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Will The Swiss Tax Reform Plan TP 17 Cost Some Cantons More Than Others?

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Key Takeaways

- In our view, Switzerland's planned corporate tax reform TP 17 could, under adverse scenarios, weigh on our ratings on cantons.
- Lower ordinary corporate profit tax rates and compensation payments to municipalities and individuals, as part of the overall reform package, imply a negative budgetary impact for almost all Swiss cantons.
- We estimate that for some cantons, the initial annual net cost may be as high as 4%-5% of operating revenues, but a few could see small revenue gains.
- Based on their ability to self-generate funds from operations, cantons' capacity to absorb the TP 17-induced cost differs materially, implying for example that Basel-City, Vaud, and Zurich should have fewer problems implementing the reform.
- A more difficult combination of pre-TP 17 fiscal capacity and TP 17-induced costs could complicate matters for a handful of cantons, such as Solothurn, Geneva, and, partially, Neuchâtel.

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Switzerland's federal government is midway through the political and legislative process necessary to implement Tax Proposal 17 (TP 17), which makes sweeping changes to the corporate tax rules. We believe that, in its current form, TP 17, poses a clear challenge for almost all cantons. The proposed bill aims to preserve the attractiveness of Switzerland's tax regime while maintaining compliance with OECD rules and the EU's demands. One of the key changes put forward is the removal of preferential tax treatment for foreign-derived profits so far enjoyed by various special-status companies at the cantonal level. Fearing the exit of corporations from Switzerland, most cantons plan to respond by slashing locally applicable ordinary corporate-profit and capital tax rates. This leads to the question: To what extent will the reform affect Swiss regional governments' budgetary performance?

We expect the introduction of TP 17 to affect primarily two of the eight rating factors we consider when analyzing local and regional governments' credit quality, namely financial management and budgetary performance. Overall, we believe that TP 17's likely impact on cantonal budgets will be significant, but that the long-term consequences for the ratings will also depend on other factors, such as economic growth and the cantons' response.

Initial TP 17 Impact Estimates For Individual Cantons Vary Widely

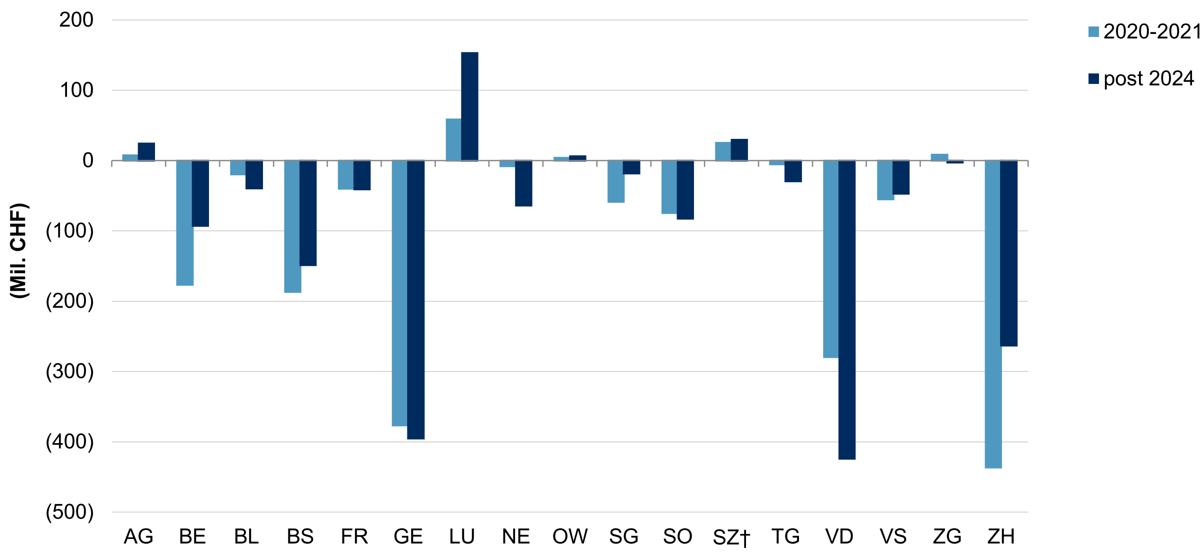
We estimate that the annual net monetary impact of TP 17 on cantons immediately following the introduction of the reform, which we assume will be in 2020 or 2021, will range from an additional cost of Swiss franc (CHF) 438 million (about $445 million; for Zurich) to a benefit of CHF58 million (for Lucerne) (see chart 1). This disparity stems from differences in the size of the regional economies, the cantons' strategies to implement TP 17, and the extent of their dependence on tax revenues from ordinary and special-status companies. To derive our impact assessment for 2020-2021, we compile data from various sources to calculate the net amount of:

- Each canton's additional share of the direct federal tax ("Direkte Bundessteuer"/"impôt federal direct"), according to the proposed reform;
- The estimated change (which is negative for almost all cantons) in cantons' corporate profit and capital tax receipts;
- Any additional revenues from the originally intended increase of the multiplier for the partial taxation of dividends to 70%; and
- The cost of any compensation measures from the cantons in favor of individuals and municipalities.

Overall, our analysis identifies an expected cost of CHF1.7 billion from lower corporate profit taxes, CHF237 million from lower capital taxes, and CHF894 million in compensation measures for municipalities and individuals, and attribute these to the individual entities for which we have data available.

Chart 1

The Impact Of TP 17's Components May Be More Negative Than Positive For Cantonal Budgets*



*Components include additional DBSt, cantonal tax changes, and compensation-measure changes in NFE.
†Results for "Variante Steuersatzsenkung". Sources: Swiss Federal Council's dispatch on Tax Proposal 17, cantonal documents and press releases, S&P Global Ratings' calculations.

TP 17's Interaction With The Fiscal Equalization Mechanism Will Have Mixed Effects

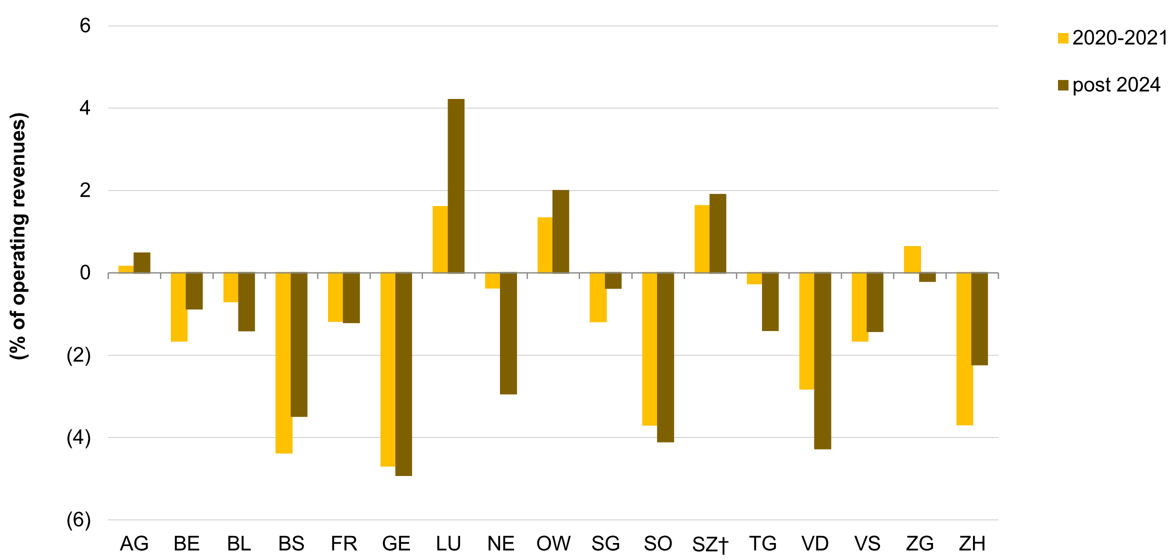
We project that, starting in 2024, the interaction of TP 17 with the Swiss National Fiscal Equalization Mechanism (NFE) will offset some of the initial TP 17 losses for Zurich, Basel-City, and Bern; while Neuchâtel and Vaud, for example, may incur additional costs from the resulting NFE adjustments. The reason for this is that weights applied to corporate profits for the purpose of calculating payments to or from cantons under the NFE scheme will change under TP 17. In consequence, we expect that changes to NFE payments that accrue gradually from 2024 will materially modify the reform's net budgetary impact on some cantons. The relative ranking of cantons in our impact assessment will therefore likely change. As an illustration, assuming all other factors are unchanged, we estimate that while Lucerne will remain the largest beneficiary of TP 17 (estimated to gain CHF153 million annually after NFE adjustments), Zurich may benefit from having to make lower NFE payments; therefore Zurich will switch places with Geneva and Vaud (-CHF395 million and -CHF424 million, respectively) as the canton most affected by TP 17 in monetary terms.

TP 17 Would Likely Cost Some Cantons 4%-5% Of Operating Revenues

We estimate that, relative to the size of cantons' budgets, Geneva, Vaud, Solothurn (post NFE changes), and Basel-City (before NFE changes) will face the highest cost once TP 17 takes effect: between 4% and 5% of operating revenues (see chart 2). In absolute monetary terms, TP 17 will have a greater effect on cantons with larger populations and economies, but distributed over a greater budget. By contrast, for some midsize cantons, such as Schwyz, Lucerne, or Solothurn, the cost of TP 17 will have a more meaningful impact on operating revenues. To gauge the subsequent differences between cantons, we divide the result of our monetary impact assessment on each canton by the related operating revenues. This does not significantly alter the rankings, but reduces the spread of results. We find that the TP 17-induced cost for the more severely affected cantons could reach up to 4%-5% of operating revenues.

Chart 2

Estimated Relative Impact Of TP 17 Components On Cantonal Budgets*



*TP 17 components: additional DBSt, cantonal tax changes, and compensation measure, changes in NFE.
§Calculation uses annual average over 2014-2017 period. †Results for "Variante Steuersatzsenkung".
Sources: Swiss Federal Council's dispatch on tax proposal 17, cantonal documents and press releases, S&P Global Ratings' calculations.

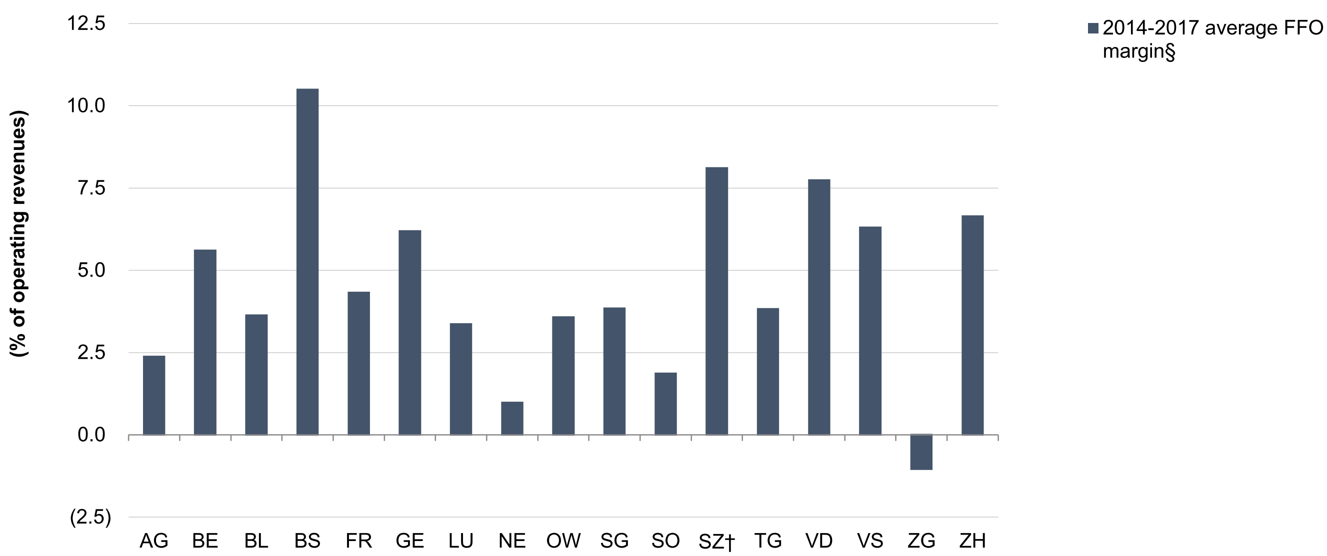
Cantons' Pre-TP 17 Fiscal Absorption Capacity Differs

Basel-City, Schwyz, Vaud, and Zurich appear to have the largest headroom to digest future TP 17 costs, since their average funds from operations (FFO) margins (FFO divided by operating revenues), for 2014-2017 clearly exceed 6% (see chart 3).

Zug, Neuchâtel, Solothurn, and Aargau, on the other hand, display markedly weaker absorption capacity, with FFO margins below 2.5%. We produce the FFO margin for each canton using average "Selbstfinanzierung" or "Autofinancement" data, now routinely disclosed by almost all cantons under the applicable Swiss accounting standard. Assuming past averages to be indicative of future performance, we consider this metric to be a useful barometer of cantons' general ability to afford potential revenue losses from TP 17.

Chart 3

Initial Affordability Indicator: Cantons' Pre-TP 17 FFO Margins*§



*
FFO--Funds from operations ("Selbstfinanzierung"/"Autofinancement" as defined under HRM2 standard). §Calculation uses annual average over 2014-2017 period. Sources: Cantons' Annual Reports, S&P Global Ratings' calculations. Cash flow data adjusted for extraordinary pension fund recapitalization payments.

Simulated Post-TP 17 Cash Flow Positions Highlight Fiscal Hurdles

The results of combining our TP 17 impact estimates and cantons' recent FFO margins show that the challenges TP 17 poses will vary significantly among the Swiss cantons in 2020-2021 (see chart 4) and after 2024 (see chart 5), but appear most severe for Solothurn, Geneva, and Neuchâtel (post NFE changes). Based on our results, we cluster Swiss cantons into four distinct groups, those that:

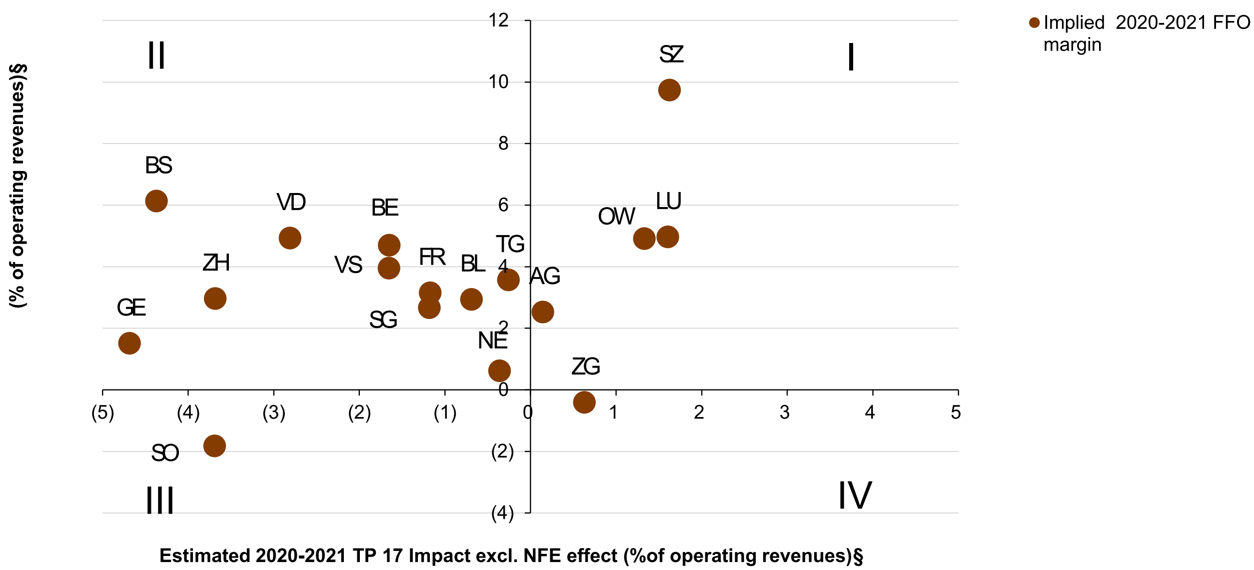
- Appear to benefit fiscally from TP 17, such as Lucerne, Obwalden, Schwyz, Aargau and, partially, Zug (all featuring in or near quadrants I and IV of charts 4 and 5).
- Face moderate to significant TP 17 costs relative to their operating revenues, but due to stronger fiscal absorption capacity will likely maintain healthier post-reform FFO margins, such as Basel-City, Vaud, Zurich, and, partially, Valais and Bern (all in or near the upper parts of

quadrant II in charts 4 and 5).

- Face significant TP 17 costs combined with weaker initial fiscal positions, and are hence likely to be the most tested by TP 17, meaning primarily Solothurn, and to a lesser degree Geneva and Neuchâtel (post NFE effects) (all in or near quadrant III of charts 4 and 5).
- Display average to fairly robust recent FFO margins, and a moderate impact from TP 17 (in quadrant II, but close to the origin in charts 4 and 5; all other cantons).

Chart 4

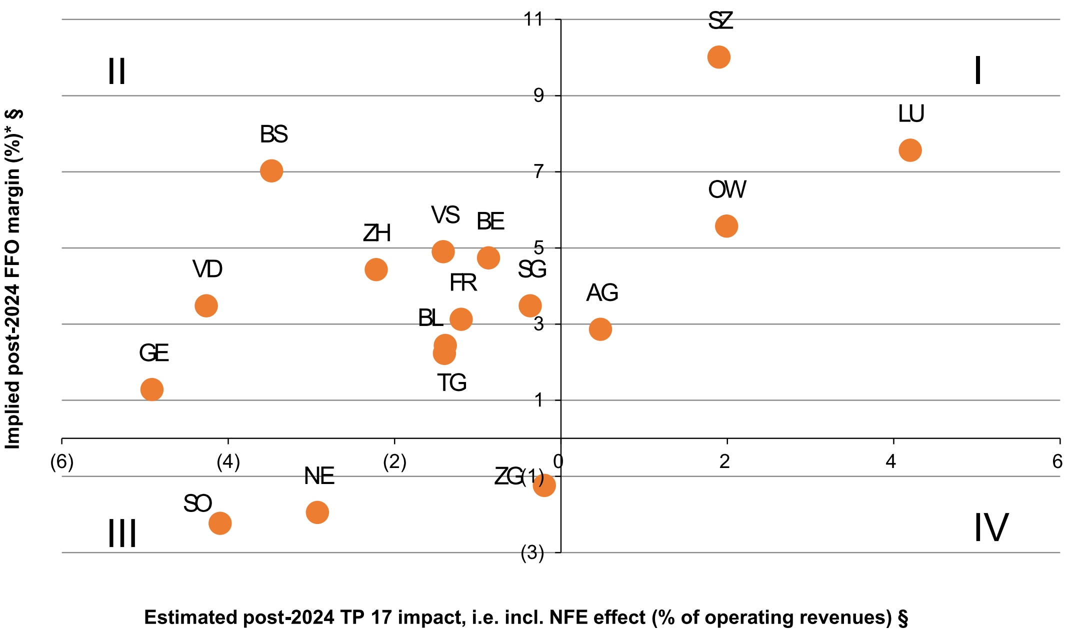
Implied Post-TP 17 2020-2021 Cantonal Budgets: FFO Margin Before NFE Effects
Estimated TP 17 Impact Versus Implied Post TP 17 FFO Margin*§



*FFO--Funds from operations ("Selbstfinanzierung" / "Autofinancement" as defined under HRM2 standard.
§Calculation uses annual average of operating revenues over 2014-2017 period. Sources: Swiss Federal Council's dispatch on tax proposal 17, cantonal documents and press releases, S&P Global Ratings' calculations.

Chart 5

Implied Post-2024 Position Of Cantonal Budgets (Post TP 17, Including NFE Effects)
Estimated TP 17 Impact Versus Implied Post TP 17 FFO Margin*§



*FFO--Funds from operations ("Selbstfinanzierung"/"Autofinancement" as defined under HRM2 standard). §Calculation uses annual average of operating revenues over 2014-2017 period. Sources: Swiss Federal Council's dispatch on tax proposal 17, cantonal documents and press releases, S&P Global Ratings' calculations.

Our simulation approach is fairly mechanistic and does not necessarily recognize more elaborate or dynamic cantonal strategies in response to TP 17. Consequently, for any canton that stands out in the results, one needs to look closer at the underlying factors to get the full picture before making a final assessment.

In this context, and for cantons we rate, we note that TP 17 currently affects only the far end of our usual two- to three-year forecast horizon for budgetary performance. Once we approach the years when we expect TP 17 to actually affect the cantons' results, we would be better able to assess our ratings on individual cantons. In particular, we would consider any adverse scenarios prevailing at that time, such as insufficient management strategies or generally tougher economic conditions.

Appendix I: TP 17 In A Nutshell: Background, Key Elements, And Timing

On June 7th, 2018, the Swiss Council of States, the parliamentary chamber representing the Swiss cantons, approved TP 17, albeit with significant modifications. Selected by their relevance for cantonal budgets, TP 17 currently comprises the following key elements:

- The abolition of current rules for special-status companies across Switzerland, resulting in these companies becoming subject to ordinary taxation at the federal, cantonal, and municipal level.
- An increase in the Swiss cantons' share in the direct federal tax to 21.2% from 17%, to provide an estimated total of CHF990 million annually to the cantons as compensation for the expected reduction of their ordinary corporate profit and capital tax rates once TP 17 is implemented.
- The option for cantons to introduce certain internationally non-contentious tax breaks for corporates into their local tax laws, primarily a supplementary tax reduction of not more than 50% on qualifying expenses for research and development (R&D) activities, and so-called "patent boxes" under which taxes payable on profits from patents can be reduced by up to 90%.
- A downward revision of the multiplier for the partial taxation of dividends to at least 50% at the cantonal level.
- A realignment of the weights on corporate profits for the purpose of determining payments to be made or received by cantons under the Swiss fiscal equalization scheme NFE, which, because of the look-back mechanism in the calculation methodology, would only be phased in four to six years after TP 17's effective date.

By now, most cantonal governments have formulated and communicated plans to significantly lower their regional corporate profit and capital tax rates. The median of the targeted rate reductions amounts to approximately three percentage points. Furthermore, to address voiced criticism of a socially unbalanced reform plan, and to support municipalities affected, the majority of cantons are also planning additional compensation measures targeting individuals and local governments.

TP 17 is currently being discussed in the Economic Affairs and Taxation Committee of the Swiss National Council, the Swiss parliaments' other chamber. The full chamber is expected to vote on this bill during this year's autumn session (Sept. 10-28). If no referendum were initiated, TP 17 would likely take effect on Jan. 1, 2020. However, judging from what happened with TP 17's predecessor bill CTR III, a national referendum on TP 17 is a possibility. In that case, a referendum would likely take place in 2019 and, assuming approval of TP 17, the effective date of the tax law changes would then probably move to Jan. 1, 2021. Mirroring the procedure at the federal level, most but not all Swiss cantons still have to undergo a similar legislative process, and possibly local referendums, to adjust their tax rates and make the various other local determinations required under TP 17, for example, the use of patent boxes, R&D cost recognition, or dividend taxation.

In our view, the timeline for the implementation of TP 17 seems ambitious, and the risk of voters rejecting the entire package or its implementation in individual cantons is not negligible. In its official dispatch on the subject in March 2018, the Swiss federal finance ministry estimates that TP 17 and the known cantonal implementation plans will initially create a total cost of CHF686 million (mostly as additional shares of the direct federal tax paid to cantons) for the federal government. For the cantons and municipalities, the ministry estimates the cost at CHF1.1 billion (mostly in lost cantonal tax revenues only partially offset by additional shares in the federal direct tax).

Methodological And Data Constraints

Our analysis, while in our view adequately capturing the direction and approximate magnitude of TP 17's impact on cantonal budgets, is limited by practical and methodological constraints:

Data availability. Not all cantons have published detailed assessments of TP 17 on their budgets. In fact, we do not present results for Appenzell-Ausserrhoden, Appenzell-Innerrhoden, Glarus, Graubünden, Jura, Nidwalden, Schaffhausen, Ticino, and Uri (none rated), due to a lack of available detailed disclosure. Furthermore, for Geneva, Vaud, and Zurich, we rely partially on data published in connection with TP 17's predecessor initiative (CTR III), which raises questions about whether the data are current and transferable.

Accuracy of publicly disclosed data. We limit ourselves to publicly disclosed data. It is not a certainty that all current plans and impact assessments for TP 17 available in the public domain are comprehensive and disclosed in an unbiased way.

Budgetary adjustments outside TP 17. Cantons could elect, at some point in the future, to implement general savings measures outside the perimeter of TP 17 legislation to mitigate any negative budgetary impact. Our analysis is therefore not able to capture these effects.

Staggered, nonsynchronized implementation. The cantons will not implement TP 17 simultaneously or in one step. Rather, while certain cantons such as Ticino and Vaud have already legislated to start TP 17-related adjustments in 2019, others plan to implement tax reductions in several smaller yearly steps from 2020. Furthermore, the four- to six-year look-back period applied in calculating intercantonal fiscal equalization payments implies a lengthy transition period.

Appendix II: Selected Data

Swiss Cantons: Selected Data On TP 17-related Cost/Benefits

Canton		Pre-TP 17 max. profit tax rate	Post-TP 17 max. profit tax rate	Share of special status companies in total corporate tax revenues	Additional revenues from higher share of Direct Federal Tax under TP 17	Cost/benefit of TP 17-related cantonal tax changes and compensation measures	Net TP17 cost/benefit to canton, excl. NFE effect	TP 17-induced change in resource equalization payments	Estimated net TP17 cost/benefit to canton, incl. NFE effect	2014-2017 average FFO-margin	TP 17 cost/benefit (excl. NFE effect) / 2014-2017 aver. operating revenues	TP 17 cost/benefit (incl. NFE effect) / 2014-2017 aver. operating revenues
Main Data Sources*		Dispatch	Dispatch	Dispatch	Dispatch	CD, MR	S&P	Dispatch	S&P	FDK, AR	S&P	S&P
		(%)	(%)	(%)	(mil. CHF)	(mil. CHF)	(mil. CHF)	(mil. CHF)	(mil. CHF)	(%)	(%)	(%)
Aargau	AG	18.6	18.2	1.5	46	(39)	8	17	24	2.4	0.1	0.5
Bern	BE	21.6	16.4	1.7	69	(246)	(177)	84	(93)	5.6	(1.7)	(0.9)
Basel-Country	BL	20.7	13.9	15.9	28	(48)	(20)	(20)	(40)	3.6	(0.7)	(1.4)
Basel-City	BS	22.2	13.0	58.6	63	(250)	(187)	38	(149)	10.5	(4.4)	(3.5)
Fribourg	FR	19.9	13.7	14.4	27	(67)	(40)	(1)	(41)	4.3	(1.2)	(1.2)
Geneva	GE	24.2	13.5	25.8	111	(488)	(377)	(18)	(395)	6.2	(4.7)	(4.9)
Luzern	LU	12.3	12.3	8.3	38	20	58	94	153	3.4	1.6	4.2
Neuchâtel	NE	15.6	13.5	61.3	20	(28)	(8)	(56)	(64)	1.0	(0.4)	(2.9)
Obwalden	OW	12.7	12.7	7.8	5	(1)	4	2	6	3.6	1.3	2.0
St. Gallen	SG	17.4	15.2	10.1	36	(95)	(59)	40	(18)	3.8	(1.2)	(0.4)
Solothurn	SO	21.4	13.1	2.0	16	(90)	(74)	(8)	(83)	1.9	(3.7)	(4.1)
Schwyz†	SZ	15.2	14.4	23.0	35	(10)	25	4	30	8.1	1.6	1.9
Thurgau	TG	16.4	13.4	2.9	17	(22)	(5)	(24)	(29)	3.8	(0.3)	(1.4)
Vaud	VD	21.4	14.0	22.0	113	(393)	(280)	(145)	(424)	7.7	(2.8)	(4.3)
Valais	VS	21.6	15.6	2.5	17	(72)	(55)	8	(47)	6.3	(1.6)	(1.4)
Zug	ZG	14.6	12.1	52.9	68	(60)	8	(11)	(3)	(1.0)	0.6	(0.2)
Zurich	ZH	21.2	18.2	7.8	196	(633)	(437)	173	(263)	6.6	(3.7)	(2.2)

†Results for "Variante Steuersatzsenkung". *Sources: Swiss Federal Council's dispatch on tax proposal 17 (Dispatch), cantonal consultation documents and press releases (CD), media reports (MR), cantonal annual reports (AR), Conference of Cantonal Finance Directors (FDK), S&P Global Ratings' calculations (S&P)

This report does not constitute a rating action.