EUROPEAN PARLIAMENT

**DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION**
**DIRECTORATE B**
**- POLICY DEPARTMENT -**

# NOTE
# ON
# THE POLITICAL AND ECONOMICAL SITUATION OF

# SWITZERLAND

## AND ITS RELATIONS WITH THE EUROPEAN UNION

***Abstract:***
*Following a brief summary of Switzerland's unique political system, this paper outlines the current political situation, where increased polarisation still threatens legislative deadlock.*
*It then portrays the economic situation of the country, characterised by rapidly shrinking government deficit due to GDP growth exceeding expectations.*
*Finally, the note reviews EU-Swiss relations, where numerous bilateral agreements have been concluded in order to reconcile the need for close integration with EU structures with the reluctance of the Swiss people to share sovereignty rights.*

*Any opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the official position of the European Parliament.*

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# 1. POLITICAL SITUATION

Despite its official name of "Swiss Confederation", Switzerland is not a confederation, but a federal state, albeit decentralised to an unusual degree for Europe. Executive and legislative powers at the federal level are accordingly limited, and the 26 Cantons wield considerable day-to-day political power and enjoy a large degree of autonomy, in particular over public services and the taxation to finance them.

## 1.1. Background: the Political System

- **Parliament**: The ***Federal Assembly*** consists of two chambers:

- The ***Council of States*** *("Ständerat"*, the upper house), 46 members, represents the Cantons: each Canton elects two members according to various electoral systems;
- The ***National Council*** *("Nationalrat",* the lower chamber), made up of 200 members, represents the country as a whole rather than Cantonal interest. It is elected for a four-year term by proportional representation.

The two chambers have identical powers: a bill is only passed when they both consent . The Federal Assembly is divided into factions which consist of members of the same party or of members of parties with similar agendas. Therefore, a parliamentary faction is not necessarily the same as a party, and party affiliation is not strictly enforced in the Assembly. To form a faction, at least five members must band together.

**- Government**: The ***Federal Council*** *("Bundesrat")* consists of seven ministers of equal rank, individually elected by the Federal Assembly to serve four-year terms. Two seats are reserved for French-speaking Cantons. The Federal Council takes the lead in determining Switzerland's overall economic and political direction. Since 1959, a fixed distribution of seats among the main parties was meant to ensure political stability: two Christian Democrats (CVP), two Social Democrats (SP), two Radicals (FDP) and one member of the populist Swiss People's Party (SVP). This "magic formula" was upheld even after the SVP became the second-strongest party in 1999, but became untenable after the 2003 elections.

**- Head of State**: The office of ***President*** is relatively weak, confined to chairing meetings of the Federal Council and to various representative roles. The members of the Federal Council take the post in annual rotation. However, as Switzerland has become more internationally engaged (since, in particular, the successful referendum of 2002 concerning UN membership), the profile of the post is beginning to rise.

- **Direct democracy:** A long-standing characteristic of Switzerland's political system, provisions for direct decision-making by the people exist at the federal, cantonal and local level. At the federal level, laws and many international treaties passed by Parliament are submitted to a referendum if requested by eight cantons or 50 000 votes. There are also provisions for "people's initiatives" proposing changes to existing laws or even to the constitution. The number of both people's initiatives and referendums has increased significantly in recent years.

## 1.2 Current situation

Confirming the SVP's success of 1999, the 2003 elections saw the SVP emerge as the strongest party:

| | |
|---|---|
| Swiss People's Party (SVP) | 26,7 % |
| Social Democrat Party (SP) | 23,3 % |
| Radical Democratic Party (FDP) | 17,3 % |
| Christian Democratic Party (CVP) | 14,4 % |
| Green Party | 7,4 % |
| Liberal Party | 2,2 % |

These results made maintaining the 'magic formula' untenable. When the Federal Council had to be renewed, the SVP therefore obtained a second seat at the expense of the Christian Democrats. The current government line-up is as follows:

Federal President & minister for environment, transport, energy & communications: Moritz Leuenberger (SP)

Vice-president & Minister for foreign affairs: Micheline Calmy-Rey (SP)

Minister for economic affairs: Joseph Deiss (CVP)

Minister of finance: Hans-Rudolf Merz (FDP)

Minister of defence: Samuel Schmid (SVP)

Minister for justice & police: Christoph Blocher (SVP)

Interior minister: Pascal Couchepin (FDP)

Swiss political life remains marked by the increased polarisation that resulted from this strengthening of the SVP and the left-wing SP, to the detriment of the centre-right FDP and the centrist CVP. The rise of the SVP has led to a greater emphasis on populist policies, such as a tightening of asylum and immigration laws. However, the ability of the SVP to push through radical policies remains constrained by the fact that, given the parliamentary strength of the parties, any legislation needs to be approved by at least three of the four main parties. In addition, the constitution makes it easy for parties and interest groups to require referendums on legislative proposals, so wide backing is needed for new laws to be passed. This also means that while the SP has little chance of pushing through economic policy with a strongly left-wing agenda, it has successfully blocked several FDP/SVP proposals for substantial economic reform by calling referendums, and will continue to do so.

There is little chance of a change in the composition of the Federal Council ahead of the general election in October 2007. Joseph Deiss, the federal councillor responsible for the Ministry of Economic Affairs, announced in April that he would step down, but he will be replaced by a member of his own party, the Christian Democratic Party (CVP), probably Doris Leuthard. Judging by recent opinion polls, the general election will not lead to further substantial change in the make-up of parliament, as support for the SVP now appears to have stabilised. Nonetheless, there will be some debate over whether the current system, whereby all four main parties are represented in government, should remain in place. The four-party

coalition will very probably be renewed, although some analysts see a small chance that the SVP will leave the government to pursue a more effective opposition policy. The SVP may also call on the Radical Democratic Party (FDP) and the CVP to push the Social-democratic Party (SP) out of government, but is unlikely to get much support.

## 2. THE ECONOMY

The Swiss economy performed better than expected in 2005, its GDP growing by 1.8%. Based on new figures for the first quarter of 2006, analysts forecast 3.5% growth for this year, to be followed by a slowdown to 2.3% in 2007. In view of Switzerland's specialisation in investment goods, strong demand in emerging markets for capacity-increasing investments and, more generally, still-strong world trade growth should result in buoyant export growth in 2006, followed by only a moderate slowdown in 2007. Although the domestic economy is strengthening, leading to a rise in import growth, the main driver of the economy this year would be the external sector. This means that external risks — a slowdown in emerging-market demand as a result of the global tightening of financial conditions, a major international correction related to the US current-account deficit or a further rise in oil prices — would reduce Swiss GDP growth substantially. At the same time, recent data suggest that the Swiss economy is growing at a fast pace, leaving room for further upward surprises.

### 2.1 Economic policy outlook

Partly as a result of the strengthening of the right-of-centre parties, but also in response to the sluggish pace of economic growth over the past two decades, the government is paying greater attention to improving the business environment. Discussions are based on the government's growth package presented in February 2004, aimed at boosting trend growth. The package includes market-oriented reforms of public healthcare and pension insurance and measures to liberalise product markets, particularly the electricity market and agriculture. The previous rejections of a key bill on electricity market liberalisation in September 2002 and of a series of other economic bills suggest that referendum campaigns on economic reforms will be difficult to win. In May 2006 the rejection by the National Council of a bill that would have allowed the full privatisation of Swisscom, the former telecommunications monopolist, also underlined the strength of opposition to major liberalisation measures. Nevertheless, most reform plans should ultimately be realised, although this will often require several attempts and a substantial watering-down of initial proposals. Administrative decisions by sectoral regulators and the Competition Commission will also strengthen competition.

### 2.2 Monetary policy

On March 16th 2006 the Swiss National Bank (SNB, the central bank) raised its central target for its reference interest rate by 25 basis points to 1.25%, following three increases by a total of 75 basis points in June and September 2004 and in December 2005. SNB officials justified the rise in March with the continued improvement in economic conditions and stated that they intended to raise rates further.

The Swiss franc will continue to be subject to bouts of volatility, as a result of its status as a safe-haven. Concerns about global economic imbalances and geopolitical fears will lead to periodic flights into Swiss franc-denominated assets. The SNB will attempt to dampen the

resulting pressure on the currency to strengthen by intervening in the foreign-exchange market (and in the case of major fluctuations, through its monetary policy instruments), but its ability to stop an appreciation in the case of serious global turbulence would be limited.

### 2.3 Fiscal policy

As in 2004, the federal government deficit in 2005 came in much lower than projected by the government, at just CHF100m, compared with a budget projection of CHF 1.8bn. The approved budget for 2006 foresees a federal government deficit of CHF 585m in 2006, while for 2007 the government's financial plan projects a surplus of CHF 400m. Some analysts view these targets as overly pessimistic (partly through being based on low growth estimates), and expect a moderate federal government surplus already in 2006, as the federal finances will be helped by two fiscal consolidation packages approved in April 2004 and June 2005.

Reliable final data for cantonal and local finances — which are far more important in Switzerland than in most other countries because of the high degree of decentralisation in the Swiss system — are published with long time lags. According to an initial estimate, the general government deficit fell from 1.2% of GDP in 2004 to 0.6% of GDP (excluding one-off receipts of 4.7% of GDP from the sale of Swiss National Bank gold reserves) in 2005. The general government balance is therefore expected to show a moderate surplus in 2006, which will increase further in 2007.

## 3. EU - SWITZERLAND RELATIONS

EU/Switzerland cooperation has been both long-lasting and intensive. Geographically fully surrounded by the EU since 1995, Switzerland shares culture, language and economic integration with its neighbouring countries. With over 70 bilateral agreements currently in place, the first dating back to the early days of the European Coal and Steel Community (1956), no other third country has as many agreements with the EU as Switzerland.

In a referendum held on 6 December 1992, the Swiss people rejected the ratification of the EEA agreement previously negotiated by their government. As a consequence, the Swiss Government decided to suspend negotiations for EC accession, which had begun that year, until further notice. Switzerland retains observer status at the EEA however, allowing it to follow the evolution closely.

### 3.1 Bilateral Trade

The European Union is Switzerland's main trading partner, absorbing almost two thirds of its exports and supplying more than four fifths of its imports, according to Swiss figures for 2004. Viewed from the other side, Switzerland is currently the fourth largest trading partner of the EU. Trade figures for 2005 show EUR 66 billion in imports and EUR 82 billion in exports. In terms of imports, Switzerland was the EU's sixth most important trading partner last year, after the USA, China, Japan, Russia and Norway. Regarding exports, Switzerland ranked second after the USA in the same period.

The Swiss economy is highly integrated internationally, capitalising on an open trade regime for industrial products but with a protected and heavily subsidised agricultural sector. Tariffs on manufactures are generally low, and in principle there are no quantitative restrictions, anti-dumping, countervailing or safeguard actions. However, in a number of sectors, the market entry has long suffered from "private" or "informal" barriers, which can

be attributed to a legacy of weak anti-cartel legislation, specific and protective technical regulations, certain investment restrictions, and exclusive rights under intellectual property legislation.

Swiss merchandise exports are concentrated on a few sectors, particularly chemicals and medicinal products, machinery, instruments and of course watches. Switzerland provided 22% of the EU's total imports of chemical products, as well as 12% of total imports of power generating machinery in 2005.

Developed countries are the main partners for foreign direct investment in Switzerland, but the outflow towards Central and Eastern European countries has recently increased. The United States is the main investor as well as the main destination, in terms of FDI stock. Inward stock is more concentrated, with only three investors accounting for almost 70% (USA, the Netherlands, Germany). The most important destinations of Swiss FDI are the USA, UK and Germany.

### 3.2 Bilateral Agreements

In order to minimise the negative consequences of the rejection of the EEA agreement, negotiations on a first package of bilateral agreements ("Bilateral I")began in 1994. They covered seven sectors: Free Movement of Persons, Trade in Agricultural Products, Public Procurement, Conformity Assessments, Air Transport, Transport by Road and Rail, Swiss Participation in the 5th Framework Programme for Research. Negotiations were concluded in 1999, and the agreements entered into force on 1st June 2002. The on-going implementation of these agreements obliges Switzerland to take over relevant Community legislation in the covered sectors.

Negotiations on a second bilateral package ("Bilateral II") were opened soon after, and concluded in 2004. These cover a total of nine areas: agreements on Processed Agricultural Products, Statistics, Pensions, Environment, Media, Schengen/Dublin (confirmed by referendum in June 2005), Fight against Fraud, and Savings Taxation, plus a declaration of intent on Education/Vocational Training/Youth.

According to the European Commission, efforts should now be concentrated on the correct implementation and consolidation of these various existing agreements, rather than starting a new round of bilateral sector negotiations.

Among upcoming issues, the most sensitive concerns certain forms of ***predatory corporate tax regimes which exist in some Swiss cantons***, and are being addressed under the EC-Switzerland Agreement of 1972. Such regimes are not allowed inside the EU (Art. 87 TEC and Code of Conduct of 1997), and they seem to qualify as state aid prohibited by Art. 23 of the Agreement. The issue has already been raised in the European Parliament and the Economic and Social Committee. Member States are committed to promote the standard of the Code of Conduct vis-à-vis third countries; they fully support the consultation procedure under Article 27 of the Agreement which the Commission has launched for legal as well as political reasons: Legally, these tax regimes would appear to qualify as state aid which is incompatible with the good functioning of the Agreement. Politically, it seems difficult to accept that a close neighbour and privileged partner like Switzerland should maintain such tax schemes, the only objective of which is to attract foreign "letterbox" holdings, depriving EU Member States of billions in tax revenue.

## 3.3 Impact of EU Enlargement

The recent EU enlargement has had consequences for a number of existing arrangements between the EU and the Swiss Confederation. The adaptation of existing bilateral agreements has been in principle a technical question. However, for the ***Agreement on Free Movement of Persons***, a mixed agreement containing transitional provisions, formal negotiations with the ten new Member States had to be conducted. The resulting agreement was ratified by referendum on 25 September 2005, with 56 % of votes in favour.

As an EFTA member, Switzerland has also committed to contribute EUR 130 million per year over a period of five years (CHF 1 billion in total) towards lessening the economic and social gap between the old and the new member states of the EU. Under this cohesion scheme, Switzerland shall support specific projects in different areas, which it will choose and carry out autonomously. A memorandum of understanding to that effect was signed on 27 February 2006. It will become operational once the internal procedures for the appropriation of credits are concluded. A public referendum on the contribution may be called for, which then would be held in November 2006. Switzerland will later conclude binding implementing agreements with each beneficiary state.

## 3.4 The Accession Question

Put on hold in 1992 after the failed referendum on EEA membership, Switzerland's application for EU accession technically remains open. The government still pursues a policy of long term Swiss integration into EU, to the point of having established an Integration Office under the Department of Foreign and Economic Affairs.

The Swiss Government has commissioned a study for the second half of 2006 which is to look into the feasibility of various options for future relations with the EU. Apart from the conditions for EU membership, the document will also investigate accession to the EEA, a continuation of the bilateral sector approach, and a framework agreement. Pending the detailed results of this study, in principle all these options would seem possible from an EU point of view. However, the European Commission has pointed out that a framework in the form of an association agreement would only make sense if it created added value: It could for example merge existing agreements under one joint committee, which would be empowered to regularly update the agreements in line with the evolving acquis.

Politically, this review is unlikely to lead to any significant changes. Past referenda on foreign-policy issues, opinion polls and the strong position of the isolationist SVP all indicate that any step implying a curtailment of Swiss neutrality and sovereignty would meet with strong opposition. Consequently, Switzerland will in all likelihood remain outside the EU until well beyond 2010. On the other hand, an SVP initiative to formally withdraw the dormant application for EU membership does not seem likely to get much support.