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

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ABSTRACT

This paper studies social tax expenditures as an instrument of social policy, considering its broader social and political ramifications, particularly regressive distributive impacts, the targeting of social protection and making markets for non-state providers. Using OECD data and government budgets, we look at 'tax breaks for social purposes' in Portugal since the 1980s, with a focus on healthcare, educational and mortgage loan expenses. Portugal presents a comparatively high level of TBSP before the Great Recession. Why? Using Portugal as a theory-developing case, the paper argues 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 favouring middle and higher strata. 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. Such a resilient outcome was curbed only in 2011 by the harsh conditionality of the economic and financial adjustment programme of the Portuguese bailout, an instance of how deep crises provide opportunities for path-shifting reconfigurations of social policy.

KEYWORDS

Portugal; fiscal welfare; social tax expenditures; social protection; healthcare

Introduction

In assessing the state's commitment to welfare, early social scientific literature looked at patterns of levels of public, direct social expenditure, usually measured as share of national GDP. Two kinds of criticism emerged. Scholars in the power resources tradition turned the focus to multi-dimensional policy-regimes and country clusters, based on measures of the decommodification of social rights, benefit generosity 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 for neglecting 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, 2013, Gilbert and Gilbert 1989, Greve 1994, Howard 1997, 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 acknowledged in his 'divisions of welfare'. Welfare provided and distributed through the tax system (fiscal welfare) is considered along with social (state-provided social services and cash benefits) and occupational (benefits in cash or in kind through

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employers) forms. Tax deductions and reliefs are forms of collective provision similar to a transfer payment: 'both are manifestations of social policies in favour of identified groups in the population' (Titmuss 1958, p. 45). Fiscal welfare is analogous to social welfare; it is social policy by other means (Sinfield 1978).

We (still) know little about this 'hidden welfare state' (Greve 1994, Howard 1997) as it has been under-researched and under-theorized by the literature on welfare protection. It is therefore not surprising that it has received scant attention from the scholarship on the Portuguese welfare state.[1]

However, at least since 1989, a high level of indirect social expenditure has become a hallmark of the Portuguese tax and welfare regimes. In 2010, the year before the Troika adjustment programme, 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' (Ministério das Finanças 2012, p. 100). The OECD, using a different definitional measure, 'tax breaks with social purposes' (TBSP), 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 answers the question by developing a set of theoretical insights from the Portuguese case. We make a three-part argument, each addressing a specific puzzle. Why was the tax expenditure policy regime created? How to explain its resilience, despite ongoing fiscal constraints and a regressive income distribution? How was it curbed in 2011? We first argue that *politics makes policy*: in the critical juncture following the late transition to democracy and structural economic reform, tax and welfare policy developments combined to create social tax expenditures as an instance of targeted social expenditure benefiting middle and elite strata. We then argue that *policy makes politics*: once in place, the tax expenditure regime spawned powerful interests and a wide take up rate. Path-dependency obtained, as the political costs of moving to another regime rose, despite increasing revenue loss and regressive inequality effects. Such a resilient outcome was tamed only in 2011 by the Troika's harsh conditionality, an instance of how deep crises provide opportunities for path-shifting social policy reconfiguration.

The article is structured as follows. It starts by reviewing the literature on tax policy and welfare regime development as the relevant frameworks for the analysis of fiscal welfare. Next, it explores the empirical patterns of fiscal welfare in Portugal. We first place Portuguese TBSP within the OECD context, prior to the Great Recession; then, we run a longitudinal analysis (1989–2011), with a focus on tax breaks for healthcare. The next section tries to explain the Portuguese empirical patterns, deploying it as a theory-generating case study. We conclude by reiterating the main empirical findings and the core explanatory argument.

Fiscal Welfare: A Framework for Analysis

Fiscal welfare is a hybrid object. Its regime belongs to tax policy, but it works like an (indirect) expenditure. It is an instrument of social policy, but delivers through means other than direct outlays or benefits. Such features place fiscal welfare at the crossroads of the literatures on tax policy and welfare regimes and perhaps help explain the scant theoretical attention it has received. This section focusing on the relevant social scientific theories for explaining the Portuguese patterns of fiscal welfare is preceded by a short historical context.

Tax Policy in Western Industrial Democracies – Historical Background

Since World War II tax policy was instrumental in achieving social and economic policy goals. A regime of high marginal rates, generous tax incentives for investment and capital export controls was the centrepiece of the post-war 'historical compromise' between capital and labour across industrialised democracies, balancing the pursuit of equity and growth in the Keynesian welfare state (Steinmo 1993, pp. 193–207).

This policy regime moved from class taxation to mass taxation. While before the War 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: lower tax thresholds with steep progressive structures and very high marginal rates (often in excess of 90 per cent), for both individuals and corporations. After doubling in 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, p. 213, Tanzi 2011, pp. 95–8). Rapidly expanding welfare states benefited mightily.

As a Keynesian tool for steering the capitalist economy, taxes sought to affect private economic decisions, such as the timing, structure and shape of investment. Governments micro-manipulated the economy through the tax code irrespective of party, ideology and level of economic wealth (Steinmo 2003, p. 214). Tax expenditures were one such mechanism.

Following the 1970s prolonged crisis of stagnant growth, severe unemployment and bouts of inflation, governments increasingly worried with fiscal imbalances dropped the main tenets of Keynesian economic management paradigm and tried different mixes of expenditure cuts and tax increases. Under supply-side, neoliberal reform, competitiveness would follow price stability, balanced budgets, the taming of inflation and of public debt. Governments' ability to implement expansionary, counter-cyclical, inflation yielding polices ought to be constrained by a commitment to fiscal, monetary and economic policy rules, under the supervision of independent central banks and international institutions.

Tax policy was overhauled. The salience given to equity and growth objectives, the deployment of investment and behavioural incentives, were revised: progressivity was reduced, marginal income and corporate tax rates were scaled back and tax-based incentives were eliminated to broaden the tax base (Swank and Steinmo 2002, p. 650). Following the American *Tax Reform Act* (1986), industrial democracies sought control of public expenditure, fiscal discipline, a larger tax base and cracked down on tax evasion. The OECD average marginal tax rate went from 63 per cent in 1976 to 43 per cent in 1992, reducing progressivity (Steinmo 2003, p. 222). Tax reform served a supply-side, market-conforming reform agenda: rate cuts with base-broadening elimination of tax-expenditures became 'part and parcel of neoliberal economic orthodoxy' (Swank 2006, p. 850).

Tax expenditures came to epitomise the woes of the post-War policy regime: inefficient (in allocating productive investment), expensive (a drain on tax collection), and unfair (as obscure giveaways to the rich), prompting higher public scrutiny. Thus, mandatory tax expenditure budgets were legislated in Germany (1967), USA (1974), Austria (1979), Spain (1979) and France (1982), and the publication of annual reports to parliaments was mandated in the UK and Canada (1979), Portugal (1980), Ireland (1981) and Australia (1981) (Tobes Portillo 1991, pp. 51–77).

Nevertheless, tax expenditures were far from extinct – to the contrary. In the USA, social policy was exempted from most of the tax expenditure reduction provisions in the 1986 Act. Indeed, they had become a feature – not a bug – of the welfare regime (Howard 1997, Hacker 2002, Faricy 2015). The drop in the size of tax expenditures was not sustained as the government added new tax expenditures and expanded existing provisions. By 2000, tax expenditures represented a larger share of GDP than they had in mid-1970s (Howard 2009). Despite the lack of extensive longitudinal and comparative data, OECD data points to a similar pattern in Europe.[2] We argue the reason lies in the connection between tax policy and social policy in the post-golden era of welfare development.

Insights from Tax Policy Theory

Tax burden patterns in modern capitalist democracies have been explained by a combination of macroeconomic and institutional factors (Steinmo and Tolbert 1998, pp. 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, pp. 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, organisational 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.

This literature's focus on taxation as extraction evidently limits its direct relevance for our current purposes, given that fiscal welfare is indirect expenditure. In fact, the political logic of imposing a tax burden is different from using the tax system to provide a benefit. Yet, we shall adapt this literature's explanatory insights and mechanisms to tax expenditure policy-making in Portugal.

Theories of Welfare Regimes and Social Policy Development

Tax expenditures are an instrument of social policy. As such, the literature on the development of social policy and welfare regimes is highly pertinent. We view the increasing use of social tax expenditures as a means of 'welfare state restructuring' in the post-Golden Era. It transforms the way in which social protection is organised and delivered, redefining the relations of power governing a programme, and the 'rights and duties of stakeholders and clients' (Van Kersbergen and Vis 2014, p. 3).

In the last decades, variation across welfare regimes became less defined 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, p. 338). Gilbert's concept of 'enabling state' denotes a set of developmental traits of welfare reform since the 1980s: 'enable people to work and to enable the market and the voluntary sector to assume an expanded role in providing social protection', making a shift towards 'work-oriented policies, privatisation of social welfare, [and] increased targeting of benefits' (Gilbert 2002, p. 5, 16). Social tax expenditures are exemplary of this trend.

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 organisations to influence the allocation of scarce resources (Sinfield 1978, p. 149). Inherently, tax expenditures affect the fundamental public/private mix in the welfare regime by objectively fostering private (or third sector) provision through the market.[3] Hence, 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. Yet, we shall see below that cases cluster imperfectly around welfare regimes: there is variation across *and within* different regimes, particularly the conservative.

The increased targeting of social benefits is a defining feature of welfare restructuring which speaks directly to tax expenditures and one that is particularly relevant to Southern European new democracies, which evolved hybrid welfare regimes from a Bismarckian root. Karakoç (2017, 2018) 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 mobilise volatile electorates. Unlike older democracies in which party systems developed over decades of institutionalised 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 organised 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 through public transfers, such as pensions, unemployment and health protection, parental leave, child benefits and occupational benefits. We extend this argument from direct to indirect social spending, where the policy environment is even more propitious. Indeed, fiscal welfare is socially targeted, redistributes income towards middle and upper strata, and thrives in a policy environment more insulated from public scrutiny.

Like other welfare programmes, fiscal welfare creates constituencies. Tax expenditures make market for the private supply of welfare, spawning new bases of organised support. Unlike direct social expenditure programmes, fiscal welfare is promoted by private providers of insurance, corporations and professional groups. Once a fiscal welfare regime is in place, non-state providers develop a conservative stake in the *status quo* (Mettler 2011, p. 19). Groups with an interest in social tax expenditures are bank and insurance industries, professional corporations such as medical associations or third sector, social economy organisations and private educational institutions. The stronger their power resources and the stronger their influence on policymaking, the bigger and more long-standing tax breaks are bound to become. Pierson's 'new politics' rationale for welfare state resilience (2001) – benefit-related electoral constituencies, vested interests and path-dependence – also obtains in the case of fiscal welfare. Perhaps more so, considering their obscure nature. While spending programmes often require specific legislative action, tax breaks are ensconced 'in must-pass revenue bills' and annual budgets (Howard 1997, p. 179), thus concealing 'the government's role from the view of the general public', including from those who benefit from them (Mettler 2011, p. 5).[4]

Fiscal welfare is interwoven with redistributive issues of inequality because most tax expenditures have regressive effects upon income distribution. Higher income strata benefit disproportionately more relative to low-income groups (Greve 1994, p. 207).[5] 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, p. 23).[6] Regressive distribution derives also from 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 poorer family households, unable to 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, p. 18). By favouring the selection principle (targeting), fiscal welfare affects the design of social protection, moving against a universalistic logic.

This section brought to the fore theoretical insights for the study of tax expenditures, from the field of tax policy and of social policy and welfare regimes. They both highlight the relevance of macro contexts, the relative power of classes or groups, electoral politics and the accessibility of political elites to public pressures, which we will deploy on the Portuguese case. This paper deliberately uses Portugal as a case study for developing explanatory hypothesis. It is not our goal to account for patterns of cross-case variation through theory-testing (George and Bennett 2004, Gerring 2006, Mahoney 2007). Thus, the comparison we provide in the next section serves a contextualising purpose.

The Golden Age of Fiscal Welfare in Portugal

This section addresses tax expenditures in Portugal between 1989 and 2011. It firstly situates the case, prior to the Great Recession, within OECD countries regarding TBSP and then performs a longitudinal analysis focusing both the level and composition of tax expenditures with a specific emphasis on the health sector.

Table 1. TBSP 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
USA	2.1	2.1	1	23	2
Germany	1.6	1.8	2	8	5
France	1.2	1.1	3	1	1
Portugal	**1.1**	**1.1**	**4**	**10**	**10**
Canada	1.1	1.6	4	22	15
Spain	0.5	0.7	6	9	14
United Kingdom	0.5	0.5	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: Own elaboration from Adema *et al.* (2011); Adema *et al.* (2014, pp. 14–15).

Portugal in Context: Tax Breaks with Social Purposes in OECD Countries

Table 1 shows the magnitude and rank order of TBSP[7] in a selection of OECD countries. The variation across cases does not map neatly onto the familiar three worlds of welfare capitalism (Esping-Andersen 1990). Still, residual levels in Nordic countries fit expectations well, considering the little room for private provision in that regime since reforms in the nineties began taxing social benefits. Inversely, it is hardly surprising to find that countries with higher TBSP include the North-American liberal regimes. However, there is variation here: British TBSP are on or below average. The conservative type, including Southern Europe, shows the wider and most interesting variation: from high in Germany (1.6 per cent) and Portugal (1.1 per cent), to medium in Spain (0.5 per cent), to low in Italy (0.2 per cent). Portugal's high ranking in fourth place stands out.

Social Tax Expenditures in Portugal from 1989 to 2011

In Portugal, TBSP[8] more than doubled in the decade before the bailout, 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), mortgage 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 top 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 averages 34 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. (DGCI 1989–1998, Adema *et al.* 2011)

The Case of Healthcare Tax Expenditures

Tax spending with healthcare has been the largest. In 2004, it was the largest 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). The same year, 74 per cent of Portuguese families included in their income tax returns 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 quarter of the families (CFSSNS 2007, pp. 118–19).

Healthcare tax expenditures grew steadily from 1992 to 2010. The growth levelled off with the onset of the crisis, and declined in 2011 with the Portuguese bailout. Chart 2 discriminates between OOP payments and insurance premiums. Unlike in the US or Germany, the volume of tax

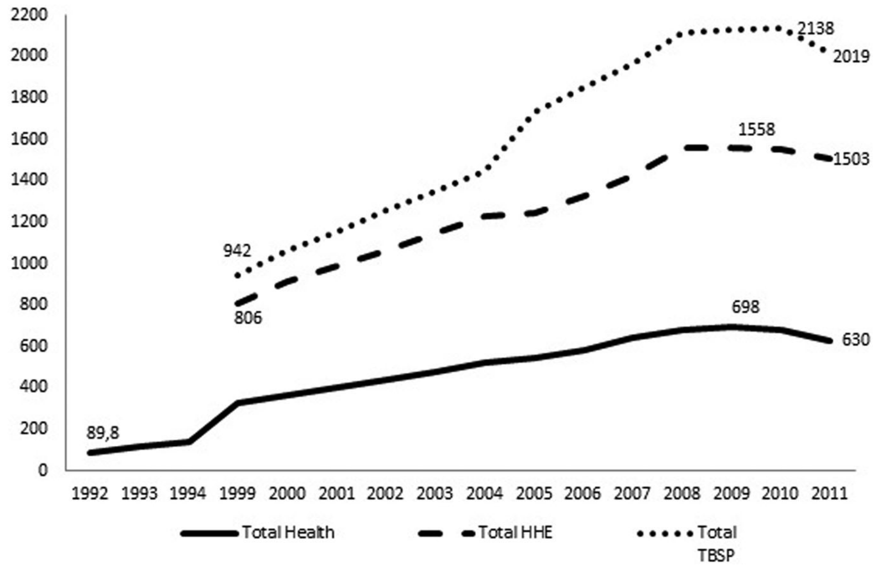

Chart 1. TBSP by level and structure, 1992–2011, in M€. Source: Own elaboration from Adema *et al.* (2011); DGCI (1989–1998); Gouveia (1997).

expenditures with health insurance is very small, never more than 6 per cent. Insurance is 'supplementary to the National Health Service (NHS) coverage': 20 per cent of the population has taken it up, of which about half are employer provided group insurance and the other are individual policies (Barros *et al.* 2011, p. 65).

This is a general feature of Portuguese social tax expenditures: the tax spending towards private insurance is much smaller than towards 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 mortgage loans, not healthcare.[9] Thus, while Portuguese TBSP grew throughout, its redistributive impact towards the better-off is not as regressive as in those countries that favour tax expenditures towards financial insurance products. While increased TBSP is an objective public subsidy to private provision of welfare, it is not indicative of a path-shifting move to market financialisation of welfare.

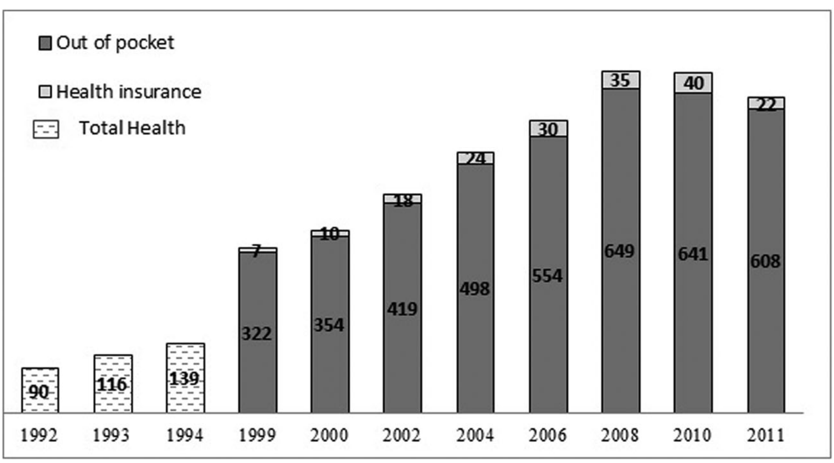

Chart 2. Healthcare TBSP, by volume and composition, 1992–2011, in M€. Source: Own elaboration from Adema *et al.* (2011); DGCI (1989–1998).

Table 2 shows the continuous growth of healthcare TBSP relative to total national health expenditures, public health expenditures and GDP. These are very significant sums from the point of view of lost revenue for financing public health services, NHS sustainability and equity. For instance, in 2010 the revenue foregone in health tax expenditures was ten times the revenue paid in user charges in the Portuguese NHS.

Because TBSP finance OOP expenses, their high level indicates the centrality of OOP expenses in the financing of healthcare. Portuguese OOP are among the highest in Europe, never below 20 per cent of total expenditure: 23 per cent in 2006 (or three quarters of the overall private share of 29 per cent). 2009, OOP accounted for 4.2 per cent of final household consumption, the seventh highest of OECD countries (2011, p. 135). The Portuguese income tax system is 'slightly regressive in health care due to a high share of OOP payments along with a heavy reliance on indirect taxes'. The generous system of tax benefits to private health spending compounds the regressive lean of health care funding (Barros *et al*. 2011, p. 52).

Table 3 evinces how health TBSP regressively distribute income to middle and upper strata.[10] Since 1980, the national total went from 1 to 18 per cent, benefiting mostly the better-off. The share refunded in 2000 to the better-off (24 per cent average for the top three deciles) is much larger 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). The policy change in 1999 from tax allowances to tax credits, to the benefit of tax payers in the first 8 deciles, did not stop the 2000 distribution of recovered income from following the income distribution rather than the health expenditure one (which is more evenly distributed, even skewed, towards lower income deciles). Health TBSP became less regressive during the 2000s, yet far from equitable (CSFSNS 2007, p. 121).

Health tax breaks are doubly regressive. Tax-paying families can benefit; low-income families, not liable to income tax, cannot – despite making health expenditures. In 1990, 90 per cent of pensioners received pensions below the minimum wage (78 per cent in 2013) (Pinto and Santos 1993, p. 196, Santos *et al*. 2018, p. 482), and were not required to file income tax return, despite having health expenses. In 2000, four in every ten families could not benefit from any tax break because their

Table 2. Healthcare TBSP trends, 1992–2011.

TBSP as a share of (%)	1992	2000	2004	2008	2011
Total Health Expenditures	2	3.3	3.7	**4.1**	3.8
Public Health Expenditures	3	4.9	5.3	**6.2**	5.8
GDP	0.13	0.29	0.35	**0.40**	0.37

Source: own elaboration from Gouveia (1997), DGCI (1989–1998).

Table 3. Share of health expenditures recovered, by income group, 1980–2000.

	% of recovered expenditures		
Income decile	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, p. 121).

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, p. 123). In fact, the distribution of health risks is the inverse of the distribution of tax benefits across income groups. Though low-income households pay relatively more health expenditures, they cannot '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, p. 53).

Explaining the Golden Age of Tax Expenditures in Portugal

This section develops a new argument for the long rise and later taming of Portuguese fiscal welfare, from 1989 to 2011. It addresses three empirical questions. Why was the tax expenditure policy regime created in 1989? Why did it grow continuously, in view of fiscal discipline concerns and such regressive income distribution? Why was it curbed in 2011?

The Beginning of the Social Tax Expenditure Policy Regime

Section two argued that fiscal welfare ought to be understood from two analytical frameworks: tax policy and social policy development. This section introduces the creation of tax expenditures in Portugal in both these contexts.

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. After the 1974 Carnation 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 a low income level. Tax incentives were deployed to influence private investment decisions and other 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, p. 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 *complementary tax*, continued as designed back in the 1960s. The tax structure was deemed by the Prime-Minister Cavaco Silva as unfair, inefficient and archaic (Silva 1989).

From the mid-seventies, 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 (1974–76) with a social-democratic political economy in dire economic and financial straits, triggering an IMF (International Monetary Fund) intervention in 1977, followed by a steep economic crisis in the first half of the eighties, which triggered a second IMF intervention and adjustment programme, in 1983–85.

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 to mass taxation *and* the eighties market-conforming tax reform.[11] 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.[12] The new income tax sought to regulate tax incentives in a more ordered and accountable way.[13] It created social tax expenditures for healthcare, education, mortgage interest, rest homes, private pensions and life insurance.[14] These were all tax allowances[15] and all had statutory limits – except for health expenses: deducted in full with no cap, yielding a steep regressive effect upon income distribution (Gouveia 1997, p. 82, CSFSNS 2007, p. 114). This was admittedly designed to foster the private sector's role in health provision, to enlarge the fiscal base while preventing tax evasion by private doctors (CSFSNS 2007, p. 111).[16]

Social Protection and Redistribution in Newly Democratic Portugal

In Western Europe, since the end of the seventies, welfare states underwent varying forms of retrenchment and recalibration (Huber and Stephens 2001, Pierson 2001, 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 programmes under fiscal, unemployment and demographic pressures, coverage and expenditure levels continued to expand well into the new century, aided by a looming economy (GDP *per capita* growth of 3.5 per cent per year from 1986 to 1999). As a result of 'catch-up convergence' in expenditure levels with EU (European Union) countries, universal coverage in social security was attained, while the intensity of protection also rose (O'Connor 2007, pp. 233–6).

Portugal presents a successful transition to democracy, structural economic reform and welfare state (Maravall 1997, pp. 74–125). 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. This showed that the opening up to the international economy after the golden age was 'still compatible with welfare state development' (Glatzer 2005, p. 107).

Portugal 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 – and the politics it entails – is what demands clarification. In that regard, the literature concerning the role of electoral politics proves extremely useful.

The Portuguese party system was established after the 1974 revolution. The recently created center-left *Partido Socialista* (PS) and the new center-right *Partido Social-Democrata* (PSD) became the largest parties, which have been in office (alone or in coalition) since 1976. They are catch-all parties with a strong electoral orientation and incipient linkages to civil society, seeking throughout to mobilise a vast centrist electorate (Gunther 2003, Teixeira 2009, p. 283, Belchior and Freire 2013).[17] Tax expenditures have become effective instruments in the mobilisation of votes and in securing the electoral allegiance of middle-classes to the governing parties, alongside other policies benefiting the rise of families' net income (Lobo 1996).[18]

Indeed, tax expenditures were set up in 1989 by the governing party (PSD), in the context of sustained economic growth and accession to the EU, amid various fiscal expansionary measures which resulted in the growth of families' net income and ultimately in the incumbent's re-election (Lobo 1996, p. 1111). Moreover, the scant parliamentary debates on the creation of the tax expenditure regime make it clear that both centre-left and centre-right parties see it as a benefit for the middle-classes, even if to the disadvantage of lower income strata.[19]

We extend and modify Karakoç's argument on the targeting of social benefits in new democracies: targeting may flow through direct or indirect means. Portugal displays a case of 'targeted fiscal welfare'. In democratic Portugal, the remaking of the authoritarian corporatist heritage of fragmented employers' and workers' organisations and insurance funds went furthest, delivering the lowest fragmentation of social protection in Southern Europe (Marí-Klose and Moreno-Fuentes 2013, Petmesidou 2012). In conjunction with a relative lower salience of clientelistic linkages (Afonso *et al.* 2015) lower fragmentation channelled the targeting 'thrust' to the indirect side of social expenditure (fiscal welfare). In more fragmented Southern European welfare regimes (such as Italy and especially Greece), the targeting occurs on the direct side of social expenditure and is a 'crucial instrument in clientelistic-particularistic exchanges' (Petmesidou 2012, p. 187).

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 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 subsidised 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 this orientation by 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 health expenses *in toto* was paradigmatic (Pinto and Santos 1993, p. 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, p. 106).

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 kept the policy regime in place, and growing. Over time, tax expenditures spawned an array of provider interest groups with enduring vested interests and elicited widespread support from middle class strata. Path-dependency obtained as change presented increasing political costs, in spite of rising revenue loss and inequality effects, as seen above.

Looking first at the supply side, we shall find that fiscal welfare is spent with goods and services provided in the market by powerful and well organised economic, professional and civil society organisations. These provider interest groups develop a vested interest in fiscal welfare for they stand to gain from it: the government, via tax expenditures, makes markets for them by subsidising their consumers, and often the providers themselves (for example, by exempting third-sector providers from the corporate tax).[20]

Which providers? In the healthcare arena, 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 expanding association protocols with the Ministry of Education, while pre-schools and rest homes are owned mostly 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 implement public policy together with the government (Fernandes and Branco 2017). Fiscal welfare contributed decisively to the burgeoning mortgage credit market. The banking sector found in widespread fiscal welfare to mortgages an objective subsidy to credit consumers, therefore to its core business of credit provision.

These are powerful associative, economic and financial sectors, very well organised, with representative peak national associative bodies, often integrated in neo-corporatist institutions of policy-making. The Medical Association holds a professional monopoly and wide regulatory functions granted by the Constitution and is a major stakeholder in the National Health Service.

The 'third sector' constellation of *ca*. 5000 IPSS, *Misericórdias* and mutual associations is the strongest and best organised 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 M€ 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. According to Santos, Rodrigues and Teles, 'Between 1987 and 2011, 73 per cent of the government budget devoted to housing was spent on subsidies associated with loans for permanent ownership' (2018, p. 480). A regime of subsidised credit for home loans was effectively 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 per cent of all credit to individuals, sum total of 119,6 M€ (6,6 per cent 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 breaks are used in a widespread manner by income taxpayers. In 2004, 75 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 (*Estatuto dos Benefícios Fiscais)* were also turned from tax allowances to tax credits, namely for retirement pension plans (Ministério das Finanças 1999, pp. 93–9). 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 per cent tax credit but with a cap.

Despite bi-partisan support for the tax expenditures regime, 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 latter were strongly against the move from allowances to tax credits, asserting that, 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.[21] The centre-left government explicitly justified the change with the need to curb the regressivity of the allowance regime. As the socialist Finance Minister argued during the parliamentary debate: '*This measure intends to alleviate the profound regressivity, the contrary of progressivity, (…) that has always been present in the IRS system*' (DAR, November 12th 1998, p. 633). Thus, while different left and right parties' programmatic preferences (Faricy 2015) do not seem to drive the Portuguese case overall, it may help explain variation *within* the tax expenditure regime, since the changes introduced in 1999 by the centre-left government curbed some of the regressive distributive effects (see Table 3, above).

As regards health policy, particularly in the period up to 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, p. 17). The role of the state changed from financer and provider of health services to that of 'buying and coverage of health services provided by the private sector' (Mozzicafreddo 1992, p. 70).[22] In the long run, the NHS generated a peculir mix of public, private and third sector. Around 30 per cent of the total health expenditure is private, of which three quarters 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 NGOs 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, p. 19).

The End of a Golden Age?

Tax expenditures have grown in Portugal in an era of permanent fiscal discipline, namely since the accession to the European Monetary Union (EMU) and then the Euro. May 2011, the adjustment programme in the Portuguese bailout cut them down and curbed their regressive effects on income distribution, not out of a particular concern with inequality, but driven by the need to cut expenditures, as explicitly stated in the bailout documents.

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 to 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 (Ministério das Finanças 2012–2013).

The *Memorandum on Economic and Financial Policies* and the *Memorandum of Understanding on Specific Economic Policy Conditionality* (MoU) 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 (Governo de Portugal 2011a, 2011b). The 2012 budget set progressive limits for social tax expenditures from the third to the sixth income brackets (Ministério das Finanças 2012). That year, taxpayers in the top two income brackets could no longer benefit from any tax credits, while those in the lower brackets continued to do so with no limit. From 2013 on just those in the lowest bracket were eligible.

The MoU 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 organised interests (Petmesidou and Guillén 2014, p. 301, Rodrigues and Adão e Silva 2015, p. 36). The adjustment Programme yielded an array of spending cuts in public outlays, and of cyclical and structural reforms, most notably in the case of labour market regulation, with path-shifting outcomes (Cardoso and Branco 2018).

Conclusions

Fiscal welfare has been a social policy modality relatively neglected by the comparative literature on social policy.[23] This paper helps to fill 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 – above 1 per cent of GDP. Its biggest share is for refunding health OOP, which have, as per usual 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. Indeed, health TBSP 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. Finally, the fact that health TBSP towards private insurance are residual suggests that they have helped to make 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? We presented a three-part argument, deploying insights developed in the theoretical discussion. We first argue 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 favouring middle and higher strata. 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 the Euro (1999).

In this context, this paper argues that the Portuguese tax expenditure regime ought to be understood with reference to the interaction between the relative degree of fragmentation of social protection regimes (as it connects with the nature of targeting through direct social expenditure) and the steady opening to private providers of specific social protection arenas, such as healthcare, housing and education. Finally, we contend that such a resilient outcome was curbed only in 2011 by the harsh conditionality of the economic and financial adjustment programme of the Portuguese bailout, an instance of how deep crises provide opportunities for path-shifting reconfigurations of social policy.

Notes

1. The exception is Santos and Rodrigues (2006).
2. Indeed, a OECD (2010, pp. 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.
3. For example, in Thatcherite Britain, tax relief for private pensions rose 106 per cent while direct expenditure on state and supplementary pensions rose only 13 per cent. Whereas total 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 eighties, relief to mortgages approached 7000 M£ *per annum*, while government gross capital expenditure on housing was around 3700 M£ (Judge 1987, p. 19, Mann 1992, p. 95).
4. During the 1990s, in Denmark and in the UK, the cost of tax expenditures remained unclear for lack of regular monitoring and publicity. When public spending was put under increasingly tight controls, such obscure nature made the likelihood that they would be cut down or constrained that much smaller (Kvist and Sinfield 1996, p. 38).
5. The exception is pro-poor or pro-working poor measures such as the EITC (USA), the WTC and Child Tax Credit (UK) or instances of negative income tax. See Howard (1997) and Myles and Pierson (1997).
6. This is a solid empirical finding. See data in Howard (1997, p. 28), Howard (2009, p. 91), Hacker (2002, p. 39), Mettler (2011, p. 23), Faricy (2015, pp. 186–96). For Portuguese data, see Pinto and Santos (1993, pp. 195–7, 202); Gouveia (1997, pp. 95–6); Santos and Rodrigues (2006, pp. 111–16) and CSFSNS (2007, pp. 121–3).
7. 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).
8. With the goal of enhancing comparability, we use the same definitional perimeter as Adema *et al*. (2011, 2014). Note that this refers only to the income tax and excludes pensions. This option does not mean a lack of acknowledgment of the relevance of pension plans in the Portuguese tax expenditure regime. In fact, the value of PPR (financial applications which offer their capitalised value at retirement) has increased significantly during the nineties and the early 2000s (Santos *et al*., 2018, p. 484), actively promoted via income and capital tax breaks. Still, the value of tax breaks for healthcare or housing, for instance, have consistently been around three times higher than those referring to PPR. This provides a measure of the relative importance of pensions plans within the Portuguese tax expenditures regime. Between 1999 and 2011, while the first have amounted, in average, to *ca.* 500 M€ each *per annum,* tax breaks towards PPR have represented an average value of 116 M€ (Ministério das Finanças, 1999–2011).
9. Even though this paper does not explore in depth the housing tax expenditure regime, it is important to underline that since the eighties, government policy on housing has focused the promotion of private ownership through the fiscal support of mortgage housing loans. As with private healthcare, the access to this type of loans – and to the ensuing tax breaks – is tilted towards middle and upper strata.
10. See Gouveia (1997, p. 96), and Santos and Rodrigues (2006, pp. 111–16) for additional empirical evidence.
11. Decree-Law 442-A/88, November 30th.
12. 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, pp. 241–8).
13. Decree-law 215/89, July 1st.
14. The regulatory framework is laid down in the Constitution (Art. 109), the *Estatuto dos Benefícios Fiscais* (EBF) (Art. 2, n° 3, decree-law 215/89), and the *Lei de Enquadramento do Orçamento do Estado* (1991, in the wording of the art. 13, n.° 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.

15. Deductions made to gross income.
16. 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, p. 193).
17. Moreover, during the revolutionary period the traditional class/religion divides among voters have been surpassed by strong confrontations concerning the democratic nature of the political regime which underpinned a vast centrist electorate, whose vote is strongly influenced by short-term factors (Gunther 2004, Jalali 2004, Teixeira 2009).
18. In Portugal, economic policies are crucial in the mobilisation of voters as, on the one hand, it is a historically poor and unequal country and, on the other, the improvement of living conditions is seen as a necessary output of the new democratic regime.
19. *Diário da Assembleia da República*, April 29th, June 17th and July 22nd, 1988.
20. Our insight, that emerging powerful interest groups stand to benefit from targeted fiscal welfare policies deployed by parties seeking electoral gains, should qualify the framework and relative salience of clientelistic exchanges across Southern Europe (cf. Afonso *et al*. 2015).
21. *Diário da Assembleia da República*, 11–13 November, 1998.
22. A report from the Ministry of Finance advocated the increasing importance of policy models that 'replaced the direct intervention of the state in economic and social life with marked-based solutions and private entrepeneurship' (Minstério das Finanças 1993, p. 63). From 2000 to 2008, up to 48 per cent (2002) of public health spending went to private providers. This share has been decreasing, but in 2008 it was still 43 per cent (INE 2010, p. 20).
23. An important exception is Morel *et al*. (2018).

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