THE AMERICAN
AEI The Online Magazine of the American Enterprise Institute

Europe's failed experiment in tax-hike austerity

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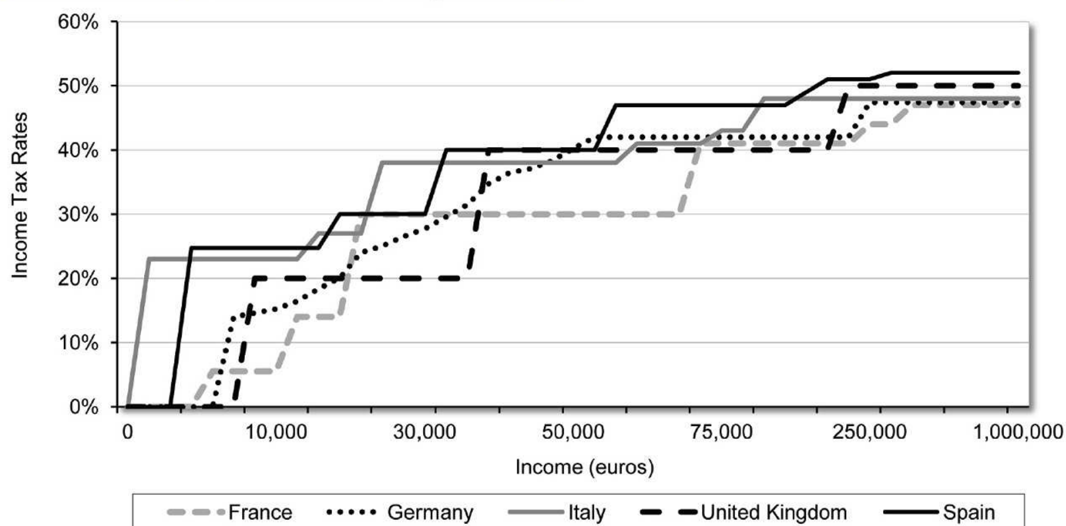
May 9, 2012, 12:59 pm

Personal Income Tax Rates in Selected European Countries



The anti-austerity crowd on the left just can't seem to accept "yes" for an answer. Yes, austerity isn't working in Europe. But for some reason, austerity critics decline to acknowledge that such a high-tax region probably shouldn't have started cranking up taxes. Here' s just a taste of the EU's tax-hike mania:

Greece. In 2010 and 2011, Greece passed a bunch of tax hikes — including a 10 point, 77% increase in its value-added tax — meant to raise revenue equal to 3.4% of GDP. How did that work out? Not so good:

> The finance ministry said the central government deficit grew by 15 percent in the first nine months of the year compared with the same period last year. It rose to 19.16 billion euros. That was despite tax increases that were supposed to bring in more money – tax receipts actually fell.

Spain. Heading into 2012, Spain had already increased its value-added tax, excise duties, and top income tax rates. Then last December, its new government, Reuters reported, "announced a slew of surprise tax hikes" as well as spending cuts. It announced "initial public spending cuts of 8.9 billion euros ($11.5 billion) and tax hikes aimed at bringing in an additional 6 billion euros a year" to tackle its debt problems. Thanks to those tax hikes, Spaniards will now be paying one of the highest personal income tax rates in Europe. Investment taxes were also raised to as high as 27% from 19%, according to a Cato Institute analysis. And last month, the government announced it will increase its value-added tax in 2013 as well as other indirect taxes in order to raise about 8 billion euros.

Italy. Here is technocrat Mario Monti's idea of austerity:

> But for the most part, the new austerity package is based on tax increases. It would reinstate a property tax on first homes, which Mr. Berlusconi had eliminated as an election promise in 2008. It would also impose a 1.5 percent tax on revenues brought into Italy under an earlier tax amnesty, and add taxes on cigarettes and gas, which is close to 1.70 euros per liter, or more than $8 a gallon. The governor of the Bank of Italy, Ignazio Visco, said last week that the measures would increase Italy's tax burden to 45 percent, a level that businesses say is unsustainable.

And Monti again:

> With local governments starved for property tax money, Monti has revived the property tax, reinstating it at even higher rates. The property tax "shouldn't have been abolished," Monti said, adding that Italy now "needs to make up for lost time, not in years, but in months." Monti brushed off political criticism that his government was relying too much on new or higher taxes to reduce Italy's debt. He blamed stubbornly chronic tax evasion for being one big reason new taxes were needed. He also fingered as a culprit what he called the "hidden tax of corruption in public contracts and hiring."

The economic literature is clear. The way to cut debt is by cutting spending. Tax hikes should be kept to a minimum and best accomplished by base broadening rather than by raising marginal rates. As an AEI study found:

> Our results indicate that there are several traits common to successful consolidations. … To facilitate success in future consolidations, our results and the previous literature indicate that a suitable low-end target for the expenditure share is around 85 percent of

the total fiscal consolidation. … Of the individual expenditure items, our results indicate that social transfer reductions should comprise the largest share of the consolidation; there is a stark difference between the very large transfer shares in successful consolidations and very small transfer shares in unsuccessful consolidations. Reductions to subsidies, government wage expenditures, and investments should play a smaller, but sizeable role.

… It is more difficult to make a prescription for the revenue items as there is little consensus across our results. … Given these caveats, our results indicate that revenue increases should come from indirect and business taxes more than income taxes, but the magnitudes of these preferences are not clear. More likely the best recommendations derive from the tax literature, which are to maximize revenues where possible by lowering rates and broadening the base.

Putting aside the issue of the euro for a moment, the fiscal reforms Europe needs are clear: Smaller welfare states, less intrusive regulation, and pro-growth tax cuts. Of course, just raising taxes is a lot simpler. Sure is a lot quicker. But it's not working. I hope the Obama White House notices the tax-hike fiasco going in Europe since it is pretty much the exact path he wants the U.S. to follow.