The golden age of tax expenditures.

Fiscal welfare and inequality in Portugal (1989-2011)*

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1. Introduction

In assessing the state's commitment to welfare, early social scientific literature focused on patterns, over time and across cases, of levels of public, direct social expenditure, usually measured as share of national GDP[1]. Two kinds of criticism emerged. Scholars in the power resources tradition turned the theoretical and analytical focus to multi-dimensional policy-regimes and clusters, based on measures of the decommodification of social rights, generosity of benefits and the stratification pattern induced by the welfare regime[2]. Others have argued that direct social expenditure is a flawed measure of welfare effort or generosity, focusing instead the tax system's impact upon gross public expenditure and the role of indirect social expenditure, both in terms of volume and function performed across welfare policy regimes[3].

Child tax credits, reduced rates for pensions or tax relief for interests paid in mortgage loans are all forms of *indirect* welfare provision. Indeed, Titmuss acknowledged that much in his «divisions of welfare» framework: social (state-provided social services and cash benefits); occupational (benefits in cash or in kind through employers); and fiscal, in which welfare is provided and distributed through the tax system[4]. Deductions and tax allowances are a form of collective provision, «analogous to a transfer payment: it increases the taxpayer's net disposable income at the expense of the rest of the community. In that sense fiscal welfare is similar to social welfare»[5]. It is social policy by other means[6].

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[1] Wilensky, 1975: 2

[2] Stephens, 1979; Korpi, 1982; Esping-Andersen, 1990.

[3] Sinfield, 1978, 2004 and 2013; Gilbert and Gilbert, 1989; Greve 1994; Howard, 1997; Adema 1999; Gilbert 2002; Hacker 2002; Adema and Whiteford, 2010; Adema, Fron and Ladaique, 2011 and 2014

[4] Titmuss, 2001 [1955]: 63, 65-67.

[5] Reisman, 2001: 138.

[6] Sinfield, 1978.

We (still) know little about this «hidden welfare state»[7] as it has been under-researched and under-theorized by the social scientific literature on welfare regimes. No wonder it has received scant attention from the scholarship on the Portuguese welfare state[8].

And yet, at least since 1989, a high level of indirect social expenditures has become a hallmark of the Portuguese tax and welfare regime. The year before the Troika Adjustment Program, 2010, of the overall volume of tax expenditures, 15481 M€ (9% of GDP), 3073 M€ (1.8% of GDP) were spent with «social protection» and «health»[9]. Using a different definitional measure, «tax breaks with social purposes», the OECD ranked Portugal in 4th place in 2009, at 1.1% of GDP, a comparatively high level, second only to the USA (2.1%), Germany (1.6%) and France (1.2%)[10].

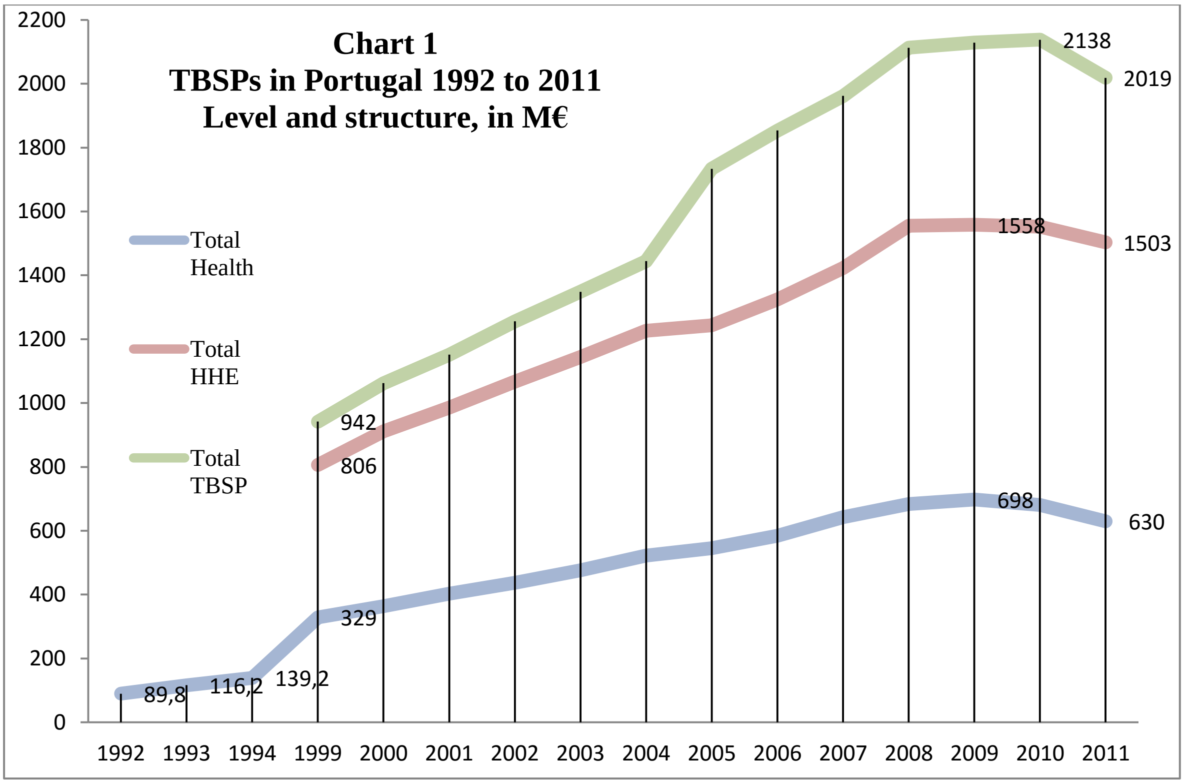
How to explain such patterns? This paper aims to answer this question by developing a set of theoretical insights from the Portuguese case. The argument is structured in three parts, each addressing a specific empirical puzzle. Why was the tax expenditure policy regime created? How to explain its steady growth and resilience, in view of the need to balance the budget and its regressive income distribution? How was it curbed in 2011? We first argue that *politics makes policy*: in the critical juncture following the double, late transition to democracy and structural economic reform, tax and welfare policy developments combined to create social tax expenditures as a modality of targeted social expenditure favoring middle and elite groups, according to a pattern characteristic of third wave, new democracies. We then argue that *policy makes politics*: once created, the tax expenditures policy regime spawned powerful vested interests and a wide take up rate. Path-dependency obtained, as the political costs of moving to another regime become greater, in spite of mounting revenue loss and regressive inequality effects. Such a resilient outcome was tamed only in 2011 by the

[7] Howard, 1997; Greve, 1994: 203
[8] The exception is Santos and Rodrigues, 2006.
[9] Relatório OE 2013: 99-100.
[10] Adema, Fron and Ladaique, 2014; see also Adema, Fron and Ladaique, 2011.

harsh conditionality of the Troika adjustment program, an instance of how deep crises provide opportunities for path-shifting social policy reconfiguration.

The paper is structured as follows. We start by showing the empirical patterns concerning fiscal welfare in Portugal through a longitudinal analysis from 1989 to 2011, with a particular focus on the largest tax break, healthcare, and then by situating Portugal within OECD countries as regards levels and composition of tax breaks with social purposes, before the Great Recession. The second part deals with the explanation of the empirical patterns, primarily using Portugal as a theory-generating case-study for developing explanatory hypothesis. We shall first review the social scientific theories of fiscal policy and welfare regime development, and then deploy a set of theoretical insights to the Portuguese case. We conclude by reiterating the main empirical findings and the core explanatory argument.

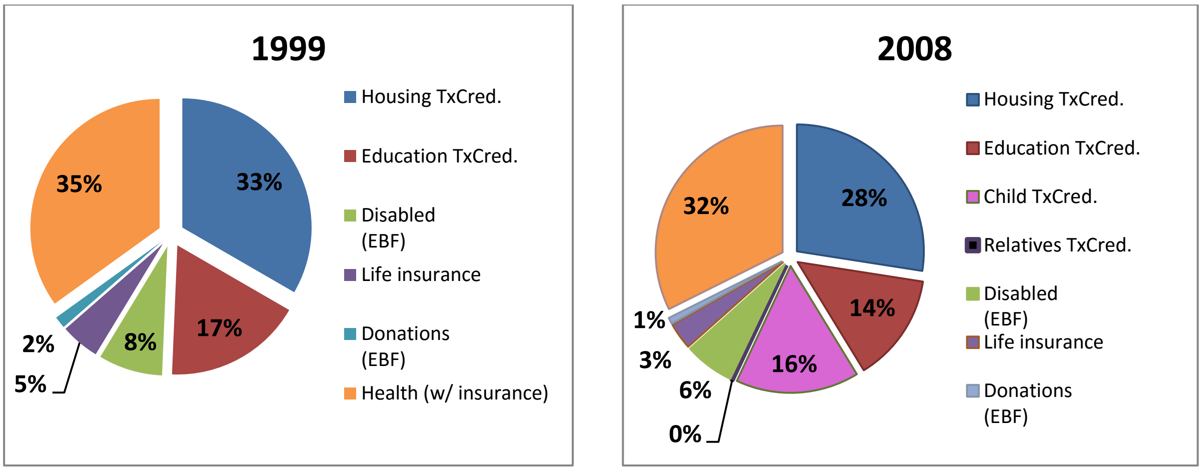
2. The Golden Age of Fiscal welfare in Portugal: a longitudinal analysis



Source: own elaboration from: Adema, Fron and Ladaique, 2011; DGCI; CGE; Gouveia (1997)

In Portugal[11], tax expenditures with social purposes[12] more than doubled in the decade before the bail-out, from 942 M€ in 1999 to 2138 M€ in 2010, *ca.* 1.2% of GDP. The largest categories of indirect social expenditure being healthcare, housing and education (HHE), particularly those related with the relief of out-of-pocket payments in health (medication, medical appointments and exams), home loans interests and education expenses (including of children). Chart 1 shows a marked increase in TBSP on health, housing and education since 1999, rising from 806 M€ to a maximum value of 1558 M€ in 2009 (*ca.* 1% of GDP) and dropping slightly to 1503 M€ in 2011.

Chart 2: Composition of TBSP, by broad category, 1999 and 2008



Source: own elaboration from Adema, Fron and Ladaique, 2011; DGCI; CGE

From 1999 to 2008 the composition and rank order of TBSPs has been fairly stable. Tax spending on healthcare ranges between 35% and 32%; on housing, for up to one-third, and on education for about 16%. Together, these categories account for 85% (1999) and 74% (2008) of the total. The novelty is the child tax credit in 2008, with 16%.

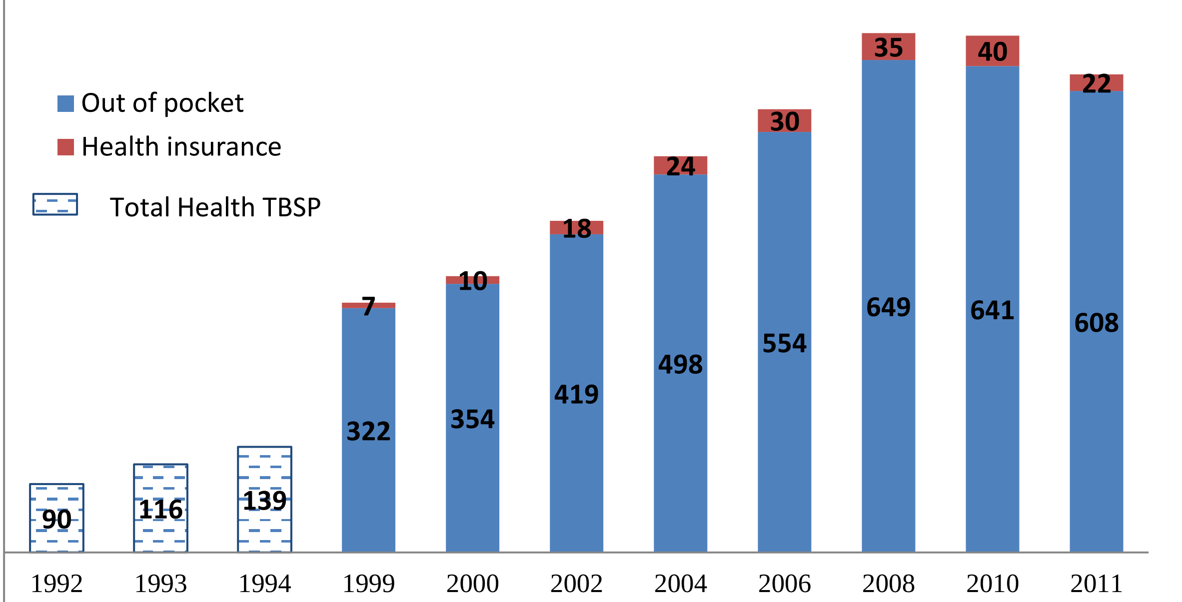
[11] The main regulatory framework is laid down in the Constitution (Art. 109), the *Estatuto dos Benefícios Fiscais* (Art. 2, n.º 3, decree-law n.º 215/89), and the *Lei de Enquadramento do Orçamento do Estado* (1991, in the wording of the art. 13, n.º 1, of Law n.º 91/2001), which mandate that the annual state budget includes a report on tax expenditures and an estimation of the revenue foregone.

[12] We employ here for the sake of comparison the same definitional perimeter as Adema et al 2011 and 2014. Note that this refers only to the income tax and excludes pensions.

Healthcare tax expenditures: volume, revenue lost and inequality

Tax spending with healthcare is markedly the largest. For instance, in 2004, health tax expenditure was the biggest tax credit in the income tax (32%), followed by housing loans (27%), education (15%) and pension plans (8%). The same year, 74% of Portuguese families included in their tax income out-of-pocket expenses eligible for tax credit, yet only 8% did so for health insurance; education and housing tax expenditures were included by around one in every four families[13].

Chart 3: Healthcare TBSPs, volume and composition, in M€



Source: own elaboration from Adema, Fron and Ladaique, 2011; DGCI; CGE and OECD 1998.

Chart 3 shows the steady growth of healthcare tax expenditures from 1992 to 2011 (at market prices), discriminating between out-of-pocket payments and insurance premiums. The growth levelled off after 2008, and declined in 2011 with the Portuguese bail-out. Unlike in the US or even in Germany, the volume of tax expenditures with health insurance is very small, never more than 6%. Insurance is «supplementary to the NHS coverage»: around 20%

[13] CFSSNS, 2007: 118-119

of the population has taken them up, of which about half the policies are group insurance provided by the employer and the other half are individual policies[14].

Note that this is an instance of a more general feature of Portuguese social tax expenditures: the fiscal effort towards private insurance is much smaller than towards of out-of-pocket expenses. In fact, the relative salience of health insurance declines from mid-2000s, unlike other countries where TBSPs are high. Within the insurance products, the largest tax break is that towards interests in home loans, not healthcare. Thus, despite the growth of Portuguese TBSPs, its redistributive impact favoring the better-off is not as harsh as in those countries that favor tax expenditures towards financial insurance products. Although the growth in TBSPs indicates a public subsidy to the private provision of welfare, it is not a path-shifting move towards the market financialization of welfare.

Revenue lost

Table 1: Healthcare TBSPs Trends, 1992-2011

TBSP as a share of (%)	1992	1999	2000	2002	2004	2006	2008	2010	2011
Total Health Expenditures	2	3,2	3,3	3,6	3,7	3,9	**4,1**	3,9	3,8
Public Health Expenditures	3	4,7	4,9	5,0	5,3	5,7	**6,2**	5,8	5,8
GDP	0,13	0,28	0,29	0,31	0,35	0,36	**0,40**	0,39	0,37

Source: own elaboration from Gouveia, 1997: DGCI, PORDATA, and OECD 1998

Table 1 shows the continuous growth of healthcare TBSPs relative to total national health expenditures, public health expenditures and to GDP until the peak in 2008. These are very significant amounts from the point of view of the revenue lost for financing public health services, NHS sustainability and equity. Note that in 2010 the revenue foregone in

[14] Barros et al., 2011: 65.

health tax expenditures was ten times the revenue paid in user charges in the Portuguese NHS.

These figures result from the significance of out-of-pocket (OOPs) expenses (user charges and direct payments) in the financing of healthcare. OOPs are among the highest in Europe. Since 2000 OOPs were never less than 20% of total health expenditure. In 2006, they were 23%, and 3/4 of the private share of 29% (vs. 71% public). In 2009, Portugal ranked 7th in the OECD regarding OOPs as share of final household consumption with 4.2% (average: 3.2%)[15]. The redistributive income tax system in Portugal «turns out to be slightly regressive in health care due to a high share of OOP payments along with a heavy reliance on indirect taxes». The «existence of a generous (by international standards) system of tax benefits to private health spending adds to this regressivity of health care funding»[16].

Inequality: benefits to the better-off

Table 2: Share of health expenditures recovered via tax expenditures (1980-2000)

Income decile	**% of recovered expenditures**		
	1980	**1990**	**2000**
1 (poorest)	0	1	6
2	0	2	7
3	0	5	11
4	0	7	11
5	0	9	15
6	1	10	18
7	1	15	19
8	1	17	21
9	1	22	24
10 (richest)	2	27	27
National total	**1**	**14**	**18**

Source: CFSSNS, 2007: 121

[15] OECD, 2011: 135
[16] Barros et al, 2011: 52

Health TBSPs regressively distribute income to the better-off, the middle and higher strata (Table 2)[17]. Over time, the national level rose from 1% to a significant 18%. The share refunded in 2000 to the better-off (24% average for the top three deciles) is much bigger than the share recovered by the poorer families (8% average for the lower three deciles). The magnitude of the regressive effect increased markedly from 1980 to 1989, and then subsided a bit to 2000 (the ratio between the top-three and the lower-three average went from 8.5 in 1990 to 3 in 2000).

Gouveia acknowledged in 1997 the regressive impact and called for a change from allowances to tax credits, as this would benefit 80% of income tax payers, the first 8 deciles of incomes[18]. Even after this reform was adopted, the 2000 distribution of recovered income follows the income distribution rather than the health expenditure distribution, which is more evenly distributed across the population or even skewed towards the lower income deciles. Health TBSPs were less regressive during the 2000s than before, yet far from equitable[19].

Health tax expenditures are doubly regressive. First, only tax-paying families can benefit from them, while low-income ones which do not pay any IRS, cannot. In 1990, 90% of pensioners received pensions below the minimum wage, and were not required to file income tax return, in spite of having health expenses[20]. In 2000, four in every ten families did not benefit from any tax break because their income was not enough to pay income tax, and accounted for 40% of health expenditures. Conversely, those paying the 35% top marginal rate (7.1% of the population) made 9.6% of health expenses and received 16.1% of all health tax expenditures. Those paying the marginal rate of 40% (2% of the population) had paid 3.3% of expenses, while making 5.4% of all health TBSPs[21]. Moreover, the distribution of health risks across income groups is the inverse of the distribution of benefit across income

[17] Gouveia, 1997: 96 and Santos and Rodrigues, 2006: 111-116 provide additional empirical evidence.
[18] Gouveia, 1997: 98.
[19] CSFSNS, 2007: 121-122
[20] Pinto and Santos, 1993: 196
[21] CFSSNS, 2007: 123

groups: even though low-income households make relatively more health expenditures they are «less able to obtain a higher percentage refund from the tax system than the high-income households (6% vs. 27%, when analyzing the lower and upper income groups of the income distribution)»[22].

Comparing Portugal: Tax Breaks with Social Purposes in OECD countries

Before the Great Recession, TBSP's[23] were high (more than double the OECD average of 0.5%) in the US, Germany, Canada, France and Portugal. Conversely, in Sweden, Denmark and Finland they were residual. Spain, Italy and the UK stood at a middling level. Portugal's ranking (4th) stands out – at 1.1% of GDP –, second only to the US (2.1%), Germany (1.6%), and France (1.2%).

Table 3 TBSPs in OECD countries before the Great Recession

	TBSP % GDP 2009	**TBSP % GDP 2007**	**Ranking TBSP 2009**	**Ranking Gross Public Social Expenditure 2009**	**Ranking Net Public Social Expenditure 2009**
United States	2.1	1.9	1	23	2
Germany	1.6	1.7	2	8	5
France	1.2	1.1	3	1	1
Portugal	**1.1**	**1.2**	**4**	**10**	**10**
Canada	1.1	1.5	4	22	15
Spain	0.5	0.6	6	9	14
United Kingdom	0.5	0.6	6	12	4
Italy	0.2	0.3	8	7	8
Sweden	0.0	0.0	9	3	6
Denmark	0.0	0.0	9	2	9

Source: Adema et al, 2011; Adema et al. 2014: 14-15

[22] Pita Barros et. al, 2011: 52-53

[23] OECD's definition: «reductions, exemptions, deductions or postponements of taxes, which: a) perform the same policy function as transfer payments which, if they existed, would be classified as social expenditures; or b) are aimed at stimulating private provision of benefits» . They can be similar to cash benefits (e.g. child tax credits) or stimulus to the provision of private benefits (e.g. tax relief for private health insurance). See OECD, 2010. Major limitations: refer only to the income tax and exclude pensions (but see Hughes and Sinfield, 2004)

Cross-case variation does not map onto the familiar three worlds of welfare capitalism, and thus cannot be explained by the welfare regime logic[24]. Still, Nordic, social democratic countries fit expectations well, considering the little room for private provision in that welfare regime ever since reforms in the 1990s started to tax social benefits. Inversely, it is hardly surprising to find that countries with higher TBSPs include the liberal regimes in the US and Canada. However, there is variation within this regime: TBSPs are on or below average in the United Kingdom and New Zealand. And yet, the greatest variation is to be found in the Bismarckian, conservative continental type, including Southern Europe: high – Germany (1.6%) and Portugal (1.1%); medium – Spain and Belgium (*ca.* 0.5%); low to very low – Italy (0.2%) and Austria (0.1%).

When looking at structure, different patterns emerge. While the top ranking of the US is mainly due to tax breaks for insurance-type private provision (mostly healthcare), in France and Germany tax breaks similar to cash benefits for families (such as child tax credits), prevail. In fact, Germany, Spain, France and the UK prioritize family support, unlike Italy and especially Portugal (mainly healthcare and housing). The variation in structure points to causal directions to be explored, such as the tension between old and new social risks within a constrained fiscal space.

We shall deal with the explanatory issue next. This paper aims to contribute to an explanation primarily by using Portugal as a case-study for developing hypothesis, rather than accounting for patterns of cross-case variation through theory-testing[25].

3. Theoretical explorations on fiscal welfare

Fiscal welfare is a hybrid object. Its regime belongs to tax policy, though it works like an (indirect) expenditure. It is an instrument of social policy, but delivers through means

[24] Esping-Andersen 1990.
[25] George and Bennett, 2004; Mahoney, 2007; Gerring, 2009

other than direct outlays or benefits. These features place fiscal welfare at the crossroads of the social scientific literatures on the determinants of fiscal policy and welfare regimes and perhaps help explain the scant theoretical attention it has received.

If it is no longer true, as John Campbell once asserted, that political sociologists pay much more attention to the determinants of expenditures than taxes, in connection to social protection, it is still true that tax expenditures have been relatively under-researched, and most of all under-theorized[26]. In spite of Titmuss' insights, much the same could be said about the literature on welfare regimes and social policy, owing to its usual focus on direct expenditures, benefit regimes, or both[27]. Moreover, in spite of OECD's recent efforts, comparative research is still hampered «by deep-rooted data limitations stemming from national variations in defining and measuring tax expenditures»[28].

3.1 *Theories of taxation and tax policy development*

Tax burden patterns in modern capitalist democracies have been accounted for by three main general explanations, which can be combined. The first, as a result of macroeconomic structures and performance; second, the product of variation in public attitudes or voter preferences; third, as the outcome of institutional structures that set the rules offering various incentives to political actors, and yielding different power resources and interests[29].

Campbell provides an elegant synthesis, a «conceptual model of taxation». Levels and structure of taxation are influenced by pressures stemming from geopolitical, economic or fiscal constraints to which political elites respond by changing tax policy, it according to the

[26] Campbell, 1993: 1564. A recent volume on *The New Fiscal Sociology* (Prasad et al., 2009) features a chapter on tax expenditures by Christopher Howard.
[27] Sinfield is an early and notable exception (1978), along with Greve (1994), Howard (1999) and Hacker (2002).
[28] Stebbing and Spies-Butcher, 2010: 2.
[29] Steinmo and Tolbert, 1998: 166-170.

strength of social classes and interest groups, the system of political representation and state institutional structure[30].

The balance of power resources among classes and interest groups influences the levels and structure if taxation. Classes and other social groups seek to influence policy-making in ways that depend on their levels of tax tolerance, preferences regarding forms of taxation, organizational and economic resources. This influence is mediated by systems of political representation (structure of political parties and electoral representation), the relative presence of pluralist or neo-corporatist systems of interest representation, as well as shifting control of government by different political parties. The state's institutional structure further mediates the influence of groups and interests upon policy-making. The degree to which political elites are accessible to public pressure, in terms of concentration of accountability and relative dispersion of power and veto points, and have the capacity to collect taxes, determines their ability to act, alone or in social coalitions, according to their own preferences, or those of other groups[31].

As regards the present paper, one major limitation of this literature is the focus on revenue in the form of taxes, while tax expenditures are (indirect) expenditure (Steinmo is a notable exception). So, is it the case the politics of tax expenditures is radically different from that of taxes? No. In fact, one can endeavor to adapt this literature's vision of the sources and the circuit of causal factors to tax expenditure policy-making. It is to that task we now turn.

During and after World War II tax policy became instrumental for achieving social and economic policy goals. The regime of high marginal tax rates combined with generous tax incentives for investment and controls regulating capital export was a centerpiece of the post-

[30] Campbell, 1993: 173-175.
[31] Authors deploying or testing one or more of these explanatory factors are, *inter alia*, Steinmo, 1993; Steinmo and Tolbert, 1998; Gould, 2001; Gould and Baker, 2002; Hicks and Swank, 1992; Lijhpart and Crepaz, 1991; Howard, 1997; Hacker, 2002; Baramendi and Rueda, 2007.

war historical compromise between capital and labor in all industrialized democracies and contributed to the joint pursuit of equity and growth in the Keynesian welfare state[32].

This policy regime evinced two main features. First, it moved from class taxation to mass taxation. Whereas before income taxes were paid only by the richest, after the war more than 60% of income earners paid taxes. The tax base was broadened in an inclusive and democratic way: tax thresholds were lowered, with steep progressive structures and very high marginal rates (often in excess of 90%), for both individuals and corporations. Consequently, tax revenues as share of GDP had doubled in most countries by the end of the War. After the War, tax revenues in OECD countries went from 25% to 33% between 1960 and 1980[33]. This increase was used to finance rapidly expanding welfare states, albeit differently according to different welfare regimes[34].

Second, taxes were used as a tool for the Keynesian management of the capitalist economy, affecting the timing, structure and shape of investment and other private economic decisions. Governments pursued micro-manipulations of the economy through the tax code irrespective of party, ideology and level of economic wealth[35]. Tax expenditures were one such mechanism, namely as a crucial instrument of social policy. In the USA they became a structural feature of the welfare regime[36].

In the aftermath of the 1970s prolonged crisis with stagnant growth, severe unemployment and bouts of inflation, governments worried with fiscal imbalances tried to deal with them through different combinations of expenditure cuts and tax increases, abandoning the main tenets of the Keynesian economic management paradigm.

Taxation was one policy arena profoundly changed. The relative priority given to equity and growth objectives, the use of investment and behavioral incentives, and the level

[32] Steinmo 1993: 26-29, 193-207
[33] Steinmo, 2003: 213; Tanzi, 2011: 95-98
[34] Steinmo, 1993; Baldwin, 1990: 116-133
[35] Steinmo, 2003: 213-214
[36] Howard, 1997; Hacker, 2002; Faricy, 2015

of tax rates were notably changed: progressivity was reduced, marginal income and corporate tax rates were scaled back, and tax-based incentives were eliminated to broaden the tax base[37].

Following the lead of the American *Tax Reform Act* (1986)[38], tax reform in industrial democracies sought public expenditure control, fiscal discipline, the broadening of the tax base and crack down on tax evasion. Progressivity was lowered by cutting down marginal tax rates. OECD average marginal tax rates declined from 63% in 1976, to 56% in 1986, to 43% in 1992[39]. According to Swank this wave of tax reform was «market-conforming»: «statutory rate cuts with base-broadening elimination of tax-expenditures have become part and parcel of neoliberal economic orthodoxy»[40].

Tax expenditures came to epitomize the pathologies of the post-World War II policy regime. A byzantine maze of loopholes, they were inefficient (in the allocation of productive investment), expensive (a drain on tax collection) and socially unfair (as giveaways to the rich outside public scrutiny)[41]. Tax expenditures were see as uncalled for interventions of the state and ought to be scaled back and better scrutinized. No wonder, then, that mandatory tax expenditures budgets were legislated in Germany (1967), USA (1974), Austria (1979), Spain (1979), France (1982), or publication of annual reports to parliaments mandated in the UK and Canada (1979), Portugal (1980), Ireland (1981), and Australia (1981)[42].

And yet, tax expenditures were far from extinct, to the contrary. In the USA, even though the 1986 Act targeted tax expenditures for elimination or reduction, social policy was excluded from most of the provisions. After 1986 the large drop in the size of most tax expenditures was not sustained, «as the government added new tax expenditures, expanded

[37] Steinmo and Swank, 2002; 650; Swank, 2006: 848; Kato, 2003: 14
[38] Swank, 2006.
[39] Steinmo, 2003: 222
[40] Swank, 2006: 848-850
[41] Steinmo, 2003, 216
[42] Tobes Portillo, 1991: 51-54; 72-77

existing provisions». By 2000, tax expenditures represented a larger share of GDP than they had in mid-1970s[43].

Even though there is a lack of extensive longitudinal and comparative data, we would venture similar patterns evolved in Europe. Indeed, the OECD 2010 report shows that tax expenditures are alive and have been growing from 2000 to 2008, both in the income and capital taxes, particularly those with social purposes, either as a share of GDP, as a share of the relevant tax revenue, or simply in the their numbers[44]. The reason, we argue, must be sought in the connection between tax policy and social policy in the post-golden era of welfare development. In order to understand why, we now turn to welfare regimes and social policy development.

3.2 *Tax expenditures as welfare restructuring in the post-golden era*

In the post-Golden Era, a recent appraisal states, «the major dividing line between different welfare state regimes is defined less by the extent of total welfare effort and more by differences in the public-private mix of benefit provision and the consequences thereof on distributional outcomes»[45]. Gilbert's «enabling state» tries to capture a set of developmental features of welfare states since the 1980s[46]: arrangements designed to «enable people to work and to enable the market and the voluntary sector to assume an expanded role in providing social protection», making for a shift towards «work-oriented policies, privatization of social welfare, increased targeting of benefits and move from emphasis on social rights of citizenship to civic duties of community members»[47].

Social tax expenditures are exemplar of this trend. In Thatcherite Britain, from 1979/80 to 1983/84, tax relief for private pensions increased 106% while direct expenditure on state

[43] Howard, 2009: 95.
[44] OECD, 2010: 169-237
[45] Obinger and Wagschal, 2010: 338
[46] Gilbert and Gilbert, 1989.
[47] Gilbert, 2002: 5, 16

and supplementary retirement pensions rose only 13%. Whereas total general and income related subsidies for public sector housing were cut by 22%, mortgage interest tax relief increased by 29%. By the end of the 1980s, subsidies to mortgages approached 7000 M£ per annum, while government gross capital expenditure on housing was around 3700 M£.[48]

In fact, we perceive social tax expenditures as a modality of welfare state *restructuring*, a term employed by Van Kersbergen and Vis to indicate «the type of reorganization of benefits and service delivery that is undertaken to redefine the relations of power that govern a program, amend the rights and duties of stakeholders and clients, or terminate a policy entirely»[49]. We shall develop these themes in the present section.

The alternative between state direct social expenditure and indirect provision through the tax system is not merely a choice between neutral policy instruments, nor simply a difference in administrative methods. Rather, it implies a fundamental political choice regarding the balance of power in society, the way different power resources in markets and in politics yield institutions.

At stake is the way social policy expresses the balance of power-resources in society, i.e., the relative power of certain classes or organizations to influence the allocation of scarce resources[50]. Tax expenditure affect the fundamental public/private mix in the welfare regime by objectively fostering private (or third sector) provision through the market. And so, the extent to which the welfare regime relies on the private market or third sector for provision should be a reliable cross-case explanatory factor. However, the comparative data for 2009 shows that cases do not cluster according to welfare regime. The non-existent TBSPs in Nordic countries fit expectations well considering the little room for private, market provision. The liberal cases of the USA and Canada with high levels of TBSPs would seem to confirm the argument, for the inverse reasons, were it not for the low levels of the United

[48] Judge, 1987: 19; Mann, 1992: 95.
[49] Van Kersbergen and Vis, 2014: 3.
[50] Sinfield, 1978: 149.

Kingdom and New Zealand. But especially, as we have noted, the Bismarckian, continental regimes offer the greatest variation, ranging from high, Germany, France and Portugal, to medium, Spain and Belgium, to low or very low, Italy and Austria. If one recalls that the OECD dos not consider tax breaks for pensions, which are the biggest single welfare benefit in these regimes, something seems to be amiss.

One ought to look at social tax expenditures also within the framework of permanent welfare reform triggered by the shift toward a post-industrial society and the attending new social risk structure[51]. From this perspective, they are a possible social policy outcome of the interplay between new and old social risks within a constrained fiscal space. Social tax breaks, in balancing work and care, labor market activation, poverty fighting in the employed and pensions, are a different modality (relative to traditional social policies and policy instruments) for the accommodation of reform pressures emanating from new social risks, through the indirect conquest of fiscal space. If we focus the cases in which welfare provision does not rely heavily either on the market or the state (where tax expenditures are either structurally favored or constrained), we note how children or elderly tax credits, in-work tax credits, earned income allowances or pension credits for child rearing, are directed towards new social risks. To this extent, at least partially, the longitudinal and cross-case variation in the levels and composition of TBSPs ought to be the result of the «politics of the new welfare state»[52].

Once a fiscal welfare regime asserts itself, private providers – the bank and insurance industries, professional corporations such as medical associations or third sector organizations – stand to benefit from social tax expenditures and acquire vested interests with a conservative stake in keeping the *status quo*[53]. The stronger their power resources, and the

[51] Taylor-Gooby, 2004; Armingeon and Bonoli, 2006; Bonoli and Natali, 2012.
[52] Hausermann, 2012.
[53] Mettler, 2011: 19

stronger their influence upon policy-making, the bigger and long-standing tax breaks are bound to become.

One reason for such outcome is that fiscal welfare policy-making hails from supply side politics and tends to be concealed and obscure. On the one hand, tax expenditures reward demands and interests put forward by the supply side of welfare, not the demand side. Unlike policy distributive decisions in response to demands and interests expressed by large, popular, majoritarian social groups which constitute the beneficiaries of welfare benefits (demand side), fiscal welfare is promoted by private providers of insurance, corporations and professional groups which offer benefits in the welfare market (supply side).

On the other hand, tax expenditures remain obscure. In the USA and elsewhere, while spending programs require specific, new legislation, tax expenditures «can be tucked away in must-pass revenue bills»[54]. Despite growing cost, scope and regressive income distribution, they obscure «the government's role from the view of the general public», including from those who benefit from them[55]. During the 1990s, in Denmark and the UK the tax expenditure level was not monitored regularly and publicly, the cost of major tax benefits remained unclear. Consequently, there was «much less likelihood that they be cut or constrained even when public spending is being placed under increasingly tight control»[56].

Fiscal welfare is deeply connected with complex issues of inequality and redistribution. Most tax expenditures have regressive effects upon income distribution: higher income strata benefit disproportionately relative to low-income groups[57]. Such «upside down effect» derives from the better-off being able to invest more in tax-privileged activities, paying

[54] Howard, 1997: 179
[55] Mettler, 2011: 5
[56] Kvist and Sinfield, 1996: 38.
[57] Greve, 1994: 207. The exception being pro-poor fiscal welfare such as the EITC (USA) or the WTC and Child Tax Credit (UK). See Howard, 1997 and Myles and Pearson, 1997.

disproportionately less in taxes[58]. Also, regressive distribution towards middle and high-income groups is due to the fact that tax expenditures require an income high enough to pay income tax, which is not the case for a very significant share of family households, the poorer ones, who therefore cannot benefit from any tax deduction. Thus, when provision moves from direct to indirect methods social policy develops a regressive effect upon income distribution. This effect is compounded when welfare regimes undergo dualization or stratification, since public and private, direct and indirect, modes of welfare provision tend to focus on different groups and to use different instruments[59].

Thus, indirect social expenditure affects the configuration of social protection, favoring the selection principle (targeting), as opposed to a universalistic logic. Direct and indirect social expenditures embody distinct views of the adequate role of states in the regulation of welfare: tax expenditures favor private provision in the market, while direct expenditure favors the government's role as provider with a view to risk-pooling and redistribution. For instance, in the US this option is tied to different partisan and ideological choices, along the Republican/Democrat divide, and with the mobilisation of middle- and upper-income interests, with predictable consequences for income distribution[60].

Foregone tax revenues weigh on the side of expenditure when it comes to balancing the budget. This is worth remembering because they have grown, in Portugal as elsewhere, in an era of permanent fiscal moderation, if not austerity. A combination of powerful vested interests, obscure policy-making and regressive income distribution suggests a path-dependent outcome through policy feedbacks. The fact that Portuguese tax expenditures were cut down only by the bail-out Program of May 2011 illustrates the point well. It is to this narrative we now turn.

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[58] Sinfield, 2013: 23 and Wilkinson, 1986. See data in Howard, 1997: 28; Howard, 2009: 91; Hacker, 2002: 39; Mettler, 2011: 23; Faricy, 2011: 77; Portuguese data in Pinto and Santos, 1993: 195-197, 202; Gouveia, 1997: 95-96; Santos and Rodrigues, 2006: 111-116; CSFSNS, 2007: 121-123.

[59] Stebbing and Spies-Butcher, 2010: 18

[60] Faricy, 2015.

4. The golden age of tax expenditures in Portugal: explanatory hypothesis

Building from the previous section's insights, the present section tries to develop an explanation for the rise of Portuguese social tax expenditures from 1989 up until 2011. The argument is presented in three parts, each addressing specific empirical questions. First, why and how was the tax expenditure policy regime created in 1989? Second, why did it grow continuously, considering fiscal discipline concerns and the regressive income distribution? Third, why and how was it substantially curbed in 2011?

4.1 *Why started?*

Tax reform in democratic Portugal

The Portuguese transition to a modern tax regime took place comparatively late, following the late transition to democracy in 1974. From 1974 to 1989, Portugal went through, in quick succession and in a messier way, the sequential stages tax reform stages of western industrial democracies since World War II.

After 1974 Portugal deployed aspects of the post-Second World War tax policy regime. Taxes were used for redistribution and as a tool for managing a now state-heavy mixed economy, with a steeply progressive structure with high marginal rates of about 90% starting at a low level, lower tax thresholds. Tax incentives were used as instruments to influence decisions about when and in what to invest and other private economic decisions. The same way these reforms yielded a huge rise in tax revenues from 1945 to 1980 elsewhere, so to in Portugal after 1974[61]. However, the transition from class tax to mass tax was incomplete since the parcellarized structure and the unequal and autonomous taxation of different income

[61] Tanzi, 2011: 95

sources, topped with a *complementary tax*, continued as designed back in the 1960s. The tax structure was viewed as unfair, inefficient and archaic[62].

As elsewhere, a combination of stagnation, unemployment and inflation triggered from mid 1970s new directions in fiscal policy, welfare regimes and tax reform. So too in Portugal, which exited the revolutionary period with a social-democratic political economy in dire economic and financial straits, triggering an IMF intervention in 1977, followed by a steep economic crisis in the first half of the 1980s, which triggered a second IMF intervention and adjustment program, in 1983-84.

The creation in January 1989 of a unified personal income tax, the *Imposto sobre o Rendimento das Pessoas Singulares* (IRS), replacing a set of partial, confusing and unfair taxes embodies both the shift from class tax to mass tax *and* the 1980s market-conforming tax reform[63]. The IRS unifies taxation over personal income in its various sources. The rationale was to reduce the progressivity and broaden the tax base by cutting down evasion and the informal economy that had been fostered by high marginal rates, haphazard loopholes and low administrative capacity[64].

The new income tax sought to regulate tax incentives in a more ordered and accountable way[65]. It created social tax expenditures (both for out-of-pocket and insurance expenditures), for healthcare, education, mortgage interest, rest homes, private pensions and life insurance policies. These were all allowances (deductions made to gross income), and all had statutory limits – all, except health expenditures, which were deducted in full with no cap. Such design has a steep regressive effect upon income distribution, since the magnitude of the benefit follows the taxpayer's highest marginal rate: those in the 10% bracket would «recover» *ca.* 10% of health expenses; those in the 40% bracket, would do so for 40% of

[62] Silva, 1989.
[63] Decree-Law n.º 442-A/88, November 30
[64] The marginal rate of the superseded imposto complementar was 80%, which compares with the new IRS' 40%. See Silva, 1989: 241-248, particularly pp. 244-245.
[65] See the «Estatuto dos benefícios fiscais», decree-law n.º 215/89, July 1st.

health expenses[66]. This was designed as a way to foster the role of the private sector in health provision and to enlarge the fiscal base while preventing tax evasion by private doctors[67].

Welfare state and redistribution in newly democratic Portugal

In Western Europe, welfare states since the end of the 1970s, under changed economic conditions of higher unemployment, slower growth and inflation generating rising fiscal pressures, underwent varying forms of retrenchment and recalibration[68]. Portugal offers a distinctive pattern, shared with other Southern European new democracies. The late social revolutionary transition to democracy implied that the Portuguese welfare state also matured comparatively late, evolving a peculiar combination of Bismarckian-inherited features, like the occupational roots of social security, and revolution-induced Beveridgian universalistic traits, such as a public, free and universal National Health Service[69]. While others adjusted or curbed their programs under fiscal, unemployment and demographic pressures, coverage and expenditure levels continued to expand well into the new century, aided by an economic boom from 1986 to 1999, with GDP *per capita* growth of 3.5% per year. Universal coverage in social security and services was attained, while its intensity also rose, as a result of «catch-up convergence» in expenditure levels with EU countries[70].

Portugal presents a successful transition to democracy, structural economic reform and welfare state[71]. This «social democratic approach» allowed Portugal to build a welfare state comprising universal healthcare, universal public education and pension coverage during a period of major economic restructuring amidst adverse economic conditions, showing that the opening up to the international economy after the Golden Age was «still compatible with

[66] Gouveia, 1997: 82; CSFSNS, 2007: 114
[67] CSFSNS, 2007: 111. Previous health tax breaks existed in the *imposto complementar*, but this tax contributed only 6% of all direct tax revenues, a minor role. See Pinto and Santos, 1993: 193.
[68] Huber and Stephens 2001; Pierson, 2002 and 2011; Scruggs, 20007; Hemerycjk 2013
[69] Branco, 2016;
[70] O'Connor, 2007: 233-36
[71] Maravall 1993: 77-124 and 1997: 74-125

welfare state development»[72]. Huber and Stephens underline the egalitarian effects of a social revolutionary transition to democracy and a left-leaning partisan distribution of political power on policy orientation[73].

Portugal, therefore, is not a case in which social tax expenditures grew while direct social expenditures contracted. To the contrary, both grew in tandem throughout. Now, the point is to explain the manner of that growth, its redistributive implications and politics.

Karakoc tackles the issue of redistribution in new democracies in Southern and Eastern Europe[74]. Why, he asks, are new democracies less successful in curbing inequality than older democracies in Western Europe? In new democracies, against the backdrop of the unwillingness of the poor to participate in politics and weakly institutionalized parties and party systems, governments resort to targeted social policies as a way to mobilize volatile electorates. Unlike older democracies in which party systems developed over decades of institutionalized competition and incorporated the interests of disenfranchised groups into the political system, party systems in new democracies were build top-down. Here, elite and middle class groups emerged with a higher capacity to influence the distribution of public resources to their benefit relative to the poor. Parties lacking long-standing linkages to civil society, both from the left and right, and facing high levels of uncertainty each electoral cycle, resorted to policies targeted at satisfying the interests of organized middle class groups in order to secure their electoral fealty. Political parties in new democracies found it effective to target social policy at segments of the population such as the military or civil servants, crucial white collar (teachers, bank employees) and blue collar (miners, railroad workers, port workers) professional categories, the insiders of the labor market, through public cash spending on pensions, unemployment, maternity, child benefits and benefits associated with occupations.

[72] Glatzer, 2005: 107, 112.
[73] Huber and Stephens, 2012: 216:
[74] Karakoc, 2010.

While the argument focuses direct social spending, we think it applies even better to fiscal welfare. The latter is also socially targeted, redistributes wealth towards middle and upper classes and thrives in a policy environment insular to the scrutiny of the general public. Social tax expenditures came to be seen as important for securing the electoral allegiance of middle-classes. In fact, the reading of the scant parliamentary debates on tax expenditures makes it abundantly clear that both center-left and center-right parties, which have generally governed Portugal alone or in coalition since 1976, see it as a benefit for the middle-classes, even if to the disadvantage of the lower income strata. In fact, the will to reduce the inequality-inducing effects of the 1989 policy regime lay behind the 1999 reform by a socialist government (see below).

The National Health Service and the rise of private providers

The Portuguese National Health Service was created in 1979 as a public health provider constitutionally mandated as universal, free and tax financed. The reversal of the «statist» NHS began soon in the 1980s, when public policies promoted the «constitution, expansion or even reconstruction […] of private social agents that pursuing, or not, lucrative purposes may provide for the private production of health goods and services»[75]. The role of the state as sole provider and financier of health services gave way to a larger role of the private sector as provider.

The general direction of health policy combined retrenchment of direct public outlays with the opening to private provision, often state subsidized through the acquisition of health services provided by private agents to NHS users and by tax expenditures. The 1989 tax expenditure regime congruently expresses these preferences, by both containing direct costs and turning «a significant share of NHS patients towards the private sector», via the stimulus

[75] Santos, 1987, pp. 53-56.

of private out-of-pocket expenses and insurance premiums. The possibility of deducting in the IRS the totality of such expenses was instrumental for that goal[76]. Accordingly, the structure of health financing changed from 1980 to 1990: out-of-pocket payments rose from 28% to 37%, private insurance rose from 0.6% to 1.4%, while the share of taxes fell from 66% to 55%[77].

Why continued?

In this section we argue, in short, that *policy makes politics*. Within the larger context of welfare restructuring, policy feedback mechanisms yielded a path-dependent outcome. Once in place, tax expenditures created enduring vested interests and middle class support. Path-dependency obtained, as the political costs of change grew[78], in spite of rising revenue loss and inequality effects. We argue that Pierson's «new politics», used to explain welfare state resilience, such as benefit-related electoral constituencies, vested interests and path-dependence[79], also obtain in the case of fiscal welfare – perhaps even more, considering its obscure nature.

As we have seen, the great bulk of fiscal welfare expenditures result from tax credits for expenses made with health, education services, and mortgage interest. Let us look first at the supply side. Fiscal welfare is directed towards services and goods provided in the market by powerful and well-organized economic, professional and civil society organizations. These powerful pressure groups have a vested interest in fiscal welfare for they stand to gain from it.

Which providers? In healthcare, the medical professions, represented by the professional corporation Portuguese Medical Association (*Ordem dos Médicos*) and the

[76] Pinto and Santos, 1993: 93
[77] Pinto, 1995: 106
[78] Huber and Stephes, 2001: 32.
[79] Pierson, 2001

National Pharmacy Association (*Associação Nacional das Farmácias*). In education and social care, private and third sector schools are involved in association protocols with the Ministry of Education, while pre-schools and rest homes are mostly owned by private social solidarity institutions (IPSS). IPSS, most Church-related, are formal partners of the state in the provision of social care at the local level ever since 1979. Their numbers rose from 1244 in 1979 to 3940 in 2005 and they own 90% of the 8000 daily centres, asylums, rest homes, pre-schools, and health clinics[80]. Fiscal welfare helped grow the home loan credit market. The banking sector found in widespread fiscal welfare to mortgages an objective subsidy to credit consumers, and therefore to its core business of credit provision.

These are powerful associative and economic sectors, very well organized, with representative peak national associative bodies, often integrated in neo-corporatist institutions of policy-making. The *Ordem dos Médicos* holds a professional monopoly and wide institutional functions granted in the Constitution. The «third sector» or welfare civil society of IPSS, *Misericórdias* and mutualities is perhaps the best organized sector of Portuguese civil society, and receive huge inducements from the welfare state by way of cooperation protocols, direct subsidies, and tax benefits in the corporate tax (IRC), amounting to something akin to a «parallel state» financed by public outlays[81]. The banking sector has benefited since the 1990s from a public policy of fostering home ownership through a wide range of fiscal measures and, in fact, credit provision for home ownership increased more than threefold in number of policies and seven-fold in value during the 1990s, and continued to do so in the context of the decline in interest rates brought by the euro: from 33160 M euros in 1999 to 114416 M euros in May 2011.

On the other hand, from the welfare consumer's point of view, tax benefits are hugely popular and used in a widespread manner. In 2004 745% of taxpayers included out-of-

[80] Branco, 2016; Fernandes and Branco, 2015; Glatzer, 2013
[81] Branco, 2016.

pockets health expenses elegible for tax refund, another 8% declared insurance premiums, while another 25% included education or home loan insurance expenses. The take-up rate of tax expenditures is hard to reverse. Whenever it came up in Parliament, parties were quick to dismiss it on the grounds that it implied a tax increase for the middle classes, as was the case in 1999.

The state budget for 1999 turned tax allowances (*abatimentos*) into tax credits (*deduções à colecta*), namely: health, education (including of children), rest homes, home loans and insurance premiums. The *benefícios fiscais* in the EBF were also turned from tax allowances to tax credits, namely: PPRs, saving accounts for stock options[82]. Regarding healthcare, the tax credit for out-of-pocket expenses allowed the deduction of 30% of all expenses without nominal limit; as regards health insurance, the EBF allowed a tax credit for 25% of premiums paid but with a nominal limit.

When the 1999 budget came up for debate in Parliament, it pitted the centre-left PS government against the centre-right opposition of PSD and CDS. The centre-right parties were vehemently against, asserting that while the move from allowances to tax credits was in theory more equitable, in practice it would mean a tax hike for the middle classes, while the lower classes would not benefit because they did not earn enough income to make private expenditures in health and education. The center-left government explicitly justified the move with the need to curb the extant regressivity of the allowance regime[83].

While the impact of partisan preferences of left and right parties, which Faricy found in the USA to be related to direct vs. indirect social expenditure[84], does not seem to hold in the Portuguese, it may help explain variation *within* tax expenditure regimes, since changes introduced by a centre-left government curbed the regressive distributive effects.

[82] Relatório do OE 1999, p. 93-99
[83] *Diário da Assembleia da República*, sessions 11 and 13 November, 1998.
[84] Faricy, 2011.

Regarding health policy, particularly until 1995 and from 2002 to 2005, the public health system continued to be slowly «privatized as regards the provision of care and services»[85], the role of the state changing from financer and provider of health services to that of «buying and coverage of health services provided by the private sector»[86]. In a clear statement, the Minister of Finance said, in 1993: «given the bigger efficiency of the private sector, one should only consider as intervention areas exclusive of the state those relative to benefits that cannot efficently be provided by civil society»[87]. In the period 2000 to 2008, up to 47,6% (in 2002) of public health spending went to private providers. This share has been decreasing, but in 2008 it was still 43%[88].

In the long run, the NHS generated a peculir mix of public, private and third sector. Around 30% of the total health expenditure is private, of which, 75% in out-of pocket payments, one of the largest shares in the OECD[89]. Of the public share of direct health expenditure, 40% is made towards private providers. Also, health services civil society benefitted from the public allocation of resources, as a provider of services paid, totally or in part, by the state's NHS. In fact, health services civil society get 82% of its financing from the government, a higher share than social services (26%) or educational civil society (34%)[90].

The end of a golden age?

From May 2011, as part of the Portuguese bail-out, the adjustment program cut down tax expenditures and curbed their regressive effects upon income distribution.

[85] Campos, 1991, p. 17
[86] Mozzicafreddo, 1992, p. 70.
[87] Jorge Braga de Macedo *apud* Ferreira, 2000, p. 219.
[88] INE, 2010, p. 20.
[89] Considerando a década de 2000, vd. Barros, 2011.
[90] Franco, 2005, p. 19.

There was an overall cut in tax expenditures (all taxes), from 15481 M euros (9.0% of GDP) in 2010 to 9600 M euros (5.7%) in 2013. Of these, 2590 M (1.5%) in «social protection» and «health». Just the «health» component was halved, from 735 million in 2010 to 341 in 2013[91]. 2010 to 2013 overall tax expenditures in the income tax went from 2.3% to 1.6% of GDP, most of which were out-of-pocket TBSPs. The cost of TBSPs towards private social insurance was cut from 380 million euros in 2010 to 220 in 2012[92].

The *Memorandum on Economic and Financial Policies* and the *Memorandum of Understanding on Specific Economic Policy Conditionality* significantly cut the cost of social tax expenditures, for example cutting tax credits for healthcare by two thirds, or just phased them out, v.g., towards home loans interest[93]. The 2012 state budget set progressive limits for social tax expenditures from the 3rd to the 6th income brackets[94]. Taxpayers in the top two income brackets can no longer benefit from any tax credits, while those in the first, lower, couple of brackets continue to do so with no limit (just those in the first bracket from 2013).

The adjustment program worked as the ultimate nutcracker upon a very resilient policy institution. One can see here an instance of a more general pattern across Southern Europe in which the crisis works «as a catalyst for breaking system gridlocks» by empowering governments to overcome veto points and the representation of organized interests[95].

Conclusions

Fiscal welfare has been a social policy instrument relatively neglected by the comparative literature on social policy. This paper fills the gap by looking at fiscal welfare policy and outcomes in Portugal from 1989 to 2011, truly a golden age for tax expenditures.

[91] Relatório OE 2013: 99-100
[92] Relatório OE 2012: 62
[93] MPEF, 2011: 3-4 and MECPE, 2011: 17.
[94] Relatório OE 2012: 43, 45
[95] Petsemidou and Guillen, 2014: 301; Rodrigues and Silva, 2015: 36.

Portugal presents a comparatively high level of social tax expenditures, the result of steady growth since the 90s (they more than doubled from 1999 to 2011), having become a very costly expenditure item (up to 1.2% of GDP). Its biggest share goes to the refunding of healthcare out-of-pocket expenditures, which have, as is usually the case with social tax expenditures, a clear regressive impact upon income distribution.

The largest Portuguese social tax expenditure is for the refund of out-of-pocket payments in health, never less than 33% of total TBSPS, rising to almost 700M€ in 2010. As of 2004, ¾ of Portuguese families filed them in their income tax returns. If from 1980 to 2000 the share of health expenses recovered by Portuguese families rose from 1% to 18%, it did not increase in proportion for all income groups. Healthcare TBSPs are doubly regressive because they distribute income to the better-off while the distribution of health risks across income groups is the inverse of the distribution of tax refunds across income groups. Health TBSPs towards private insurance are almost residual – 22M€ vs. 608M€ in OOPs in 2011, which means that they have worked for making market for private provision, yet not for the full financialization of healthcare.

How to account for the substantial growth of such a costly and inegalitarian policy institution? In order to explain this pattern we presented a three-part argument, deploying insights developed in the theoretical discussion. We first argued that, in the critical juncture following the late double transition to democracy and structural economic reform, tax and welfare state developments combined to create social tax expenditures as a modality of targeted social expenditure favoring middle and elite groups, according to a pattern characteristic of new democracies. We then argued that, once in place, a combination of powerful vested interests, obscure policy-making, regressive income distribution and high take-up rate across taxpaying groups obtained a path-dependent outcome, keeping inegalitarian and costly fiscal welfare growing during adverse fiscal conditions, particularly since the accession to the EMU (1992) and then the euro (1999). We finally argued that such a resilient outcome was curbed only in 2011 by the harsh conditionality of the economic and financial adjustment program of the Portuguese bail-out, an instance of how deep crises provide opportunities for path-shifting reconfigurations of social policy.

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