The Golden Age of Tax Expenditures
Fiscal Welfare and Inequality in Portugal
(1989-2011)

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ESPAnet CONFERENCE
LISBON, SEPTEMBER 14-16 2017

Research supported by the Project DEMOCRIS (PTDC/IVC-CPO/2247/2014)
1. Introduction

In assessing the state’s commitment to welfare, early social scientific literature focused on patterns of levels of public, direct social expenditure, usually measured as share of national GDP (Wilensky 1975: 2). Two kinds of criticism emerged. Scholars in the power resources tradition turned the 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 (Stephens 1979; Korpi 1983; Esping-Andersen 1990). 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 (Sinfield 1978, 2004, 2013; Gilbert and Gilbert 1989; Greve 1994; Howard 1997; Adema 1999; Gilbert 2002; Hacker 2002; Adema and Whiteford, 2010; Adema et al. 2011, 2014).

Child tax credits, reduced rates for pensions or tax relief for interests paid in mortgage loans are all forms of indirect welfare provision, as Titmuss (2001: 63-67) acknowledged early on in his ‘divisions of welfare’ framework. There, welfare provided and distributed through the tax system (fiscal welfare) is considered alongside social (state-provided social services and cash benefits) and occupational (benefits in cash or in kind through employers) forms. 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’ (Reisman 2001: 138). It is social policy by other means (Sinfield 1978).

We (still) know little about this ‘hidden welfare state’ (Howard 1997; Greve 1994: 203) as it has been under-researched and under-theorized by the literature on welfare regimes. It is
therefore not surprising that it has received scant attention from the scholarship on the Portuguese welfare state\(^1\).

And yet, at least since 1989, a high level of indirect social expenditures has become a hallmark of the Portuguese tax and welfare regime. In 2010, the year before the Troika adjustment program, of the overall volume of tax expenditures, 15481 M€ (9 per cent of GDP), 3073 M€ (1.8 per cent of GDP) were spent with ‘social protection’ and ‘health’ (Relatório… 2012: 100). The OECD, using a different definitional measure - ‘tax breaks with social purposes’-, ranked Portugal in 4th place in 2009, at 1.1 per cent of GDP, a comparatively high level, second only to the USA, Germany and France (Adema et al. 2011, 2014).

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 favouring middle and elite strata, according to a pattern characteristic of third wave, new democracies. We then argue that *policy makes politics*: once in place, 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 increased, in spite of mounting revenue loss and regressive inequality effects. Such a resilient outcome was tamed only in 2011 by the 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. The first part explores the empirical patterns of fiscal welfare in Portugal. First, through a longitudinal analysis from 1989 to 2011, with a focus on the largest tax break (for healthcare); second, 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, using Portugal as a theory-generating case-study for the development of explanatory hypothesis. We start by reviewing the social scientific theories of tax policy and welfare regime development, and then deploy a set of earned 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

In Portugal, tax expenditures with social purposes\(^2\) more than doubled in the decade before the bail-out, from 942 M€ in 1999 to 2138 M€ in 2010, ca. 1.2 per cent of GDP. The largest categories of indirect social expenditure are healthcare, housing and education (HHE), particularly those related with the relief of out-of-pocket (OOP) payments in health (medication, medical appointments and exams), home loans interests and education expenses (including of children).

(Chart 1 here)

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 per cent of GDP) and dropping slightly to 1503 M€ in 2011. 

From 1999 to 2008 the composition and rank order of TBSP has been stable. Tax spending on healthcare ranges between 35 and 32 per cent; on housing, up to one-third, and on
education for about 16 per cent. Together, these categories account for 85 (1999) and 74 per cent (2008) of the total. The 2008 novelty is the child tax credit (16 per cent) (*Estatísticas das Receitas Fiscais; Adema et al. 2011*)

**Healthcare tax expenditures: volume, revenue lost and inequality**

Over time, tax spending with healthcare has been the largest. For instance, in 2004, it was the biggest tax credit in the income tax (32 per cent), followed by housing loans (27 per cent), education (15 per cent) and pension plans (8 per cent). In the same year, 74 per cent of Portuguese families included in their tax income OOP expenses eligible for tax credit, yet only 8 per cent did so for health insurance; education and housing tax expenditures were included by around one in every four families (CFSSNS 2007: 118-119).

*(Chart 2 here)*

Chart 2 shows the steady growth of healthcare tax expenditures from 1992 to 2011 (at market prices), discriminating between OOP 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 per cent. Insurance is ‘supplementary to the NHS coverage’: *ca. 20 per cent of the population has taken them up, of which about half are employer provided group insurance and the other half are individual policies* (Barros et al. 2011: 65).

This captures a general feature of Portuguese social tax expenditures: the fiscal effort towards private insurance is much smaller than towards of OOP expenses. In fact, the relative salience of health insurance declines from mid-2000s, unlike other countries where TBSP are high. Within the insurance realm, the largest tax break is for interests in home loans, not
healthcare. Thus, while Portuguese TBSP grew throughout, its redistributive impact favouring the better-off is not as harsh as in those countries that favour tax expenditures towards financial insurance products. Although increased TBSPs denotes a public subsidy to private provision of welfare, it is not indicative of a path-shifting move to market financialisation of welfare.

Lost revenue

(Table 1 here)

Table 1 shows the continuous growth of healthcare TBSP relative to total national health expenditures, public health expenditures and GDP. 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 health tax expenditures was ten times the revenue paid in user charges in the Portuguese NHS.

Because TBSP pay for OOP expenses, their level evinces the centrality of OOP expenses in the financing of healthcare. Since 2000, OOP are among the highest in Europe, never below 20 per cent of total health expenditure. 2006, they were 23 per cent (or ¾ of the overall private share of 29 per cent). 2009, OOP accounted for 4.2 per cent of final household consumption in Portugal, the 7th highest among OECD countries (2011: 135). The Portuguese redistributive income tax system ‘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’ (Barros et al. 2011: 52).

Inequality: benefits to the better-off

(Table 2 here)
Table 2 makes clear how health TBSP regressively distribute income to the middle and higher strata\(^3\). Since 1980, the national level increased from 1 benefiting none to 18 per cent benefiting mostly some. The share refunded in 2000 to the better-off (24 per cent average for the top three deciles) is much bigger than the share recovered by the poorer families (8 per cent 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 (1997: 98) called for a change from tax allowances to tax credits, to the benefit of 80 per cent of income tax payers (first 8 income deciles). The adoption of said reform (1999) does not impede the 2000 distribution of recovered income of following the income rather than the health expenditure distribution, which is more evenly distributed or even skewed towards lower income deciles. Granted, health TBSP became less regressive during the 2000s, yet far from equitable (CSFSNS 2007: 121).

Health tax breaks are doubly regressive. Only tax-paying families can benefit from them; low-income families not liable to IRS cannot, despite paying health expenditures. In 1990, 90 per cent of pensioners received pensions below the minimum wage, and were not required to file income tax return, in spite of having health expenses (Pinto and Santos 1993: 196). In 2000, four in every ten families could not benefit from any tax break because their income was not enough to pay income tax, and yet accounted for 40 per cent of health expenditures. Conversely, those in the 35 per cent marginal rate (7.1 per cent of the population) made 9.6 per cent of health expenses and received 16.1 per cent of all health tax expenditures. Those in the top marginal rate of 40 per cent (2 per cent of the population) paid 3.3 per cent of expenses, but recovered 5.4 per cent of all health TBSP (CFSSNS 2007: 123). Moreover, the distribution of health risks across income groups is the inverse of the distribution of benefits across income
groups. Though low-income households pay relatively more health expenditures, they are ‘less able to obtain a higher percentage refund from the tax system than the high-income households (6 per cent vs. 27 per cent, when analysing the lower and upper income groups of the income distribution)’ (Pita Barros et al. 2011: 53).

*Portugal compared: tax breaks with social purposes in OECD countries*

As shown is Table 3, before the great recession, TBSP were high in the USA, 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 4th place ranking stands out.

(Table 3 here)

Cross-case variation does not map onto the familiar three worlds of welfare capitalism (Esping-Andersen 1990), and thus defies explanation by the welfare regime logic alone. 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 TBSP include the liberal regimes in the US and Canada. However, there is variation here: British TBSP are on or below average. Yet, the Bismarckian, conservative type, including Southern Europe, shows the largest variation: from high in Germany (1.6 per cent) and Portugal (1.1 per cent), to medium in Spain and Belgium (ca. 0.5 per cent), to low or very low in Italy (0.2 per cent) and Austria (0.1 per cent).

Different patterns emerge when looking at structure (. While the top ranking USA 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.
Germany, Spain, France and the UK prioritize family support, unlike Italy and especially Portugal (mainly directed to 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.

Next, we turn to the explanation of the Portuguese patterns. We deliberately use Portugal as a case study for developing hypothesis, rather than try to account for patterns of cross-case variation through theory-testing (George and Bennett 2004; Mahoney 2007; Gerring 2009), something to be explored in future research.

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

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 (Steinmo and Tolbert 1998: 166-70).

Campbell suggests a ‘conceptual model of taxation’. Taxation levels and structure result from the way political elites respond to pressures stemming from geopolitical, economic or
fiscal constraints by changing tax policy, according to the strength of social classes and interest
groups, mediated by the system of political representation and state institutional structure
(Campbell 1993: 173-5).

The balance of power resources among classes and interest groups impacts the levels and
structure of 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.5

To impose a tax burden is, however, a different thing from using the tax system to give
a benefit. As regards our current purposes, this literature is limited by its focus on tax revenue,
since fiscal welfare is (indirect) expenditure6. Yet, one can try to adapt this literature’s
explanatory factors and mechanisms to tax expenditure policy-making.

During and after World War II tax policy was instrumental for achieving social and
economic policy goals. The regime of high marginal tax rates, generous tax incentives for
investment and capital export controls was a centrepiece of the post-war historical compromise
between capital and labour across industrialized democracies, contributing to the joint pursuit
of equity and growth in the Keynesian welfare state (Steinmo 1993: 26-9, 193-207).

This policy regime moved from class taxation to mass taxation. While before the war
income only the richest paid income taxes, now more than 60 per cent 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 per cent), for both individuals and corporations. After doubling is most countries by the end of the war, tax revenues in OECD countries went from 25 to 33 per cent of GDP between 1960 and 1980 (Steinmo 2003: 213; Tanzi 2011: 95-8). Rapidly expanding welfare states were main beneficiaries of this increase (Steinmo 1993).

As a tool for the Keynesian management of the capitalist economy, taxes were designed to affect the timing, structure and shape of investment, and other private economic decisions. Governments micro-manipulated the economy through the tax code irrespective of party, ideology and level of economic wealth (Steinmo 2003: 214). Tax expenditures were one such mechanism, which in the USA became a structural feature of the welfare regime (Howard 1997; Hacker 2002; Faricy 2015).

In the aftermath of the 1970s prolonged crisis with stagnant growth, severe unemployment and bouts of inflation, governments increasingly 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.

Tax policy was overhauled. The relative priority given to equity and growth objectives, the deployment of investment and behavioural incentives, and the level of tax rates were notably revised: progressivity was reduced, marginal income and corporate tax rates were scaled back and tax-based incentives were eliminated to broaden the tax base (Steinmo and Swank 2002: 650; Kato 2003: 14; Swank 2006: 848).

Following the American *Tax Reform Act* (1986), industrial democracies sought to control public expenditure, fiscal discipline, the broadening of the tax base and crack down on tax evasion. Progressivity was lowered by cutting marginal tax rates. The OECD average marginal tax rate went from 63% in 1976, to 56% in 1986, to 43% in 1992 (Steinmo 2003: 222). The
thrust 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’ (Swank 2006: 850).

Tax expenditures came to epitomize the pathologies of the post-World War II policy regime. They were inefficient (in the allocation of productive investment), expensive (a drain on tax collection), socially unfair (as giveaways to the rich outside public scrutiny) and thus ought to be scaled back and better scrutinized (Steinmo 2003: 216). It is therefore not surprising that mandatory tax expenditure budgets were legislated in Germany (1967), USA (1974), Austria (1979), Spain (1979) and France (1982), or that publication of annual reports to parliaments was mandated in the UK and Canada (1979), Portugal (1980), Ireland (1981) and Australia (1981) (Tobes Portillo 1991: 51-4; 72-7).

And yet, tax expenditures were far from extinct, to the contrary. In the USA, even though the 1986 Act targeted the elimination or reduction of tax expenditures, 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 and expanded existing provisions (Howard 2009: 95). By 2000, tax expenditures represented a larger share of GDP than they had in mid-1970s.

Even though there is a lack of extensive longitudinal and comparative data, OECD data points to similar patterns in Europe7. 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

According to a recent appraisal, in the post-Golden Era the major difference between 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’ (Obinger and Wagschal 2010: 338). The term ‘enabling state’ denotes a set of developmental features of welfare states since the 1980s (Gilbert and Gilbert 1989): 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’ (Gilbert 2002: 5, 16).

Social tax expenditures are exemplary of this trend. In Thatcherite Britain, from 1979/80 to 1983/4, tax relief for private pensions increased 106 per cent while direct expenditure on state and supplementary retirement pensions rose only 13 per cent. Whereas total general and income related subsidies for public sector housing were cut by 22 per cent, mortgage interest tax relief increased by 29 per cent. 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£ (Judge 1987: 19; Mann 1992: 95).

We argue that the significant increase of social tax expenditures is a means of ‘welfare state restructuring’, that is, a ‘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’ (Van Kersbergen and Vis 2014: 3).

Indeed, the alternative between state direct social expenditure and indirect provision through the tax system implies a fundamental political choice regarding the balance of power resources in society, as it expresses the relative power of certain classes or organizations to influence the allocation of scarce resources (Sinfield 1978: 149). Tax expenditures 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, Table 3 shows that cases do not cluster according to welfare regimes. The non-existent TBSP 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 TBSP would seem to confirm the argument, for the inverse reasons, were it not for the low levels of the United Kingdom. As we noted, the Bismarckian regimes offer the greatest variation, ranging from high in Germany, France and Portugal, to medium in Spain and Belgium, to low or very low in Italy and Austria. Even after recalling the OECD does not consider tax breaks for pensions, which are the biggest single social benefit in these regimes, something is amiss.

Social tax expenditures ought also to be understood within the framework of permanent welfare reform triggered by the shift toward a post-industrial society and attending new social risk structure (Taylor-Gooby 2004; Armingeon and Bonoli 2006; Bonoli and Natali 2012). 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, labour market activation, in-work poverty 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. Looking at TBSP composition in the cases in which welfare provision does not rely heavily either on the market or the state (where tax expenditures are either structurally favoured 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. And so, at least in part, the longitudinal and cross-case variation in the levels and composition of TBSP ought to be the result of the ‘politics of the new welfare state’ (Hausermann 2012).
Once a fiscal welfare regime asserts itself, a host of (mostly) private providers stand to benefit from social tax expenditures and acquire vested interests with a conservative stake in the status quo (Mettler 2011: 19). The stronger their power resources and the stronger their influence on policymaking, the bigger and more long-standing tax breaks are bound to become.

The fact that fiscal welfare policy-making tends to hails from supply side politics and to be concealed and obscure also helps. First, tax expenditures reward demands and interests put forward by the supply side of welfare. Unlike policy distributive decisions in response to demands and interests expressed by large, popular, majoritarian social groups which constitute the beneficiaries of social benefits, fiscal welfare is promoted by private providers of insurance, corporations and professional groups which offer benefits in the welfare market.

Second, tax expenditures are obscure. While spending programs require specific, new legislation, tax breaks ‘can be tucked away in must-pass revenue bills’ (Howard 1997: 179), thus concealing ‘the government’s role from the view of the general public’, including from those who benefit from them (Mettler 2011: 5). During the 1990s, in Denmark and in the UK, tax expenditures were not monitored regularly and publicly and thus their cost remained unclear. Thus, when public spending was put increasingly tight controls, the likelihood that they would be cut or constrained was much smaller (Kvist and Sinfield 1996: 38).

As shown, fiscal welfare is also interwoven with issues of inequality and redistribution. Most tax expenditures have regressive effects upon income distribution: higher income strata benefit disproportionately relative to low-income groups (Greve 1994: 207). Such ‘upside down effect’ yields from the better-off being able to invest more in tax-privileged activities, paying disproportionately less in taxes (Sinfield 2013: 23). Regressive distribution is also 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 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 dualisation or stratification, since public and private, direct and indirect, modes of welfare provision tend to focus on different groups and to use different instruments (Stebbing and Spies-Butcher 2010: 18).

Fiscal welfare also affects the design of social protection by favouring the selection principle (targeting), as opposed to a universalistic logic. Direct and indirect social expenditures embody distinct views of the state’s role in the regulation of welfare: tax breaks favour private provision in the market, while direct outlays imply the government as a provider with a view to risk-pooling and redistribution.

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 bailout program of May 2011 illustrates the point well. It is to this narrative we now turn.

4. Explaining the golden age of tax expenditures in Portugal

This section develops an argument for the rise and taming of Portuguese fiscal welfare, from 1989 to 2011, by addressing three successive 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 a regressive income distribution? Third, why and how was it substantially curbed in 2011?

4.1 The beginning of the social tax expenditure policy regime

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 the sequential tax reform stages of western industrial democracies since World War II\textsuperscript{11}.

After the 1974 social revolution Portugal deployed aspects of the post-World War II 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 per cent starting at low income levels. Tax incentives were deployed to influence decisions about when and in what to invest and other private economic decisions. In the same way these reforms yielded a huge rise in tax revenues from 1945 to 1980 elsewhere, so too in Portugal after 1974 (Tanzi 2011: 95). However, the transition from class to mass taxation was incomplete since the parcellarised structure and the unequal and autonomous taxation of different income sources, topped with a complement\textit{ary tax}, continued as designed back in the 1960s. The tax structure was viewed as unfair, inefficient and archaic (Silva 1989).

As elsewhere, from mid 1970s, a combination of stagnation, unemployment and inflation triggered 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 1983-4.

The creation in January 1989 of a unified personal income tax, the \textit{Imposto sobre o Rendimento das Pessoas Singulares} (IRS), replacing a set of partial, confusing and unfair taxes embodies both the shift from class to mass taxation \textit{and} the 1980s market-conforming tax reform\textsuperscript{12}. The IRS unifies taxation of personal income across 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\textsuperscript{13}.

The new income tax sought to regulate tax incentives in a more ordered and accountable way\textsuperscript{14}. It created social tax expenditures for healthcare, education, mortgage interest, rest homes, private pensions and life insurance. These were all tax allowances (deductions made to gross income), and all had statutory limits – except health expenses, which were deducted in full with no cap. Such design has a steep regressive effect upon income distribution because the magnitude of the benefit follows the taxpayer’s highest marginal rate: those in the 10 per cent bracket would ‘recover’ ca. 10 per cent of health expenses; those in the 40 per cent bracket, would get back 40 per cent (Gouveia 1997: 82; CSFSNS 2007: 114). This was admittedly 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 (CSFSNS 2007: 111)\textsuperscript{15}.

\textit{Social protection and redistribution in newly democratic Portugal}

In Western Europe, since the end of the 1970s, welfare states underwent varying forms of retrenchment and recalibration (Huber and Stephens 2001; Pierson 2001, 2011; Scruggs 2007). 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 (Branco 2017). 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 \textit{per capita} growth of 3.5 per cent 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 (O’Connor 2007: 233-6).

Portugal presents a successful transition to democracy, structural economic reform and welfare state (Maravall 1997: 74-125; Glatzer 2005). 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 welfare state development’ (Glatzer 2005: 107).

Portugal, therefore, is not a case in which social tax expenditures grew while direct social expenditures contracted. To the contrary, both grew in tandem. The manner of that growth, its redistributive implications and the politics it entails is what demands clarification.

Karakoc (2017) argues that new democracies are less successful in curbing inequality than older democracies in Western Europe because – against the backdrop of the poor’s less willingness to participate in politics and incipient parties and party systems – governments in new democracies 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. Parties lacking long-standing linkages to civil society, from both 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 found it effective to target social policy at segments of the population such as the military or civil servants, crucial white and blue collar professional categories (labour market insiders) through public transfers, such as pensions, unemployment and health protection, parental leave, child benefits and benefits associated with occupations.
We extend this argument from direct to indirect social spending, where it plays out even more convincingly, as we shall see. Fiscal welfare 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 important for securing the electoral allegiance of middle-classes to the governing parties.\textsuperscript{16}

The National Health Service and the rise of private providers

The Portuguese National Health Service (NHS) 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 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 income tax breaks. 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 of private OOP expenses and insurance premiums. The possibility of deducting in the IRS the totality of health expenses was instrumental (Pinto and Santos 1993: 93). Accordingly, the structure of health financing changed from 1980 to 1990: OOP payments rose from 28 to 37 per cent, private insurance rose from 0.6 to 1.4 per cent, while the share of taxes decreased from 66 to 55 per cent (Pinto 1995: 106).

4.2 The resilience of fiscal welfare

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 elicited middle class support. Path-dependency obtained as change presented increasing political costs (Huber and Stephens 2001: 32), in spite of rising revenue loss and inequality effects. We argue that Pierson’s ‘new politics’ argument for the resilience of the welfare state (2001), such as benefit-related electoral constituencies, vested interests and path-dependence, also obtains in the case of fiscal welfare – leveraged by its unclear nature.

As shown, the great bulk of fiscal welfare results from tax credits for expenses made with health, education services, and mortgage interest. Looking at the supply side first, we determine that 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, there are professional and business interests represented by monopolistic and peak-national associations: the Portuguese Medical Association (Ordem dos Médicos), the National Pharmacy Association (Associação Nacional das Farmácias) and the pharmaceutical industry (Apifarma - Associação Portuguesa da Indústria Farmacêutica). 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, many Church-related, are formal partners of the state in the provision of social care ever since 1979, playing a key role in a quasi-corporatist system in which a national level confederation helps define and implements public policy together with the state (Glatzer 2008; Fernandes and Branco 2017). Fiscal welfare contributed decisively to the burgeoning 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, economic and financial sectors, very well organized, with representative peak national associative bodies, often integrated in neo-corporatist institutions of policy-making. The Medial Association holds a professional monopoly and wide regulatory functions granted in the Constitution and is a major stakeholder in the National Health Service.

The ‘third sector’ constellation of ca. 5000 IPSS, Misericórdias and mutualities is the strongest and best organized of Portuguese civil society, benefiting from strong public inducements by way of cooperation protocols, direct subsidies, and tax breaks in the corporate tax (IRC), amounting to something akin to a ‘parallel state’ financed by public outlays. The yearly volume of state expenditure with ‘cooperation protocols’ with IPSS rose from 200 M€ in 1994 to 1.2 Bi€ in 2009. The IPSS-run local network of social care facilities has grown in numbers (from 4400 in 1998 to 6400 in 2011), territorial coverage and variety of services, as a result of huge investment by both the national government and the European Union, from less than 100 M€ in 1995 to over 600 in 2010 (Branco 2017).

The banking sector benefited from a public policy of promoting home ownership through a wide range of subsidies and tax measures. A regime of subsidized credit for home loans was in place until 2002, capturing at least half the home loan market. Since the 1990s, it increased fourfold in number of policies and seven-fold in value. With the euro and declining interest rates, it accelerated: from 2003 to 2010 housing loans averaged 60% of all credit to individuals, sum total of 119,2 M€ (66% of GDP in 2010), peaking at 19,6 M€ in 2007 (PORDATA).

On the other hand, from the welfare consumer’s point of view, tax benefits are very popular and used in a widespread manner. In 2004, 74,5 per cent of taxpayers included OOP expenses eligible for tax refund, 8 per cent declared insurance premiums, while 25 per cent included education or home loan insurance expenses. The take-up rate of tax expenditures is politically 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 budget law for 1999 turned tax allowances (abatimentos) into tax credits (deduções à colecta) for health, education (including of children), rest homes, home loans and insurance expenses. The benefícios fiscais in the EBF were also turned from tax allowances to tax credits, namely for retirement pension plans (Relatório do OE 1999: 93-99). Regarding healthcare, the tax credit for OOP expenses allowed the deduction of 30 per cent of all expenses with no cap; as for expenses with health insurance, the EBF granted a 25 percent tax credit but with a cap.

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 conservative parties were strongly against, asserting that the move from allowances to tax credits, despite more equitable in theory, in practice would increase taxes for the middle classes, while the lower strata would not benefit because they did not earn enough income to use tax expenditures in health and education. The centre-left government explicitly framed the change with the need to curb the regressivity of the allowance regime\textsuperscript{17}. While the impact of different left and right parties’ preferences (Faricy 2015) does not seem to drive the Portuguese case, it may help explain variation within tax expenditure regimes, since changes introduced by a centre-left government curbed the regressive distributive effects.

Regarding health policy, particularly until 1995 and from 2002 to 2005, the National Health Service continued to be slowly ‘privatized as regards the provision of care and services’ (Campos 1991: 17), 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’ (Mozzicafreddo 1992: 70)\textsuperscript{18}.

In the long run, the NHS generated a peculiar mix of public, private and third sector. Around 30 per cent of the total health expenditure is private, of which ¾ are OOP, a comparatively high share. Of the public share of health expenditure, 40 per cent is used to pay 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 receives 82 per cent of its financing from the government, a higher share than social services (26 per cent) or educational civil society (34 per cent) (Franco 2005: 19).

4.3 The end of a golden age?

May 2011, the adjustment program in the Portuguese bail-out cut down tax expenditures and curbed their regressive effects on income distribution, not out of a particular concern with inequality, but driven by the need to cut expenditures.

There was a general cut in tax expenditures (all taxes), from 15481 M€ (9 per cent of GDP) in 2010 to 9600 M€ (5.7 per cent) in 2013. Of these, 2590 M€ were directed to ‘social protection’ and ‘health’. The ‘health’ component alone was halved, from 735 M€ in 2010 to 341 M€ in 2013. From 2010 and 2013 overall tax expenditures in the income tax went from 2.3 to 1.6 per cent of GDP, most of which OOP TBSP. The cost of TBSP for private social insurance was cut from 380 M€ in 2010 to 220 M€ in 2012 (Relatórios… OE 2012, 2013).

The Memorandum on Economic and Financial Policies and the Memorandum of Understanding on Specific Economic Policy Conditionality sizeably downsized social tax expenditures, v.g. cutting tax credits for healthcare by two thirds, or just phased them out, for example, towards home loans interest (MPEF 2011: 3-4; MECPE 2011: 17). The 2012 budget set progressive limits for social tax expenditures from the 3rd to the 6th income brackets (Relatório OE 2012). Taxpayers in the top two income brackets can no longer benefit from any tax credits, while those in the first, lower brackets continue to do so with no limit (from 2013, just those in the first bracket).

The MoU program worked as the ultimate nutcracker upon a very resilient policy institution. This is perhaps an instance of a more general pattern across Southern Europe in which the crisis worked ‘as a catalyst for breaking system gridlocks’ by empowering
governments to overcome veto points and the representation of organized interests (Petmesidou and Guillén 2014: 301; Rodrigues and Silva 2015: 36).

5. Conclusions

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

Portugal presents a comparatively high level of social tax expenditures, the result of a steady growth since the 1990s, having become a very costly expenditure item. Its biggest share is directed to the refunding of health OOP, 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 health OOP, never less than 33 per cent of total TBSP, rising to almost 700M€ in 2010. As of 2004, three quarters of Portuguese families included them in their income tax returns. However, the increase in the share of health expenses recovered by Portuguese families between 1980 and 2000 was not evenly distributed among income groups. Healthcare TBSP are indeed 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. Finally, the fact that health TBSP towards private insurance are almost residual, suggests that they have worked for making market for private provision, yet not for the full financialisation 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 were combined to create social tax expenditures as a modality of targeted social expenditure favouring middle and elite groups, according to a pattern specific 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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**Endnotes**

1 The exception is Santos and Rodrigues 2006.
2 For comparative reasons, we use the same definitional perimeter as Adema et al. 2011 and 2014. Note that this refers only to the income tax and excludes pensions.
4 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’ (OECD 2010); 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).
5 Authors deploying or testing one or more of these explanatory factors are 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.
6 Steinmo is a notable exception.
7 Indeed, a OECD 2010 (169-237) 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 their numbers.
8 The bank and insurance industries, professional corporations such as medical associations or third sector, social economy organizations.
9 The exception is 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.


11 The regulatory framework is laid down in the Constitution (Art. 109), the Estatuto dos Benefícios Fiscais (Art. 2, nº 3, decree-law 215/89), and the Lei de Enquadramento do Orçamento do Estado (1991, in the wording of the art. 13, n.º 1, of Law 91/2001), which mandate that the annual state budget includes a report on tax expenditures and an estimation of the revenue foregone.


13 The marginal rate of the superseded imposto complementar was 80 per cent, which compares with the new 40 per cent in the new IRS. See Silva 1989: 241-8.

14 Decree-law 215/89, July 1st.

15 Previous health tax breaks existed in the imposto complementar, but this tax contributed only 6 per cent of all direct tax revenues, a minor role. See Pinto and Santos 1993: 193.

16 In fact, parliamentary debates on tax expenditure reform make it clear that both center-left and center-right parties, which have in office 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 (see discussion below).


18 A report from the Ministry of Finance advocated the increasing importance of policy models that ‘replace the direct intervention of the state in economic and social life by marked based solutions and private entrepreneurship’ (Ministério das Finanças 1993: 63). From 2000 to 2008, up to 47,6 per cent (2002) of public health spending went to private providers. This share has been decreasing, but in 2008 it was still 43% (INE 2010: 20).