Portugal Plans to Cure Sick Economy With Big Tax Hikes

Portugal has announced big tax increases to solve its current sovereign debt crisis. Portugal's problem, like the other troubled "PIIGS" nations (Ireland, Italy, Greece and Spain), is that the government is spending much more than it is receiving in tax revenues. This has produced the "sovereign debt crisis," which means that independent private analyst firms such as Fitch Rating, Standard & Poor's and Moody's figure that it is increasingly likely that Portugal and the others will not be able to pay off their government bonds.

Therefore, Portugal has decided that it can best solve this crisis though massive tax increases. The government itself described the tax increases as "enormous" and the announcement came on the heels of news that Portugal will not be able to meet its proposed budget deficit target unless extraordinary steps are taken.

Portugal's Finance Minister Victor Gaspar noted that these increases would include an additional four percent levy on 2013 earnings, an increase in the average income tax rate from 9.8 percent to 11.8 percent, and an increase in property taxes on expensive homes.

The Portuguese economy shrank by three percent last year and it appears likely to shrink by an additional one percent, in spite of the actions of the Portuguese government to introduce austerity. In fact, it is the "austerity" that has pushed the Portuguese government into moving away from reductions in government spending and into tax increases that in large part are "soak the rich" measures.

Last month, when the government announced reforms of social security intended to make the program more actuarially solvent, the nation suffered massive demonstrations that led to the government pulling back on the reforms. This retreat caused Moody's to state that Prime Minister Coelho's "surrender" was likely to make the rest of his austerity program gain more opposition. Moody's noted that this would be "detrimental to market confidence."

Although Coelho's government appeared in no danger of falling, the question of confidence in the ability of the government to handle the sovereign debt crisis is itself potentially very expensive. When bond rating services downgrade the creditworthiness of debt, that means the government issuing the bonds must pay a higher interest rate to investors, and that uses revenue which otherwise could have gone to pay down the government debt or reduce tax rates to stimulate the economy.

The trajectory of these bond rating services' grading of Portuguese sovereign debt is all negative. In March 2010, Fitch downgraded Portugal's sovereign debt to AA-. The next month, Standard & Poor's cut Portugal's bond rating from AA- to A-. In July 2010, Moody's downgraded Portugal's bonds from Aa2 to A1.

In June 2011, Moody's downgraded Portugal's bonds from Ba1 to Ba2, citing the nation's inability to reach its deficit goals. In November 2011, Fitch downgraded Portugal's bonds from BBB- to BB+ citing

“large fiscal imbalances” and “high indebtedness across all sectors.” In January 2012, Standard & Poor’s downgraded Portugal’s bonds to BBB- prompting the nation’s finance minister to state: “S&P seems to be basing its decision on an analysis for the euro area as a whole, without taking into account the specific national situations.” The next month, Moody’s again downgraded Portugal’s bonds to Ba3 status. Portugal currently has the lowest bond rating of any nation in Western Europe.

The progression has been steady for years now: Portugal’s bonds, which are indispensable to keep the government operating at this point, are becoming increasingly more expensive to Portuguese taxpayers to issue and to pay.

The plan to massively increase taxes as a way to reduce the deficit of Portugal follows a pattern which seems to be very popular in the troubled eurozone. Greece has been tasked to crack down on those who are not paying enough taxes. The new Socialist President Hollande of France has levied huge new taxes on the rich. Spain this summer introduced a new consumption tax as a way to reduce deficits.

Still tax revenues among these troubled nations continue to falter. The Portuguese tax revenues in 2007 were €36.7 billion. In 2008 these revenues were €36.9 billion — stable but hardly improving. In 2009, Portuguese tax revenues plummeted to €32.9 billion. In 2010 those revenues actually rose to €34.7 billion. The Portuguese economy is shrinking today, so the prospects of increasing tax revenues seem slim today.

What is likely to happen when Portugal increases tax rates during an economic recession in which investors are already jumpy? Several things seem likely to happen, based upon recent eurozone history.

Portuguese citizens will leave the country and take up residence in nations with lower tax rates, something that France has already begun to see under the new socialist regime. The Portuguese will reduce their lifestyle dramatically, perhaps even returning to a more rustic life, as some parts of Greece have seen. Portuguese will simply work less and produce less, which is the ultimate end of all efforts by government to tax its way out of problems.

The solutions that would work — slashing tax rates; creating a flat tax; reducing the size of government; and making regulation as unobtrusive as possible — does not even seem to get passing consideration.

Photo: Bank of Portugal branch in Oporto

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