthy residents profit from minor progressive income and wealth taxes or – if they are foreigners – from lump-sum taxation and both groups of residents profit from the lack of federal gift and inheritance taxes.

The high numbers of transnational companies and non-profit organizations, the development of foreign investment and the number of billionaires suggest that this policy has been successful. It is obvious that tax policies favouring the rich aggravate wealth inequalities. Thus, in contrast to the moderate income inequality (Förster & d'Ercole, 2005; see also Figure 1), the wealth concentration in Switzerland is still one of the highest in the world (Gini = 0.80) (Davies et al., 2008; see also Dell et al., 2007). However, the extreme inequality in terms of wealth does not endanger social cohesion as long as the middle class is convinced that the benefits of the rich trickle down. More opposition might occur in the medium term if cantons continue to compete against each other by lowering income taxes or even eliminating the inheritance tax.

Labour migration: From low- to high-skilled immigrants

Swiss migration policy after the Second World War was driven by the labour market needs of the Swiss economy. By strictly tying migration to labour market needs, social expenditure on migrant workers was constrained. A major way of avoiding social expenditure employed up until the 1990s was to use migrants coming to Switzerland as a valve in the case of either rising unemployment or labour shortages. Immigration was temporary and tied to a job (Saisonnierstatut, seasonal worker statute). According to the seasonal worker statute, which was introduced in 1934, foreigners were allowed to work for a couple of months per year (season), but not to take permanent residence. These mostly low-skilled workers had to leave Switzerland if they lost their jobs (Falter & Flückiger, 2004; Mahnig & Piguet, 2003; Schmidt, 1995; Straubhaar & Werner, 2003; Wicker, 2003).

In 2009, about 1.7 million permanent residents were foreigners; that is, about 22 per cent of the population (Annual Population Statistics, no date). The share of foreigners within the labour force rose from 20.9 per cent in 1996 to 22.5 per cent in 2009 (Bundesamt für Statistik, no date a). In 2009, about 19.3 per cent of all foreign residents in the labour force worked in mining, manufacturing, gas, electricity or water supply (NACE[10] B-E). The second biggest share is to be found in wholesale and retail trade; repair of motor vehicles and motorcycles (NACE G: 13.8 per cent) followed by human health and social work activities (NACE Q: 11.6 per cent) (Bundesamt für Statistik, no date b). However, the highest share of foreign workers in the labour force work as professionals (ISCO 88:[11] 17.9 per cent), followed by the group of technicians and associate professionals. The share of foreigners working as managers rose from about 4 per cent in 1996 to 7.3 per cent in 2009.

Figure 3 shows the total number of foreign residents and the changes in gross domestic product since 1960. Until the beginning of the 1990s, the number of foreign workers was connected to fluctuations in the economy. Whenever economic growth slowed down and the unemployment rates were in danger of rising, migrants were the first to be made redundant. Without work the immigrants with seasonal worker

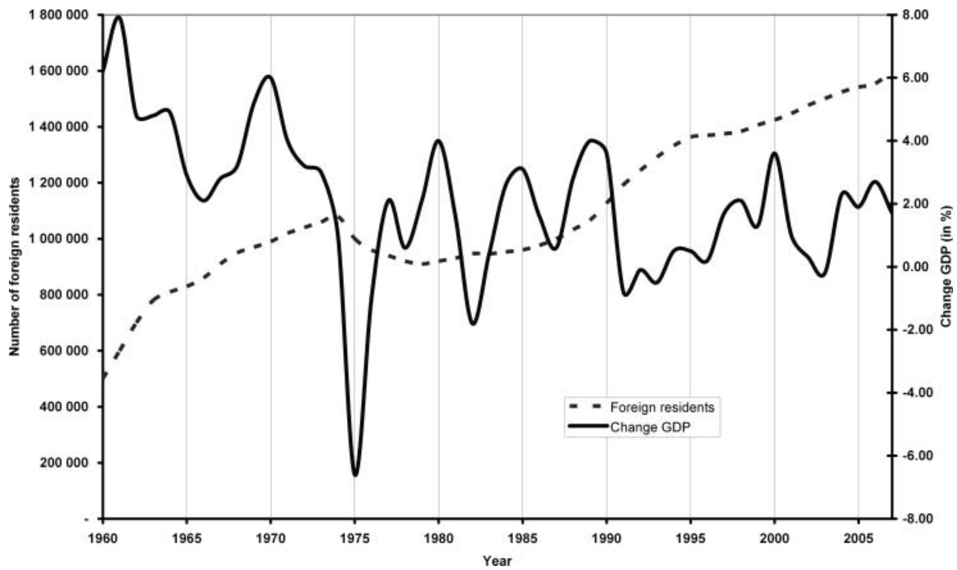

FIGURE 3 Amount of foreign resident population and change of gross domestic product in Switzerland, 1960–2007.
Source: Bundesamt für Migration (2010).

status had to leave the country and therefore did not create a burden on the welfare state. Since then, the number of foreign workers has been constantly growing independently of economic development. This is, on the one hand, because residence permits for partners and children were eased by law. On the other hand, as a result of the abolition of the seasonal worker statute in 1991 for non-EU citizens and in 2002 for EU citizens, foreigners were increasingly given permanent residence permits. Therefore they could no longer be used as a safety valve for unemployment, and low-skilled migrants, in particular, could no longer serve to correct a lack of supply in the Swiss labour market.

As Figure 4 shows, not only did the correlation between economic development and migration disappear, but the composition of migration to Switzerland has changed fundamentally since the beginning of the 1990s. The number of migrant workers in employment with primary education stagnated from 2001 at about 300,000 and decreased to about 270,000 in 2009. On the contrary, the number of migrant workers with tertiary education rose very fast from 2002 onwards (2002: 170,000; 2009: 314,000). Furthermore, an increase in the number of migrant workers with secondary education can be seen from 2006 onwards. It can be stated that there is a change in the composition of immigrants in Switzerland away from low- to high-skilled migrant workers. In terms of our hypothesis, this can be interpreted, firstly, as an acquisition of highly productive human capital from outside Switzerland, which turns out to be a competitive advantage for Switzerland (see also Grossmann & Stadelmann, 2011). Secondly, high-skilled migrants pay above-average taxes and relieve social insurances.

The change in the composition of migrants in Switzerland is not only reflected in qualifications, but also in the regional origin of immigrants. The number of migrants

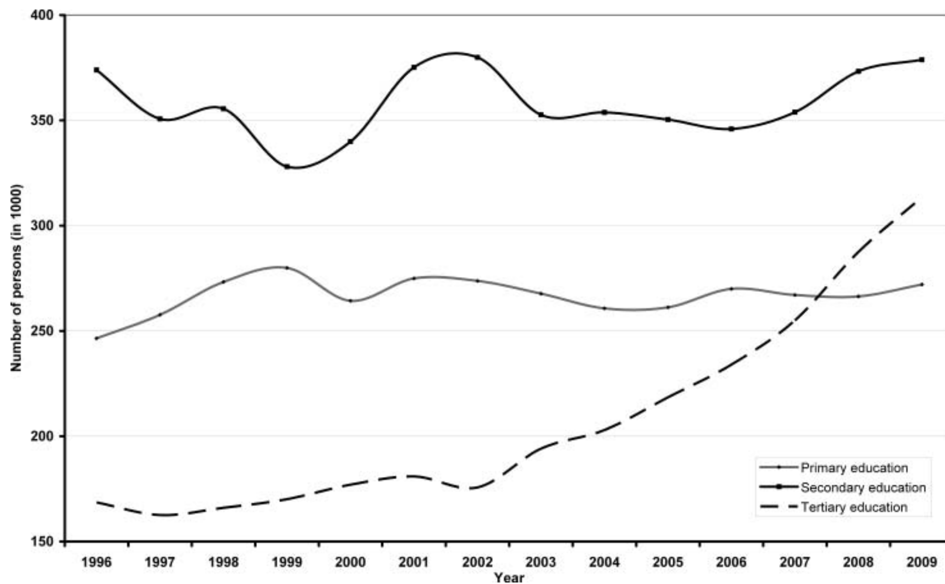

FIGURE 4 Number of foreigners in employment by educational status, 1996–2009. Source: Bundesamt für Statistik.

from countries of the European Union (EU-27) and the European Free Trade Association (EFTA countries) and from European non-EU-27/EFTA countries narrowed until 2002 (Bundesamt für Statistik, no date c). Since then, the number of EU-27/EFTA citizens has risen sharply, while the number of European non EU-27/EFTA citizens has stagnated. The number of non-European migrants has slightly decreased since 2001. With the financial crisis of 2008 the number of migrants to Switzerland from EU-27/EFTA countries slightly went down again.

Immigration to Switzerland exhibited a change in terms of the educational qualifications and geographical origin of migrants, which resulted in the accumulation of highly productive human capital from within the EU and EFTA countries. The reason for these changes was the *Bilateral Agreement between Switzerland and the European Union on the Free Movement of Persons* (signed in 1999), which regulates the opening of the Swiss labour market to employees from the European Union. In the first stage, from 2002, workers from the old member states (EU-15) saw access gradually increase, with complete freedom of movement by 1 June 2007. The second stage provided the same right of access for citizens from the new member states by 2011. Therefore the demand for labour is likely to be increasingly satisfied by migrants from the EU and EFTA countries, while migration for those from outside the EU and EFTA becomes more difficult (Mahnig & Piguet, 2003).

Conclusion

Our analysis of the competitiveness of Switzerland in the world market for protection gives insights into how its growing welfare state could be financed without significantly raising taxes and social contributions. The Swiss welfare state did not retrench,

but instead moved towards the conservative type. Moreover, Switzerland has managed to overcome the *trilemma of the service economy*. It combines high employment rates with low earnings inequality, low tax revenues and low national debt.

The key to understanding this phenomenon is Switzerland's competitiveness in the world market for protection. It is a small country that has competed very well in this market during the twentieth century, whereby firms, investors, wealthy individuals and workers have been attracted by a strong and legitimate protection of their interests for a comparatively low contribution.

The competitiveness of Switzerland is based on three pillars. Firstly, it continues to profit from its huge financial sector with its wealth management for global clients. Financial sector policies ensure money transfers from all over the world and therefore provide a good opportunity to finance increasing costs of the welfare state. Secondly, it is helped by the increase of holdings and direct investments as well as the amount of super rich or wealthy persons moving to Switzerland. Although the tax policies are minimally redistributive, the foreign investment in the Swiss economy and taxes provided by foreign companies and individuals disburden the welfare state for two major reasons. On the one hand, the investment prevents an above-average rise of the unemployment rate; on the other hand, the extra tax revenues indirectly flow into the financing of the welfare services and social assistance. Thirdly, the new migration regime including highly-qualified citizens of the EU and EFTA and excluding poorly-qualified non-EU/EFTA citizens,[12] and the massive consumption and investment levels of the super rich living in Switzerland leads to positive effects for the economy and therefore strengthens its political legitimacy.

Switzerland skims the world market for protection to finance the growing welfare state. Although the country cannot pursue its economic interests by military force, as a political entrepreneur it has the capability to levy taxes and leverage investments from foreign individuals and firms, wealthy residents and high-skilled and well-paid immigrants. Overcoming the trilemma by being competitive in the world market for protection might partially explain why the Swiss elite did not oppose welfare spending during the 1990s in the same way as the economic elites did in liberal regimes. Moreover, the Swiss configuration was able to accommodate an extreme wealth inequality without major unrest. Thus, the wealth inequality is absorbed by a high level of mean income, a low poverty rate, a moderate income inequality and low average tax burden.

The case of Switzerland turns attention to a blind spot in welfare state research. As we have shown, the structural embeddedness of countries within the world economy may be of major importance for the financing and therefore the development and composition of the welfare state. However, since the Swiss economy is embedded in a very specific way, it may be a difficult model for other countries to emulate.

Acknowledgements

Please note that order of authorship is alphabetical. Both authors contributed equally to the completion of the manuscript. The authors would like to thank the editor and the reviewers for their comments, which helped to improve the manuscript. The authors are also very grateful to Amy Gordon for checking the language of this article.

Notes

1 See SOCX (2007) of the OECD for details: http://stats.oecd.org/OECDStatDownloadFiles/OECDSOCX2007InterpretativeGuide_En.pdf.

2 Of course, the different stakeholders have different needs for protection. While companies and owners are mostly interested in the indefeasibility of their property, workers prefer a high level of decommodification. However, many stakeholders try to rent-seek by claiming exclusion of foreign competitors.

3 Legitimacy is often not only linked to high economic growth but also to high social capital, high protection of workers' rights and low social inequality. In terms of power, a neoliberal military regime such as Chile under the sway of Pinochet could offer better protection than, for example, social democratic welfare regimes. However, in terms of legitimacy, many investors and rich people often prefer regimes with high legitimacy to regimes in which property rights must be defended by expensive public and private security measures.

4 Organizations like the UEFA paradoxically enjoy a non-profit status and therefore pay hardly any taxes; workers have comparatively high social entitlements, and semi-direct democracy with its referenda and constitutional veto points promotes low tax rates.

5 Yet, the privately-funded Swiss Centre for Tax Competition, a partner organization of the US Center for Freedom and Prosperity, specifies on its website (http://www.taxcompetition.org/pages/mission): 'Indeed, every tax levy implies that some money will not be used according to the preferences willingly chosen and paid for by their rightful owner, but instead will be used for purposes that can very well be wanted only by the government's agents and none of the taxpayers who have to pay for it. The goal, therefore, should not be to look for the optimum of the Laffer curve and maximize government revenues, but rather to *minimize* the tax burden of taxpayers.'

6 http://www.financialsecrecyindex.com/2009results.html.

7 See http://www.admin.ch/ch/d/sr/c642_11.html.

8 Therefore, some rich Swiss already live now as so-called non-doms in London.

9 The Swiss National Bank defines direct investments as follows: 'The objective of direct investment is to exert a direct and lasting influence on the operations of a company abroad. As a rule, if an investor owns at least 10 per cent of the voting stock of a company abroad or sets up a subsidiary or branch abroad, this situation may be classified as direct investment' (Swiss National Bank, 2007: 16).

10 NACE: Statistical Classification of Economic Activities in the European Community.

11 ISCO: International Standard Classification of Occupations.

12 In Italian, there exists a special word for people from outside EU/EFTA, the *extracomunitari*. In our opinion, this is a brilliant linguistic manifestation of the exclusion of this group of persons.

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