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*Weathering the Global Financial Crisis.  
Is Direct Democracy of any Help?*

# Weathering the Global Financial Crisis – Is Direct Democracy of any Help?<sup>1</sup>

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**Abstract:** The global financial crisis and the European debt crisis have loomed large over the globe, with severe consequences on government finances in many countries. Switzerland has fared relatively well throughout this crisis. In this paper, surveying a selection of empirical research on Switzerland, we argue that direct democracy might be one (but not the only) reason why Switzerland has weathered the storm exceptionally well.

**JEL Classification:** H11, H12, H77, D72

**Keywords:** Direct democracy; Financial Crisis

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## 1. Introduction

The financial crisis that started in 2007 has loomed large over the globe. As a consequence, many governments are in dire straits, with important national economies on the brink of not being able to repay their accumulated debt. Also, Europe did not escape the financial crisis unscathed. The European Union (EU), the world's largest economic union, only recently returned on the path of economic growth and countries (Greece, Portugal, Ireland, and Cyprus) have received large bailouts from the Troika of EU, the World Bank (WB) and the International Monetary Fund (IMF). The financial situation in Europe is far from secure, yet, with default and exit from the Euro still looming in Greece, and larger economies, such as Spain and Italy, barely escaping bailouts. Similarly, the path of recovery of the EU economy is still fragile, with high overall levels of unemployment and extremely difficult access to the labour market for important groups of society, among them the young, in many EU countries<sup>3</sup>. Similarly, the weak financial situation of many European economies has had important and sensible impacts on public programs.

The financial crisis has also sparked a lively, intensive and necessary academic debate on finding ways to escape the crisis, but also on how to prevent (or ease) future meltdowns of financial markets and their real economic consequences. One can identify largely two camps: the austerity-camp points to the fact that countries have lived beyond their means and hence must cut spending (or increase taxes) to reduce the accumulated debt; while the recession-camp points to the fact that tightening one's belt, i.e. austerity, is not a solution to relaunch a stuttering economic engine.

However, national experiences through the financial crisis vary a lot. Countries in Europe have fared differently in recent years for many reasons. One country that appears to be a solid (economic) rock in these times of turmoil is Switzerland. The country in the heart of Europe did not experience a recession through the crisis; its level of unemployment is significantly lower than that of all EU countries, it is still one of the richest countries in the world; its governments accounts are in order (Switzerland expects a government surplus for 2013); debt is under control, etc.

Besides Switzerland's above average economic performance through the financial crisis, the country is also known as a natural laboratory of direct democracy. Direct democracy has a long tradition in Switzerland and citizens enjoy large degrees of participation in public policy shaping at all levels of government.

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<sup>3</sup> For example, youth unemployment was 37% in Italy and a staggering 55% in Spain at the end of 2012.

In this paper, I want to discuss how direct democratic institutions and their use might have helped Switzerland to escape the financial crisis relatively unscathed. For this I overview the literature on the effects of direct democracy on political and economic outcomes, focusing on the case of Switzerland.

Prior to continuing a few words of what this paper is not are in order. The paper is not an exhaustive overview of the (large) literature that studies direct democratic institutions and their effects. I focus mainly on (empirical) applications to Switzerland and even there I might not have given enough credit to some work (apologies for that). This does not mean that research on direct democracy in other countries is not important. The review is biased by my own research and by papers that have influenced my work. Further, the discussion is not necessarily a causal claim of the effects of direct democracy, although many of the articles reviewed spend considerable effort to identify causal effects. Finally, clearly, direct democracy is not the only reason why Switzerland has fared well recently. It is, first of all, a small country; it enjoys a favourable geographic location in the heart of Europe; its labour market is less regulated than in many EU countries, just to name a few. These and others might be additional (potentially more important) reasons explaining the Swiss case. A comprehensive analysis of all effects is beyond the scope of this paper and my intellectual abilities. But, the paper tries to give a contrasting, positive possible explanation of why Switzerland has fared well recently, given the significant negative press the country is receiving lately from its lax regulation of the financial sector<sup>4</sup>.

The remainder of the paper is structured as follows. In section two I present a short summary of the timeline of the global financial crisis, summarizing the main events since 2007. In Section 3 I discuss how Switzerland has fared during the crisis, mainly in comparison to other OECD economies. Section 4 presents, briefly, the public sector and political institutions of Switzerland. Section 5, the heart of the paper, reviews the literature on the economic effects of direct democracy, while Section 6 concludes.

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<sup>4</sup> Switzerland is currently under quite some pressure both from the U.S. and European countries to collaborate more actively in efforts to reduce e.g. international tax evasion.

## 2. Timeline of the Great Recession and European Debt Crisis<sup>5</sup>

It is widely agreed upon that the financial crisis was triggered by severe problems with subprime mortgages. Below an account of the most important events since 2007, including the most relevant ones in Switzerland.

February, 2007:	Reports of first losses due to subprime credits
August, 2007:	the interbank lending market slows down. The European Central Bank (ECB) pumps over 300 B€ into the banking system.
September 4, 2007:	the interbank lending market collapses
September 14, 2007:	bank-run on Northern Rock (UK), it will later be nationalized
September 7, 2008:	the U.S. government saves Fannie Mae and Freddie Mac
September 15, 2008:	Lehman Brothers declares insolvency
September 17, 2008:	the Fed pumps B\$85 in AIG, an insurance company
October 2, 2008:	approval of the Troubled Asset Relief Program (Tarp) a stimulus package of the U.S. government
October 16, 2008:	the Swiss National Bank (SNB) takes over a portfolio of toxic credits of over B\$60 to bail out UBS (a Swiss bank)
November, 2008:	the Eurozone enters recession
September, 2009:	the G20 summit adopts the implementation of higher capital requirements for banks
October 2009:	Greece admits that its budget figures have been tampered with, deficit is now 12% of GDP
April 2010:	first (of several) rescue packages for Greece
May, 2010:	launch of the European Financial Stability Facility (EFSF)
November, 2010:	EFSF rescue package for Ireland
April, 2011:	EFSF rescue package for Portugal
September, 2011:	the SNB fixes a minimum exchange rate of CHF 1.20 per Euro (the Swiss franc has not dropped below this minimum since)
December, 2011:	ECB launches Longer Term Financing Operations providing over B€1000 of liquidity to the European banking system

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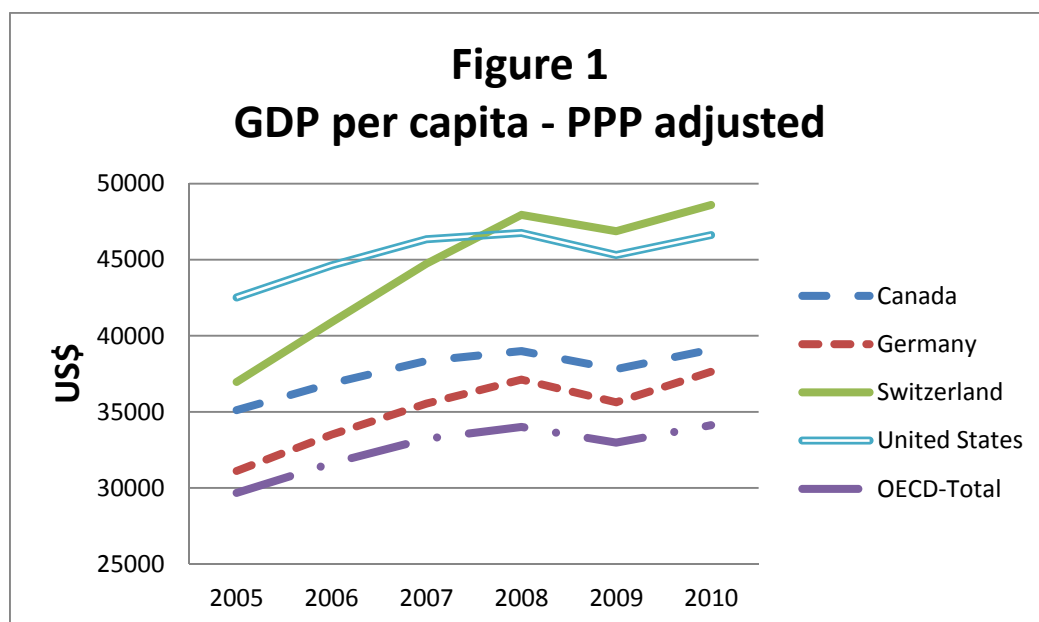
<sup>5</sup> The section is based on a timeline published by Finanz & Wirtschaft (in german) accessible on: <http://www.fuw.ch/article/chronologie-der-finanzkrise/>

- September, 2012: ECB installs the Outright Monetary Transactions (OMT) program, allowing ECB to buy unlimited sums of government bonds of critical EU member states
- July, 2013: UBS announces it will buy back the toxic credits passed to SNB

### 3. How Switzerland has Fared

Switzerland has fared relatively well over recent years. In this section we compare the economic performance of a group of countries with Switzerland<sup>6</sup>. In the comparison group we include Canada, the U.S, and the group of OECD countries. Where available we also included the Euro area (15 countries) or else Germany.

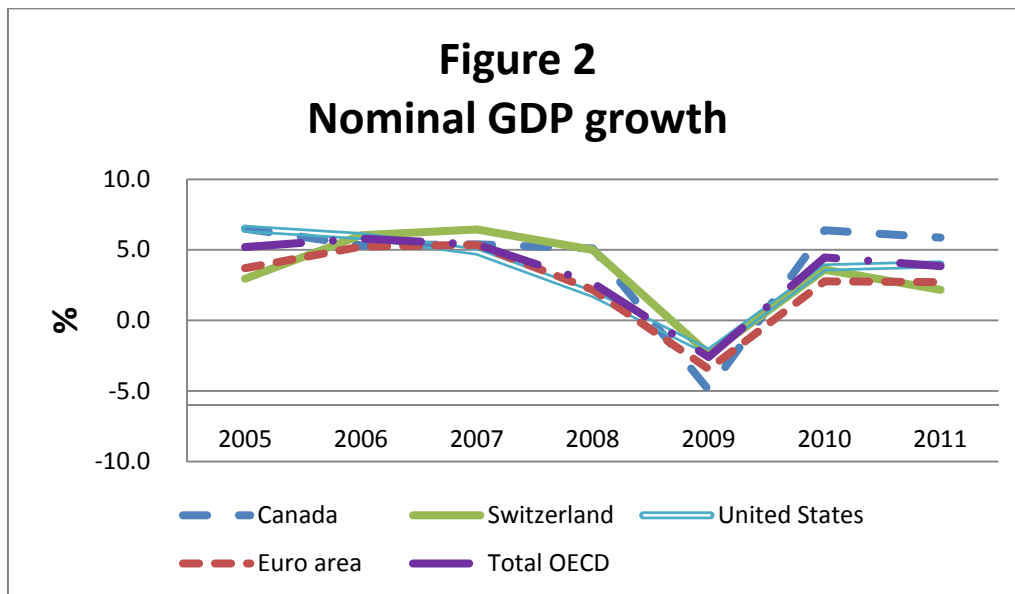
Switzerland is still one of the richest countries in the world in terms of per capita Gross Domestic Product (GDP). Figure 1 shows the evolution of (Purchasing Power Parity – PPP – adjusted) GDP from 2005 to 2010. Switzerland comes ahead of the batch, overpassing the U.S. for the last three years. Also, its GDP is significantly higher than the other developed economies in the comparison group.



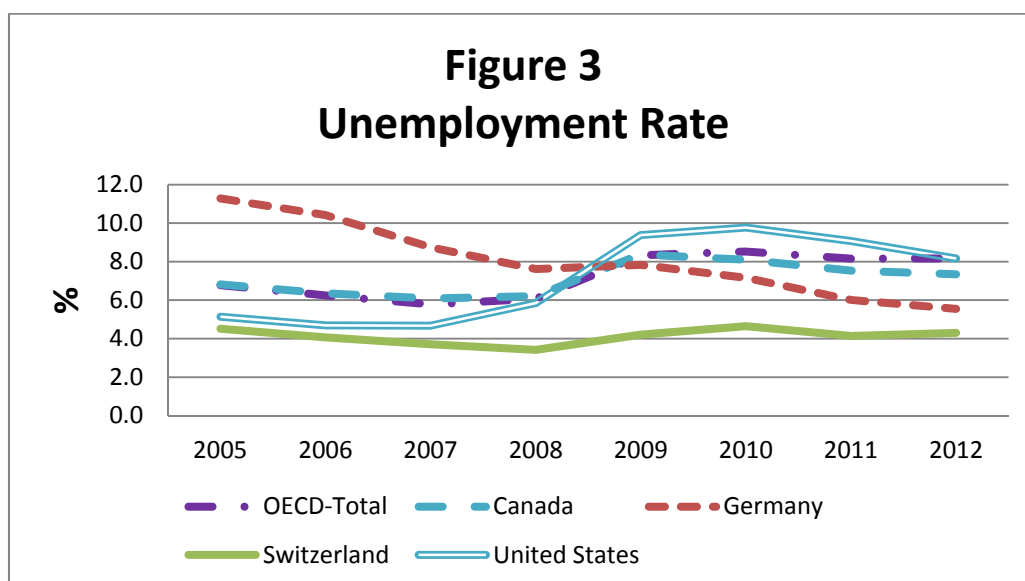
However, Switzerland has also seen its economy put under stress during the financial crisis and the ensuing Euro-crisis, suffering, along all other comparison countries, from negative growth in 2009. Figure 2 illustrates this by comparing nominal GDP growth. It can be noted that Switzerland

<sup>6</sup> All data have been collected from OECD.

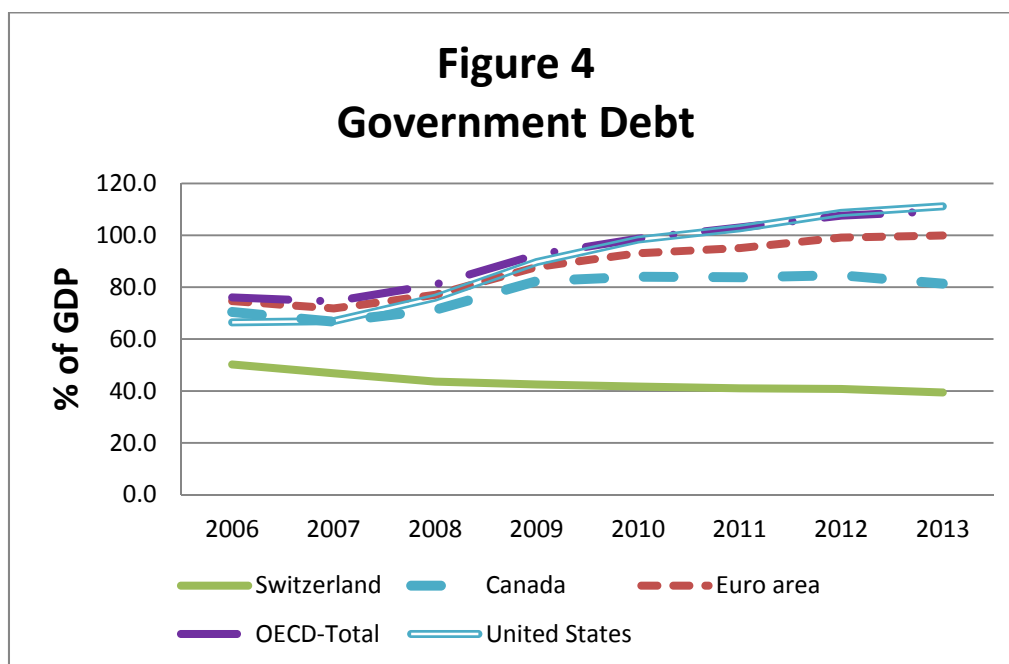
outperformed most countries in the initial years of the crisis (2007-2008), suffered among the smallest reduction and quickly recovered on a light, but sustained, growth path.



Particularly impressive is Switzerland's performance in terms of unemployment shown in Figure 3. Throughout the crisis, Switzerland has maintained its leading position with essentially stable unemployment rates at about 4%. The OECD overall, Canada and the U.S. have experienced significant increases in their unemployment rate in 2009, from which they have not recovered, yet. The country, in the batch, that has fared even better than Switzerland is Germany, throughout the crisis, Germany has continuously lowered the share of unemployed from around 11% to below 6%.

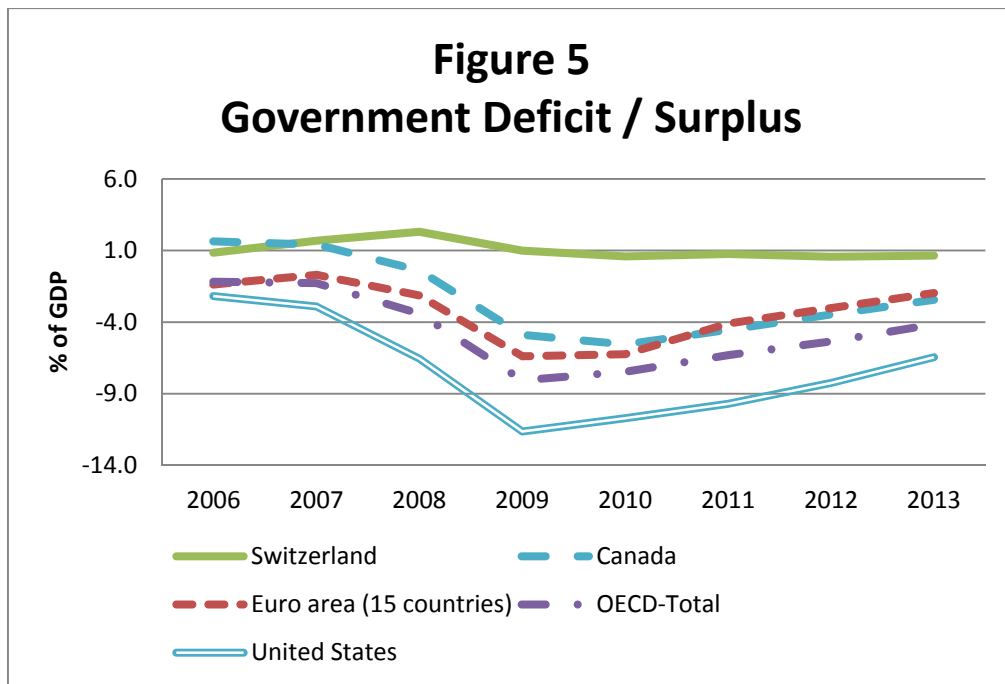


In the next few Figures I turn to the performance of the Swiss public sector. Again, the performance is remarkable. Figure 4 presents the evolution of government debt during the crisis. Not only, has Switzerland the lowest levels of debt as a percentage of GDP throughout the entire period. It has actually, managed to reduce debt during the crisis. No other country, or group of countries, in the comparison has managed to do so. Currently, debt of Switzerland is half (40%) of that of its next peer (Canada, 80%).

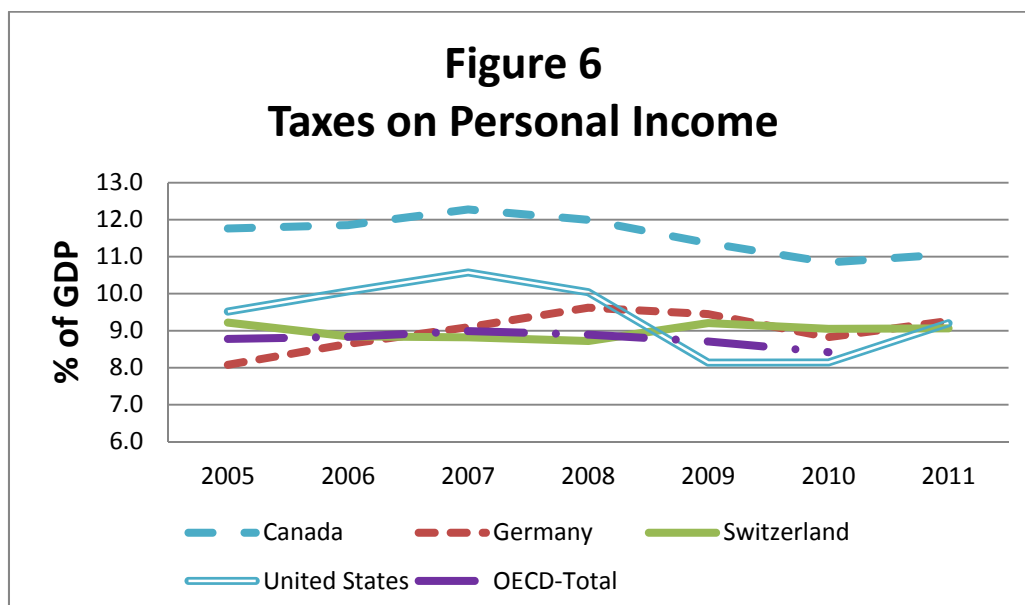


Similarly, Switzerland has generated a government surplus in all recent years, illustrated in Figure 5. This also during the most severe years of the crisis, 2009 and 2010. Note that within the comparison group, only Canada managed to generate a government surplus in the years prior to the crisis (2006-2007).

Thus, Switzerland has its public finances under control and achieves this with an average (if not low) level of taxation. As an illustration, Figure 6 presents the evolution of personal income taxes. Switzerland hovers, for this tax item, at around 9% of GDP, and is currently in line with the U.S. and Germany (the OECD average for 2011 is not available). Canada, while lowering income taxes during the crisis, is heading the batch, with approximately two percentage points higher taxes. It should be noted that income taxes are just one item of taxes, particularly it does not consider social security contributions. Overall however, it is fair to say that Switzerland has a comprehensively low tax burden.



One final note of praise for Switzerland is that it is also a very competitive country. Indeed, the most competitive one, according to the Global Competitiveness Index (GCI) (Schwab, 2012). Switzerland leads this ranking for at least the third year in a row. Looking at the details of the index, one finds that Switzerland is ranked second in the category “Basic requirements”, which includes institutions and infrastructure (ranked 5<sup>th</sup> in both categories). Further, Switzerland leads the ranking in “Labour market efficiency” and “Innovation”. I take this as a signal that institutions in Switzerland contribute in an important way to its economic performance, to which I turn next.



## **4. Switzerland: Public Sector and Institutions**

### *4.1 Public sector*

Switzerland is organized as a federation with three levels of government: federal, cantonal (state) and municipal. There are 26 cantons, and roughly 2500 municipalities that make up the 41'000 km<sup>2</sup> and slightly more than 8 million inhabitants. Thus, jurisdictions in Switzerland are small on average both at the second and third tier of government. Additionally, there are sizeable differences in terms of population, language and topography. For example, the largest canton is Zürich with 1.4 milion inhabitants, while the smallest, Appenzell Innerrhoden, has only 15000 inhabitants.

The country is also characterized by leaving large autonomy to all jurisdictions, both in terms of expenditures and revenues. The shares (for expenditures and revenues) are approximately: 30% federal, 40% cantons and 30% municipalities. These shares have remained remarkably stable over time.

In terms of revenue generation, the federal government has the authority over some tax bases, such as the value-added-tax and most excise taxes (gasoline, tobacco). Further, federal revenue is generated from a (highly progressive) federal income tax, while there is no federal wealth tax. On the other hand, cantons and municipalities relay largely on four (shared) tax bases: personal income and wealth, and corporate income and capital; the first being the largest contributor. It should be noted that municipalities, contrary to most local authorities around the globe, do not rely much on property taxes, but rather on the (potentially mobile) income and wealth tax bases.

Table 1 presents the share of spending across all levels of government for an array of expenditure items. The largest spending areas (in terms of share of the budget) at the federal level are Defense and Welfare. Cantons instead bear the largest shares in Health, Security and Education, while municipalities concentrate spending in Environment, Social Housing and Culture. However, as can also be seen from the Table, most areas are spread over all three levels of government.

**Table 1**  
**Share of Expenditure across levels of government, 2009**

<b>Expenditure Item</b>	<b>Federal</b>	<b>Cantons</b>	<b>Municipalities</b>
Administration	57%	23%	20%
Defense	91%	4%	5%
Security	10%	64%	26%
Economy	41%	38%	21%
Environment	17%	22%	61%
Social housing	1%	17%	82%
Health	3%	84%	13%
Culture and recreation	8%	32%	60%
Education	9%	60%	31%
Welfare	42%	38%	20%

Source: Swiss Federal Department of Finance

## 4.2 *Political institutions*

I will focus, in this section, on the political institutions regarding the direct participation of citizens in public policy shaping.

Direct democracy is a cornerstone political institution in Switzerland. It has a century-old tradition. Probably the purest form of direct democracy is the citizen assembly (“Landsgemeinde”). It was widely present for decision making at the cantonal level for hundreds of years<sup>7</sup>. Besides the assembly, two main instruments of direct democracy are present at all levels of government: the initiative and the referendum. However, areas of application, conditions and use of these instruments vary widely across and within levels of government.

The citizen initiative allows citizens to bring to a ballot an issue of interest. Note that at the federal level, only constitutional initiatives are allowed, while at sub-federal jurisdictions they can also be brought forward on other types of legislation. Whether an initiative is voted upon, depends generally on a sufficiently large number of signatures, the signature requirement. These thresholds

<sup>7</sup>

Only two cantons (Appenzell Innerhoden and Glarus) avail still of the “Landsgemeinde”. The other cantons have abolished them over the last 150 years. However, a citizen assembly is still the highest political institution in many municipalities.

vary between cantons and municipalities and they can be expressed in number of signatures or percentage of citizens<sup>8</sup>.

There is even more variation in terms of referenda. First of all, referenda can be mandatory or optional. If optional, they are again linked to a signature requirement. If mandatory, the referendum can be triggered by an expenditure threshold, i.e. expenditures above the threshold need to be approved via the referendum. Referenda can also be allowed in various areas of legislation, notably expenditure and taxation decisions.

At the sub-federal level the agenda setter for the direct democratic instruments is the canton. Cantonal constitutions define the availability and conditions for all jurisdictions in their constituency. Thus, besides characterizing the direct democratic instruments available for cantonal decisions, it also describes what municipalities can or cannot do. Again here, we observe large variation across cantons. For the local authorities, the constitution and subsequent laws can define exactly what instruments are available, which are then applied to all municipalities in the canton. Or it can set the rules for the set of instruments available<sup>9</sup>. Or, finally, the constitution might leave the choice of institutions entirely to the municipality.

To illustrate the wide variation across jurisdictions of direct democratic instruments Figure 7 displays, at the cantonal level, the existence of mandatory fiscal referenda both at the canton and municipality (Galletta and Jametti, 2012)<sup>10</sup>.

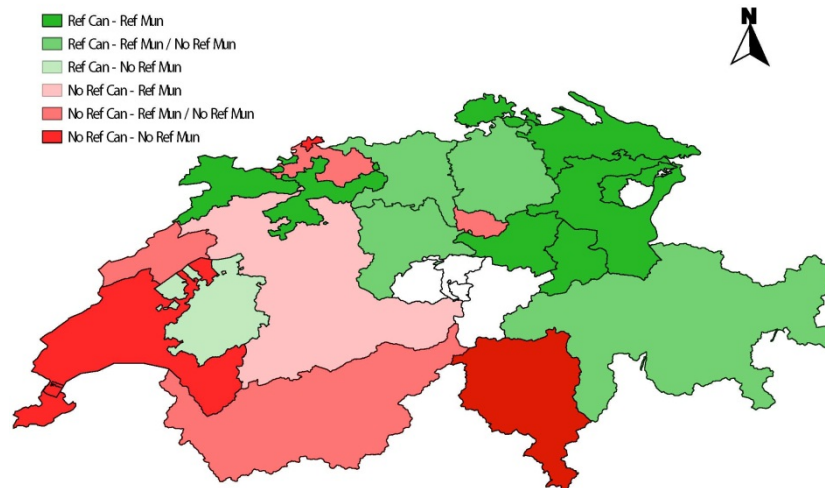
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<sup>8</sup> For example, to pass an initiative at the federal level, a total of 100'000 signatures is required.

<sup>9</sup> For example, in the canton of Vaud (with capital Lausanne) municipalities with less than 1'000 citizens have an assembly, while larger ones must have a municipal council.

<sup>10</sup> The map is based on a sample of around 130 municipalities. Cantons in white are not part of this sample.

**Figure 7**  
**Institutional Variation in Switzerland**  
**Mandatory Fiscal Referendum**



Finally, direct democratic institutions not only exist, but they are also frequently used. Table 2 presents statistics of the use of direct democratic instruments across the three levels of government. Note that the mandatory referendum is the most used instrument.

**Table 2**  
**Use of Direct Democratic Instruments**

<b>Instrument</b>	<b>Federal</b>	<b>Cantons</b>	<b>Municipalities*</b>
Initiative	76	354	187
Optional referendum	67	362	337
Mandatory referendum	45	1374	2918

Source: Micotti and Bützer (2003)

\*Based on 91 municipalities for the period 1990-2000

## 5. The Effect of Direct Democracy on Public Expenditure

### 5.1 *Theory*

What are the channels through which direct democracy can shape public policy? At the outset, there is little role for citizen participation if government is benevolent. In fiscal federalism this is nicely illustrated by the seminal contribution of Tiebout (1956). If citizens are mobile, they can “vote with their feet” and choose the jurisdiction that offers the best bundle of taxes – public services for them. Citizens then sort into communities together with individuals with similar preferences. It should be noted that differences in the level of public expenditures (and corresponding taxes) across jurisdictions are not subject of concern, since citizens choose what they like best.

Similarly, there is a limited role for direct democracy in another cornerstone of the fiscal federalism literature, namely the “Decentralization Theorem” (Oates, 1972). This theorem describes the allocation of public goods and services through a trade-off between internalizing inter-jurisdictional spillovers and scale economies and catering to local preferences.

Direct democracy comes into play in situations where politicians are not necessarily benevolent, but pursue their own goals. Politicians decisions can deviate from citizens’ preferences either because politicians seek to maximize their own utility function (Tullock, 1980), or because, despite being welfare maximizers, they are not able to fully apprehend constituents’ preferences (Matsusaka, 1992). A first strand of the theoretical literature discusses the channel through which direct democratic institutions result in political decisions closer to citizens preferences. For example, Gerber (1996) argues that direct democracy is an instrument that reduces the gap between citizen preferences and politician behavior considering a spatial voting model. When initiatives can be proposed by an interest group, the government chooses a policy which is closer to the one preferred by the median voter. Instead, when there is no threat of the initiative, the government will choose its preferred policy. Similarly, Romer and Rosenthal (1979) explore the agenda-setter model considering a situation with referendum on expenditure. Referendum gives veto power to citizens on representatives’ decisions. The central finding is that government expenditures are usually higher than the ones wished by the median voter and never lower. The gap between median voter’s preferences and policy outcome is reduced, but policy makers still have the main role in policy formation.

Feld and Kirchgässner (2000) describe how the referendum can positively affect citizens' information and political action. Given that in direct democracy voters can decide for themselves, they have an incentive to gather more information on the issue on the ballot. It also reduces the ability of politicians to pursue their personal goals. Thanks to referendum, politicians' work is under scrutiny, because citizens are better informed about it. Instead, Kessler (2005) comes to a somewhat different conclusion. Using a median-voter model focusing on the asymmetry of information between citizens and politicians, she argues that in direct democratic legislation the citizen does not invest in information acquisition because her vote is unlikely to be determinant. In contrast, under representative democracy, the politician finds it profitable to be informed because she has discretionary power.

In essence, most of the theoretical results point to the fact that direct democratic participation of the citizen in the decision making process brings adopted policies closer to the preferences of voters. Further, since politicians have a tendency to increase public expenditure beyond what is socially optimal implies that direct democracy should have a reducing effect on expenditure.

## 5.2 *Empirical applications on Switzerland*

There is a long tradition to use the large institutional variation in Switzerland as a “natural laboratory” to explore fiscal federalism and the effect of direct democracy<sup>11</sup>. In what follows I concentrate on the effect of direct democracy on the fiscal performance of governments.

Pommerehne (1978) was among the first to highlight the negative effect of direct democracy on public expenditure. He used data on Swiss municipalities in the year 1970 to show that the availability of a referendum in a municipality reduces (excess) public service provision. Feld and Kirchgässner (2001a, b) study in detail the outcome of several forms of direct democracy on public policy. Using data on 131 Swiss municipalities in the year 1990 they show that mandatory referendum on budget deficits entails a reduction in public debt, expenditure and revenue. Moreover, using data on 26 Swiss cantons for the period 1986-1997 they find that expenditure and revenue are lower in cantons with a mandatory referendum on new spending projects. They also test the effect of signature requirements for initiatives on expenditure, revenue, debt and deficit finding mixed results. The signature requirement in cantons with referendum increases spending while in cantons without referendum it reduces spending and revenue. Feld and Matsusaka (2003) have

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<sup>11</sup> As mentioned in the introduction, effects of direct democracy have been studied in other countries, e.g. the U.S.A. (Matsusaka, 1995) and Germany (Asatryan et al, 2013).

another look at Swiss cantonal institutions, this time using data for the period 1980-1998. They consider three variables representing direct democratic institutions: the presence of a mandatory fiscal referendum, the spending threshold that triggers a referendum and the initiative signature requirement. They find an important negative effect of referenda. Specifically, cantons with referendum have, *ceteris paribus*, 19% lower expenditures compared to cantons without referendum. Feld et al. (2008), using the same dataset, test the hypothesis that decentralization is more likely under direct rather than representative democracy. They consider centralization of expenditure, revenue and tax revenue as dependent variables. They confirm, in line with theory, the hypothesis that direct democracy fosters decentralization.

In a more recent contribution, Funk and Gathmann (2011) revisit the previous empirical findings, again focusing on the Swiss case. They gather information on cantonal institutions for the period 1890-2000. The dependent variables are, alternatively, cantonal expenditure, local expenditure and within-canton decentralization. The main independent variables are a dummy for the mandatory budget referendum and the initiative signature requirement. They find, in line with theory and the other empirical studies, that referenda reduce cantonal expenditure while the signature requirement increases it.

One aspect the abovementioned studies do not consider is the full spectrum of institutions at all level of governments. Indeed, the large institutional variation in Switzerland implies a potential vertical interaction between direct democratic instruments at the cantonal and municipal levels. In a recent contribution Galletta and Jametti (2012), explore this avenue. They test whether the impact of direct democracy at the upper level of government depends on the degree of citizen participation at the local level. Using a dataset of the 119 largest municipalities from 22 cantons, they find that cantonal fiscal referenda increase municipal public expenditure for localities that do not avail of a referendum, while this expansionary effect is much reduced and statistically significantly different for municipalities that also have a fiscal referendum.

Finally, direct democratic institutions and their effect have also been analyzed in the area of tax competition. Brülhart and Jametti (2006) investigate the presence of horizontal and vertical tax externalities that arise in the context of overlapping tax bases across levels of government in a federal system. Using a panel data set of Swiss cantons and municipalities, they find that vertical externalities can outweigh the more prominently discussed horizontal ones. Since their model is based on benevolent governments, they proxy this restricting the sample to municipalities with

strong direct democratic institutions (e.g. assembly, or mandatory referenda on tax setting). Brühlhart and Jametti (2007) then analyze the differential effects of tax competition for governments with different degrees of benevolence. The proxy here is, again, direct democratic participation in tax setting. They find that tax competition acts as a restraining force in municipalities that do not have strong citizen participation.

### 5.3 *The effect of direct democracy on economic performance*

To sum up, the literature presented above provides supporting evidence that indeed direct democracy is able to bring policy decisions closer to citizens' preferences, constraining the resource appetite of politicians. As a logical consequence, sound public finances are then a cornerstone for good economic performance, creating an, at least, indirect link between direct democracy and economic outcomes.

Interestingly, there is little empirical evidence on Switzerland that directly looks at the effect of direct democracy on economic performance. An exception to this is Feld and Savioz (1997). They estimate a Cobb-Douglas production function for the Swiss cantons for 1989 comparing the relative performance of cantons with elements of direct democracy to those without it, controlling for factors of production. They find, with the limitations of a cross-section, an important effect of direct democracy on economic output. *Ceteris paribus*, output in cantons with direct democracy is 17% higher than in those without.

Similarly, the pressure of direct democratic institutions to contain expenditure and debt presented above, can also contribute to fiscal stabilization. Again, empirical research in Switzerland is scarce. However, anecdotal evidence would suggest that this is indeed the case. Sound public finances at the beginning of the crisis, allowed all levels of government as well as the Swiss National Bank (the central bank) to act countercyclically, without large spurs of debt accumulation. The Swiss National Bank (so far) successfully stabilized the exchange rate of the Swiss Franc with the Euro, providing support for exporting sectors. Similarly, both federal and cantonal governments have recently invested heavily in public works projects. Baur *et al.* (2013) argue in the same direction.

## 6. Conclusions

Switzerland has fared relatively well in recent years. It seems to have weathered the storm of the financial and Euro crisis. While there are many factors that have contributed to the good economic performance, I focus in this paper of the potential role of direct democracy, of which Switzerland has a century old tradition.

The theoretical channel of the effect of direct democracy I highlight in this paper is one where politicians' decisions are closer to citizens' preferences when they are under the scrutiny of the citizen. Direct democracy can hold politicians in check.

The empirical papers overviewed in this paper, confirm the increased accountability of politicians when under direct democratic control. Direct democracy appears to have a constraining effect of expenditure, revenues and debt, which then translates into better economic performance. Direct democracy seems to work!

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