Welfare State Growth and the Current Crisis in Portugal:

Social Spending and its Challenges

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A central consequence of Portugal's transition from authoritarian rule to democracy is a massive transformation in both the size and scope of the Portuguese state. Despite much lower GDP/capita, the Portuguese state has levels of public spending that frequently rival or exceed those of the more developed states of the OECD or of the EU. As in the wealthier countries, the bulk of this spending consists of social transfers, education and health. Concerned with social protection, access to education and the right to healthcare, the Portuguese state is primarily a welfare state. These efforts are extraordinary, on several levels. The vast majority of the growth in expenditure occurred post-1974, a period marked initially by high levels of economic volatility, both domestically and internationally, but above all by a slowing of average economic growth rates. This is a welfare state built after the golden age of postwar European growth. Following the deep divisions and policy reversals of the revolutionary period, it reflects a relatively strong consensus among the major political parties concerning the functions of the state. Finally, it represents a substantial organizational and technocratic achievement. The state was able to erect institutional structures with wide scope and universal coverage that have been broadly popular. Democracy, in other words, was not only a formal achievement, but also changed the expectations citizens had of their state.

Nonetheless, outcomes have been decidedly mixed. While improvements in health have been dramatic, success has been only partial in the education sector. Poverty and inequality also remain high. More broadly, the growth of the state is in part a reflection of the uneven performance of the economy and of the private sector labor market. This is particularly the case when the measures used are expenditure relative to GDP or the creation of public sector jobs relative to private sector ones. The last decade has been in many ways a lost one, where economic convergence with rich countries' GDP/capita has actually reversed. Despite very substantial increases in taxation since 1974, budget deficits and the inability to control expenditure have been a chronic problem. Of greater concern, tools used to paper over or temporarily close these deficits have steadily vanished, leaving few options. The current crisis is thus long in the making. Even if the sovereign debt crisis gets resolved, low economic growth, problems of competitiveness and population aging are likely to place continual pressure on one of the major achievements of Portuguese democracy: its welfare state.

This chapter proceeds in several sections. After providing a broad overview of changes in the Portuguese state, the paper examines the growth of social transfers and public involvement in health and education. Middle sections focus on employment and labor market change and the continuing problems of poverty and inequality. The chapter concludes with a discussion of taxes, budget deficits and current challenges.

The Changing Size and Scope of the State: 1974 to the Start of the Current Crisis.

On the eve of the Portuguese revolution, Portugal was fighting three wars in its African colonies of Angola, Mozambique and Guinea-Bissau. It is thus not surprising that its military expenditure was large. At 6% of GDP, it was the largest single item in the government budget. Today, military expenditure has declined to 1% of GDP. But the state overall has grown tremendously, from 23% of GDP in 1974 to 46% in 2008 (Amaral, 2010: 50-51).

Four areas account for the bulk of the growth of the Portuguese state: social transfers, education, health and public employment (principally in the areas of education and health). In 1972, health expenditure was only 0.2% of GDP. By 2008 it was 5.6%. Education expenditure was 1.4% of GDP in 1972; by 2008 it was 4.4 (Rosa and Chitas, 2010: 27-28). Separate from the state budget but still part of public spending, the social security system accounted for 5.6% of GDP in 1974 but 16.1% in 2008 (*Ibid:*29). Education, health and social security thus increase from about 7.2% of GDP on the eve of the revolution to 26.1% of GDP in 2008.

Another way of looking at the growth of the state is through the number of people it employs. In 1974 200,000 people were on the public payroll. Today it is about 800,000 (Amaral, 2010: 55; Barreto, 2003). This increase far outstrips the rise in population, which grew by 25%, from 8.5 million residents in 1973 (low because of emigration) to 10.6 million (higher recently because of immigration) in 2008 (Rosa and Chitas, 2010: 12). Health care and education are labor intensive activities and it is these two sectors that account for most of the growth in public employment. Because teachers, university professors, doctors and nurses have higher than average levels of education, the share of government employment that is highly skilled has grown quickly. As a result, the government wage bill has grown faster than the already substantial increase in public employment.

Democracy has brought with it a tremendous transformation in the state, both doubling its size and massively expanding its scope while greatly reducing the proportion of national resources devoted to the military. From a budgetary perspective at least, the principal function of the state is social protection and social services. The welfare state has replaced the warfare state.

The tax increases required to finance this state have been considerable and only on rare occasions have these met with public protest. In fact cuts in expenditure are much more likely to elicit protests than increases in taxation, suggesting at least at one level that the increase in the social protection function of the state has been met with broad approval. The two principal political parties have each overseen expansions of social expenditure and polls suggest that the Portuguese broadly agree that the state has important responsibilities in health, education, pensions and the struggle against social exclusion (Cabral, Freire and Vala, 2003). For many of these areas there is broad consensus that they should be viewed as social rights.

Social Transfers

One way to measure the growth of the welfare state is to look at the growth in the number of people receiving social transfers. The number of beneficiaries of the social security system has expanded by more than 50 times since 1960 (Rosa and Chitas, 2010: 54). The number rose from a mere 56,000 in 1960 to 800,000 by 1975, 2 million by 1985, 2.5 million by 2000 and is approaching 3 million today.[1] Notable in this data is the fact that social transfers start during the Salazar dictatorship, though they grow at only a moderate pace during the low to mid 1960s, accelerating in the late 1960s and early 1970s. The low numbers reflect a variety of factors. As late as 1970, life expectancy was 67 (Amaral, 2010: 15). There were thus relatively few elderly

1 This number reflects both beneficiaries of the social security system as well as the Caixa Geral de Aposentacoes, the separate system for many state employees.

as a proportion of the population. The proportion of the elderly who met eligibility requirements was low, both because the system was relatively new and thus few qualified for benefits, and because large segments of the working population remained uncovered. This explains why disability pensions constitute the largest proportion of pensions in the early 1960s.

The rapid rise in the number of people receiving transfers in the democratic period reflects political decisions to both increase the number of risks covered as well as decisions to extend the pension system to previously unprotected segments of the population such as rural workers or domestics. Expansion of the system of social transfers predated the call in the 1976 Constitution for the establishment of a comprehensive social security system. 1974 saw the introduction of a social pension for elderly or disabled who had not contributed to the system. 1975 saw the introduction of unemployment assistance. Sickness, old age and disability insurance for the self-employed would follow. As a result, the *Lei de Bases da Seguranca Social* of 1984 is as much about reorganizing an existing system as about establishing a new one from scratch. Nonetheless coverage of new risks continued to be added to the system of social transfers. In the mid-1990s, for example, two programs designed to combat deep poverty, the *Rendimento Minimo Garantido* and the *Rendimento Social de Insercao*, were added. A broad range of risks is thus now covered by the Portuguese welfare state. These include old age, survivors, disability, sickness, child and poverty transfers. Although the monthly social pension remains small, the non-contributory scheme ensures virtually universal access to pensions by the elderly.

With the establishment of a comprehensive social protection system, the number of recipients increases virtually automatically as a result of demographic change associated with the aging of the population, longer life expectancy or deterioration in the labor market. Steep drops in fertility rates (now below replacement level) combined with increased life expectancy have led to an ever greater proportion of the population that is elderly and thus eligible for a pension. Population aging places great pressure on pay-as-you-go systems where outlays come largely from current revenues, not from savings. In 1974, the ratio of pensioners to the labor force (employed and unemployed) was 1:5. Today each pensioner is supported by only 1.7 people in the labor force (Rosa and Chitas, 2010: 54).

The cost of providing these benefits is large. From 1995 to 2008, social transfers increased from 11.2% of GDP to 15.6% (Bank of Portugal, 2009: 350). By contrast, the weight of social transfers in the Euro Area 12 declined during this period from 16.9% to 16.1% of GDP. Portugal, the poorest country in the Euro Area 12, devotes a comparable share of its wealth to social transfers.[2] Recent reforms have discouraged early retirement, altered indexation to inflation, and changed the benefits formula to reduce the weight of the more recent (usually high-earning) years of contribution and to better take into account longer life expectancy. These changes will reduce benefit amounts compared to the earlier calculus.

Health

Democratic Portugal has also seen very substantial increases in state-funded health care. As noted above, public spending on health increased from 0.2% of GDP in 1972 to 5.6% in 2008 (some analysts place it at over 7%).[3] The National Health Service, created in 1979, is

2 The Euro Area 12 consists of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

3 Research at the OECD estimated public social spending on health in 2005 to be 7.2% of GDP (Adema and Laique, 2009: 26). Variation in definitions, categorizations and data sources explain the variation in figures. For a discussion of definitions see OECD, 2007. Rosa and Chitas use data compiled by PORDATA (~~www.pordata.pt~~). For alternative data series of Portuguese social spending, see Carolo and Pereirinha, 2010.

dominant. Although Portugal has a private-public mix, with private insurance available and with doctors able to practice in the private system, the overwhelming majority of visits to the doctor take place in the public system. This is especially true for primary care and general practitioner visits. Doctor's visits per person per year have increased five-fold since 1960, from 0.9 then to 4.4 in 2008 (Rosa and Chitas, 2010: 44). A similar level of increase is found in the number of doctors in this period, which rose from 7,000 (most of them not on the public payroll then) to 39,000, and in the number of people per doctor, which fell from 1253 per doctor to 273. Similar trends apply to nurses. Budgetary outlays are not restricted to medical personnel. New hospitals and health centers have been built and diagnostic equipment purchased. In addition, the state pays for the vast bulk of pharmaceutical prescriptions. Health expenditures account for about 15% of public expenditure, which is higher than the EU-15 average. This percentage has been relatively stable since 2000, but some of this is illusory and cost pressures are likely to rise for several reasons. First, demographic pressures, again in the form of population aging and longer life expectancy, will inevitably translate into greater demand for services. Second, technological innovation in the health sector can increase costs quickly. (It should be noted that these first two sources of pressure are shared with other developed societies.) Third, the Portuguese state already runs large deficits in the medical sector, most famously with respect to pharmacies but also to other providers. This means that expenditure hasn't kept up with costs. Finally, low economic growth and pressure on the budget will exacerbate the need to control costs.

Nonetheless, the outcomes have been very substantial indeed. These large investments in health correlate with large increases in life expectancy, from 67 in 1970 to 79 in 2008 (Amaral, 2010: 15). Infant mortality has fallen from 51 per 1000 live births in 1970 to 3 per 1000 in 2008, among the lowest in the world. Deaths in childbirth have also fallen dramatically, from 116 per 100,000 births in 1960 to 4. A number of reasons beyond public investments in health are cited for this tremendous success in health outcomes. These range from greater level of education and knowledge among the population at large, health seen as a right (as stated in the Portuguese constitution), and improved material conditions in housing, diet, water and sanitation. Luciano Amaral notes the important point that the Salazar dictatorship saw major improvements in these indicators without corresponding public investments in health. Life expectancy increased from 38 in 1930 to 67 in 1970 and infant mortality declined from 144 per 1000 live births to 51, for example (Ibid: 24). This raises the interesting question of how much health indicators would have improved as a result of economic growth and improved living standards, irrespective of public investments in health. Perhaps it is fair to say that the low-hanging fruit of better diet, warmer homes, and improved sanitation systems are likely to have already made their impact. Improvements in health are certainly the result of a multiplicity of factors but it is likely that the availability of modern health care at very low cost to the user plays an increasingly important role in recent improvements. Nonetheless, the point remains that large investments in a publicly-provided health care system have been accompanied by major improvements in health outcomes.

Education

Education is another area in which massive investment by the state has taken place. Public spending on education rose from 1.4% of GDP in 1972 to 4.4% in 2008 (Rosa and Chitas, 2010: 24), though some analysts place public spending on education currently at over 6%. This considerable expenditure, amounting to about 12% of public outlays, is visible in a number of indicators that demonstrate much greater access to education under democratic rule.

The Salazar regime had made slow progress against illiteracy. In 1930 illiteracy was 60%; forty years later in 1970 it was still 26% (Amaral, 2010: 23-24). Compulsory education had increased during the last ten years of the dictatorship, to 6 years in 1964 and 8 in 1973, but enrollment lagged. In 1974 only 20% of children were enrolled in middle school. In 2007 that number was 87%. Under democracy years of compulsory education increased further, to 9 years in 1986 and to 12 in 2009, but enrollment lags continued to be a problem. High school enrollment rose from a paltry 9% in 1974 to a much improved but still meager 60% in 2007.

Improvements have been most dramatic at the beginning and the end of the education spectrum. Children enrolled in pre-school increased from 6,000 in 1960 to 266,000 in 2008 (Rosa and Chitas, 2010: 31). University degrees, once the sole purview of a small elite, were conferred on 19,000 people in 1995. By 2008, the number of students receiving university diplomas stood at 84,000. For the last two decades, a sizeable majority of degrees have been conferred on women. Since 1994, women have received 60 to 68% of the yearly total of degrees (Ibid: 35). While the large increase in university enrollment and graduations are a major achievement, the labor force remains under-educated in comparison to the more developed societies of the OECD. This is so for two principal reasons. First, older workers have much lower levels of educational attainment compared to workers in these other countries. Using data from 2006 and with the exception of Mexico, Portugal ranks lowest or very close to the bottom among OECD countries in the percentage of its population aged 25 to 64 who have completed upper secondary or completed tertiary education. The same ranking applies for the population aged 25 to 34, indicating that even in the 1990s virtually all other OECD countries, with the exception of Mexico, continued to surpass Portugal. By 2006, however, entry rates to and graduation rates from university had climbed. They were still below the midpoint of the range, but no longer at the bottom (Bank of Portugal, 2009: 386).

Second, and of greater concern, is the problem of educational failure, or *insucesso escolar* (Soares, 2010). This takes several forms. One is the large number of students who not only fail to complete high school on time, as we have seen, but who also fail to return to the educational system. One third of young people aged 18-24 is not in school and has not completed high school (Rosa and Chitas, 2010: 32). This is more than double the rate for the European Union as a whole. Another way in which *insucesso escolar* manifests itself is in the poor performance of Portuguese students in international tests. In the PISA tests, Portugal ranked fourth from the bottom, doing better than Mexico and only slightly better than Greece and Italy (Bank of Portugal, 2009: 387-388). This poor result is all the more problematic given that Portugal has the OECD's highest ratio of teachers to students and above average spending on education relative to GDP.

Social and demographic factors are often mentioned as causes of this comparatively poor performance. Teachers complain of a lack of student engagement. A large cohort of parents with low levels of educational attainment is perhaps less able to promote their children's education or perhaps value it less than parents with higher levels of education. Because education through high school is free and because the wage premium to education is high, expanding access to education and clear market signals of the opportunity cost of foregoing education don't seem enough by themselves to solve the problem of low educational attainment (Amaral, 2010: 78). Despite very large investments in education and improvements in average years of education attained, the results are decidedly mixed. High dropout rates and low performance on international tests continue to plague the Portuguese educational system.

Employment and Labor Market Change

The growth of the education and health sectors brought with it a large expansion of public employment. Although the size of the public sector is high on the public agenda today, it was long in the making. Local and central administration accounted for 196,000 jobs in 1968. By 1983 this number had risen to 516,000 and to 716,000 by 2001 (Barreto, 2007). Between 1980 and 2002 the public employment share rose from 9.7% to 17.0%, the steepest rise in the EU-15 (Handler et. al., 2005).[4] In a comparison that includes the US, Japan, Poland and the Czech Republic as well as the EU-15, Portugal's ranking in public employment share increased from 14th in 1980 to 7th in 2001, and was exceeded only by Sweden, Finland, Denmark, France and the UK. Looking at a more recent period, the OECD estimates government employment growth in Portugal between 2000 and 2005 at over 4% (OECD, 2008). Until the mid-2000s when Portugal's unemployment rate started to climb, the positive employment performance was in large measure the result of major increases in public employment.

Under democracy the state has become a significant source of jobs, accounting for about 20% of employment. This is particularly the case for university graduates, about half of whom find employment in the public sector (Bank of Portugal, 2009: 395). The weight of public employment is clearly visible in government expenditure data. The government wage bill consumed 12.9% of GDP in 2008, substantially higher than the Euro Area 12 average of 10.1% (Ibid: 350).

The state’s role in the labor market has not been restricted to public employment, however. Of equal importance are changes in employment regulations and labor market policy.

4 The EU-15 consists of the Euro Area 12 countries plus Sweden and the United Kingdom.

Although the upsurge in worker movements following the revolution was substantial and at its peak included the dramatic takeovers of farms and factories, this was relatively short-lived (~~Bermeo, 1983~~; ~~Baum, 1997~~). More long-lasting were actions taken by the state.

Unions became legal and free. Membership expanded quickly during the upsurge of worker movements but, with the exception of the public sector and a few areas of the private sector, such as banking, has declined since. Outside such areas, unions today are relatively weak. Member dues are opaque. Indicators of labor market protest actions such as the number of strikes or the number of days of work lost to strikes is low (Barreto, 2007).

However, low rates of unionization outside the public sector have been partially compensated by regulations that extend agreement between unions and employers to non-unionized workers (~~Stoleroff, 2000~~). In addition, tripartite bargaining between the state, employers' associations and the union confederations was institutionalized, though the success and impact of these economic and social accords has varied over time (~~Royo, 2002~~).

Employment protection legislation in the early years of the democracy was tightened, giving workers substantial protection from job loss but making it hard for employers to fire workers. The OECD ranks Portugal as having one of the highest degrees of employment protection legislation (OECD, 2004). Critics of employment protection legislation argue that it stifles hiring as much as it does firing. In so doing it reduces the ability of the labor market to react to changed circumstances. It is a drag on efficiency and is thought to increase unemployment.[5] Recommendations that Portugal weaken its EPL are frequent (Economist, 2011).

5 For a variety of perspectives, see Buechtemann, 1994.

However, unemployment for most of the democratic period has been quite low. The ability of the labor market to absorb the return of the Portuguese settler population from Africa and the demobilization of a large part of the military in the mid to late 1970s, when economic conditions were unfavorable, is remarkable and well-known (Blanchard and Jimeno, 1995). This has been partly attributed to wage flexibility, in turn facilitated by inflation and by currency devaluation. Four other factors have also been put forward to explain Portugal's low unemployment rate for most of this period. First, although a system for unemployment compensation was established early in the democracy, eligibility rules have remained tight by European standards. As a result the incentives faced by the unemployed to find a job quickly are quite high.

Second, employment protection legislation applies only to a protected class of employees, those with indefinite contracts. Finding it initially difficult to weaken the protections head on, Portugal, like many other Southern European states, liberalized the use of short-term and fixed-term contracts (Glatzer, 2000). A further change was the substitution of service contracts, known informally as *recibos verdes,* for employment contracts. These new types of contracts by-passed the otherwise rigid firing rules, and had the practical effect of reducing employment protection legislation.

Third, the state was eventually successful in weakening the employment protection rules directly. Reducing personnel due to economic or technological reasons is permitted, for example, and collective dismissal can be used for smaller numbers of workers than was previously the case. In comparison to other European countries, Portugal's employment regulation ranking remains high but no longer extraordinarily so.

Finally, employment growth in the public sector has masked weak employment growth in the private sector. In the absence of government employment, unemployment numbers would likely have crept up sooner. One irony is that the government itself resorted to fixed-term contracts and the use of *recibo verde* service contracts. In recent years, and particularly with the economic crisis, unemployment has grown quickly.

The evidence on the effects of employment protection legislation in Portugal is mixed. The creation and loss of jobs is relatively high, but job-switching is low and a high proportion of the unemployed are long-term (Amaral, 2010). Unemployment remained relatively low for much of the democratic period primarily because of the growth of employment in the public sector and the use of temporary and atypical contracts.

Although employment protection legislation in Portugal failed to be reflected in a high unemployment rate, it was not without negative consequences. The use of atypical and temporary contracts creates deeply inequitable divisions between protected and unprotected workers. Protected workers have indefinite contracts, job stability and participate fully in the protections offered by the welfare state. Unprotected workers are much more likely to have interrupted work histories and greater levels of financial volatility and instability making long-term planning difficult. In addition, they often fall between the cracks of social protection systems. They are at much greater risk of being ineligible for unemployment compensation, have less access to paid vacations and their spottier work histories will be reflected in lower retirement benefits. Young workers are much more likely to be unprotected, which creates a sense of frustration and disillusionment. This said, it is important to strike a comparative note. Portugal is not alone in these problems and by some indicators has done comparatively well.

Many European countries have had overall and youth unemployment rates well above the Portuguese average for much of the democratic period.

It is also important to note the huge structural changes undergone in the labor market. Women have entered the labor force in very large numbers. Unlike other Southern European and most continental European countries, Portugal's female employment rate is high. By 2007, the Portuguese female employment rate had reached 61.9% (Eurostat, 2009). Employment rates of older workers, both male and female, are higher in Portugal than in the EU average. Male employment rates used to be higher than the EU-15 average but have been declining since 2001 and by 2007, at 73.8%, had reached the EU-15 midpoint.

In 1974, the primary sector (mostly agriculture but also fishing) accounted for 34% of employment (Rosa and Chitas, 2010: 64). By 2008, this had declined to 11%. As Barreto notes, this movement out of agriculture resulted in internal population shifts towards the coasts and urban centers (Barreto and Pontes, 2007). In 1974 industry accounted for 33% of employment. This rose to 37.9% in 1991 but by 2008 had fallen to 28.9%. The service sector grew significantly during this period, from 33% of employment in 1974 to 61% in 2009. Despite the two-thirds drop in primary sector employment, Portugal remains the Western European country with the highest percentage of employment in agriculture.

The entry of women into the workforce and the rise of the service sector were the result of processes of economic development and social change, but they were also influenced by state action including the expansion of the health and education sectors. Labor market regulations shifted substantially with the turn to democracy even as the commitment to economic openness, started in the dictatorship, deepened, with profound implications for the nature of employment. As seen above, the state itself became a major employer, accounting for 1 in 5 jobs. Finally, the rise of social transfers expanded the role of the even further. By 2010, over 1 in 3 Portuguese received transfers from the state. The role of the state as a provider of income – either through social transfers or directly as an employer – had grown to levels that by several measures exceed the European average.

Poverty and Inequality

Despite a significant state effort in income support, high employment rates and, with the exception of recent years, comparatively low unemployment, Portugal continues to have among the highest poverty rates in Western Europe and among the highest levels of inequality in the European Union.[6] In 2007, with an 80/20 income quintile ratio of 6.5 in Portugal, only Romania and Bulgaria had worse levels of income inequality (Eurostat, 2009). 19.1% of the Portuguese population lived in poverty (defined as below 60% of median income) in 2000 (Rodrigues, 2007).

Several factors explain the apparent paradox of convergence to European norms in terms of substantial welfare state effort and a high level of direct state employment, but continued high poverty rates. The first set of factors has to do with the labor market, and with the problem of low wages and high wage inequality. The distribution of income is highly unequal and correlates closely with the high inequality in educational attainment. Income among agricultural workers is also low, contributing to significant regional differences in income and poverty rates. This can be seen in the high poverty rates of 50.4% for people working in agriculture and of 48.3% for people with less than a primary education (Rodrigues, 2007).

6 This section borrows from Glatzer and Baum, forthcoming.

There is considerable debate about the degree to which the Portuguese tax system and social spending reduces or helps replicate income inequality. Many analysts argue that evasion, tax shifting, deductions, reductions in the number of tax brackets, and the differential treatment of wage income from capital gains reduce the progressivity of the Portuguese tax system (Lopes 2005, OECD 2001 and OECD 2003). Writing in 2001, the OECD found that Portuguese "income taxation achieves little in the way of income redistribution" (OECD, 2001: 77). Two years later, the OECD had become more pessimistic, writing that "the fiscal system probably exacerbates the inequality of income distribution" (OECD, 2003: 90). The Portuguese welfare state, like many of the welfare states in Southern Europe, privileges pension spending. Although a social pension scheme covers individuals who did not contribute enough during their working lives to qualify for the regular state pension system, the bulk of spending occurs in the latter system and this system is Bismarckian, replicating differences in earned income.

However, other analysts find that state taxes and transfers are indeed redistributive and became substantially more so during the 1990s (Rodrigues, 2007). Improvements in tax collection and the development of substantial anti-poverty programs such as the *Rendimento Minimo Garantido* [Minimum Guaranteed Income] were effective in compensating for widening market inequalities of income. It is this greater redistributive effort of the state, countervailing ever wider wage inequality, which accounts for the relative stability of the Gini index.

Because the Portuguese welfare state is pension-heavy, it under-provides community social services such as day centers and long-term care for the elderly, the disabled or the chronically ill (Bronchi 2003). In response, the Portuguese state has developed tax incentives for charitable giving to social service non-profits and has also contracted out with these groups to provide services (Glatzer, forthcoming). The relative paucity of services in this area led some analysts to argue that Portugal was a welfare society (Santos, 1993). In the absence of state provision, society – either through the extended family or through the community – met needs. This concept has been challenged by findings that supportive social networks are richer and more prevalent at the higher end of the socio-economic and educational distribution. As a result, informally provided welfare seems to “reinforce existing social inequalities and to offer less support for those who most need support” (Wall, Aboim, Cunha and Vasconcelos, 2001: 230).

Taxes, Budget Deficits and the Run-up to Current Challenges

The very large increases in public expenditure required large increases in taxation and this Portugal has achieved, although concerns about equity and tax evasion persist. A large number of firms report annual losses, many professionals and self-employed fail to accurately report income, and tax shifting, in which income is declared as a business expense, for example, and taxed at a lower rate, is common. Nonetheless, the tax take of the government is substantial and has increased steadily over the democratic period. Notable is the convergence towards the average of the EU-12, a group of countries that on average are much wealthier than Portugal. In 1995, the total tax burden in Portugal amounted to 31.9% of GDP, still substantially less than the EU-12 average of 40.4% (Bank of Portugal, 2009: 344). By 2008 the tax gap had narrowed considerably. Portugal’s tax burden had grown to 37.5%, only 3 points below the EU-12 average, which had barely increased to 40.5%. Relative to its GDP/capita, Portugal is a high tax state.

However, the tax take is not by itself enough to cover expenditure. Expenditure in 1995 was 43.4% and 45.9% in 2008 (the latter figure is just 0.8% of GDP shy of average expenditure in the EU-12).

In stark contrast to the dictatorship, democratic Portugal has had great difficulty balancing its budget. Because budgetary problems have been so persistent, Portugal has engaged multiple times in episodes of budgetary consolidation to reduce deficits. These have frequently relied as much on tax increases as they have on expenditure cuts, even when done under IMF supervision. Balanced budgets are not, of course, a sign of virtue and budget deficits and debt play an important role in smoothing business cycles, in paying for investment and in meeting social needs. The Maastricht Criteria, for example, don't call for the elimination of budget deficits but rather limit them to no more than 3% of GDP, a limit that nonetheless has been frequently violated by many in the Euro area. Crucial to an evaluation of debts and deficits and their sustainability are the rate of economic growth, inflation and the interest rate. High growth makes it much easier to manage deficits.

The principal problem facing Portugal and a fundamental cause of its inability to borrow from the financial markets at an affordable cost are its low growth prospects. Unlike Greece, Portugal was accurate in its budgetary reporting and did not engage in fraud. Unlike Ireland and Spain, Portugal did not experience the collapse of a massive housing boom. But since 2000, growth in Portugal has been anemic, averaging just 0.7% per year (Economist, 2011). Convergence in GDP/capita towards the richer countries in Europe reversed. Triggered by the global recession and the Greek crisis, the lack of confidence among buyers of Portuguese debt came quickly. High interest rates are unsustainable for long and Portugal was forced to seek a bailout, the third since the transition to democracy, but this time with no recourse to a competitive devaluation. What happened to growth in the democratic period? How did Portugal reduce its budget deficits in the past? And what does this mean for the future of the Portuguese welfare state?

Unlike the postwar period of the dictatorship, when productivity (measured as GDP/hour worked) grew faster than in the most advanced countries, in democratic Portugal productivity has mostly grown at only the same rate as in the most developed countries (Amaral, 2010: 98). Portugal has been unable to close the gap, which since 1980 has ranged from 50% to 55% of the average productivity of these countries. Economic growth above productivity and the ability of the government to paper over budget deficits are explained by a number of factors, but these have either run their course or are otherwise no longer available. One is the growth of the labor force, principally fueled by the entry of women into the labor market. Given high current participation rates of women, this engine of growth has run its course. Fertility rates below replacement level suggest that the labor force will start to shrink, unless there is a compensating increase in immigration. As a result of these demographic shifts, high school enrollments have already peaked.

Declines in interest rates, partly stemming from anticipation of entry into the Euro and then as result of the common currency, provided the government with breathing room to consolidate debt as well as to run an expansionary policy. Declines in interest rates freed up several points of GDP from debt service to other uses. In 1995, for example, public expenditure on interest consumed 5.8% of GDP. As late as 2008, as a result of extraordinarily low rates set by the European Central Bank and after a series of budgetary consolidations earlier in the decade, interest consumed only 3% of GDP (Bank of Portugal, 2009: 350). Even if a return to low pre-crisis rates were possible, it will be a long time before interest payments consume so little of GDP.

Another consequence of the Euro was of course the elimination of exchange rate policy as an economic tool. Currency devaluations such as the crawling peg system which Portugal adopted to ensure economic competitiveness were no longer available. The calculation was that the elimination of exchange rate risk, the firmer anchoring of inflation in a Bundesbank-inspired European Central Bank and the elimination of transaction fees would elicit both higher cross-border investment as well as trade, leading to deeper economic integration. American economists in particular voiced concerns about asymmetric shocks and warned that Europe did not meet the criteria of an optimal currency area. Despite these debates, the Euro was a political project as much as an economic one and was successfully introduced. Nonetheless, the lack of an exchange rate policy constrains the actions of the Portuguese state. It is unable to restore competitiveness and promote exports through devaluation, one way in which Portugal's classic wage flexibility used to be achieved (inflation was the other means). Nominal cuts in wages are much harder to do, and especially so if the context is one of deflation.

Transfers from Brussels in the form of cohesion or structural funds were another way in which budget deficits could be closed and economic growth stimulated but this route too is largely over. Portugal is wealthier, so some regions that had previously qualified for funds no longer do. New accession members have asked for funds, and the growth of both government expenditure as well as the economy imply that even had the funds remained at their original levels, they would represent a smaller percentage of GDP.

Finally, for a number of years privatization was an important way in which governments could close budget gaps. Because so many firms have already been sold, fully or in part, this strategy is also starting to run up against limits. The measures to deal with the current crisis do involve privatization of a number of remaining state-owned-enterprises but the list is a dwindling one.

The result is to some extent paradoxical. A larger state, with greater responsibilities for social wellbeing, has lost an important set of tools that allowed it to manage the economy as well as to paper over chronic budget deficits. These tools help explain how Portugal could run an expansionary budgetary policy so frequently and how budgetary consolidation, even if temporary, could be achieved without drastic cuts in expenditure.

Now, however, the options are stark. Tax increases and cuts in spending while the economy is so weak are not only painful but throw the economy deeper into recession. In the absence of credible prospects for higher growth, debt rollovers will require unsustainably high interest payments. Deflation and continued high unemployment look likely. Exiting from the Euro, which would be very hard to manage and was until recently unthinkable, is now advocated as potentially the best option among unpalatable choices (Krugman, 2010; Rodrik, 2010), but strenuously ruled out by government. The considerably less draconian possibility of a haircut on the debt, increasingly seen as both likely and necessary by many independent analysts, continues to be disavowed by the government.

The Current Crisis: From Stimulus to Austerity to Structural Reforms

The financial and economic crisis that started in 2007 led to rapid increases in both budget deficits and government debt. Up to and including 2007, Portugal had made steady progress in correcting a high budget deficit of 5.9% of GDP in 2005. The deficit had been reduced to 4.1% in 2006 and to 3.1% in 2007 but it soared to 10.1% in 2009. This was the result not only of an 11% drop in tax receipts and increased spending as a result of the welfare state's automatic stabilizers but also a result of stimulus actions undertaken by the government, which included easing the rules on unemployment benefits. Efforts to shore up the labor market introduced in 2007-08 included targeted reductions in non-wage costs, expansions in job search and short-time working opportunities as well as training and income support for the unemployed (OECD 2012). By 2009-10, the Socialist government of Prime Minister Socrates decided to reverse course. Most of the labor market support measures introduced a year or two earlier were withdrawn as budgetary containment became the order of the day. The austerity measures implemented up to June 2011, when the new PSD-led government of Prime Minister Coelho took office, included a mix of increases in taxes, cuts in public sector pay and reductions or freezing of social benefits. Listed in a Research Note (European Commission Social Situation Observatory 2011), the mix of austerity measures tracked to investigate changes in household income included the following:

<u>Increases in Direct Taxes:</u>

Tax rates were increased by 1 and 1.5 percentage points depending on income level.

A new bracket for incomes above 153,300 EUR was introduced, raising the highest tax rate from 42 to 46.5%.

<u>Increases in Indirect Taxes:</u>

In January 2011, the standard VAT rate was increased from 20% to 23%.

At the same time the reduced VAT rate was increased from 12% to 13% and the base rate from 5% to 6%.

<u>Reductions in Tax Credits and Tax Allowances:</u>

The reference indicator for tax credits was reduced by replacing the 2011 minimum wage of 485 EUR with the 2010 minimum wage of 475 EUR or the 2011 social benefit index of 419.22 EUR.

The pension tax allowance was reduced.

Reductions in Social Benefits:

The nominal value of the social benefit index used for most social benefits was frozen at the 2009 level.

The nominal value of benefits not linked the social benefit index (such as pensions) was frozen from 2010 to 2011.

The social assistance benefit was frozen from 2010 to 2011.

Family benefit was frozen and eligibility conditions tightened.

Public Sector Pay

Public sector pay was cut by 10%.

When compared to Spain, Greece, Estonia, the UK and Ireland, simulations of the effects of Portugal's austerity measures led to the second highest increase in the risk of poverty, defined as household income below 60% of the pre-crisis median. Ireland had the highest increase in the risk of poverty among the countries studied but the size of its austerity cuts (8.1% of total household disposable income) was more than 2.5 times the size of the austerity cuts in Portugal (3.0% of total household disposable income). As a point of comparison, Spain and Greece's austerity measures during this period amounted to 2.7% and 2.2% of total household disposable income. If the poverty threshold is changed to 60% of the median of the new post-austerity distribution of income, the risk of poverty increased the most in Portugal (European Commission 2011).

The study also simulated the distributional effects of the austerity measures on household incomes and found that Portugal was the only one of the countries studied where the distribution was clearly regressive. A number of caveats need to be kept in mind. First, as mentioned by the authors of this study, the analysis focuses solely on the distributional effects of the austerity measures listed above. It excludes the very large distributional effects of the crisis itself (through increases in unemployment, for example, which were significantly larger in Spain and Greece than in Portugal). It also excludes cuts to public services that are not easily tractable in terms of the distribution of household income but which might have significant effects. Finally, the study only looks at what might be called the first wave of austerity measures implemented by June 2011. Nonetheless, the study raises important questions about not only the different size but also different design -- and impacts -- of austerity measures across countries.

The shift from initial stimulus to austerity as well as the shifting European economic outlook led to significant variation in Portuguese GDP growth rates during the crisis. Growth of 2.7% in 2007 on the eve of the crisis shifted to contractions of 0.35% in 2008 and 2.1% in 2009. GDP grew by 0.91% in 2010 but contracted by 1.6% in 2011 and is expected to contract by 3.2% this year. Difficulties in many of Portugal's most important European export markets, most notably Spain, deleveraging of debt at home, difficulty accessing credit, increasing unemployment, and the effects of new austerity measures agreed with the Troika all play significant roles in explaining the contraction.

In May 2011, the Socialist caretaker government agreed to the terms of a 78 billion EUR bailout package with the troika of the European Commission, the European Central Bank and the International Monetary Fund. The package required Portugal to not only implement additional austerity measures but to also engage in structural reforms. These included privatization of state-owned-enterprises as well as reform of its labor market and justice system. The PSD government of Prime Minister Coelho that took office in June 2011 has vowed to fully implement the troika's prescriptions and indeed to make faster progress in reducing the budget deficits than is envisioned in the plan. In contrast to Greece, where both political will and the track record of implementation have been questioned, Portugal has been cast as the "good student" of Europe, embracing and implementing the policy prescriptions it is being asked to carry out. Nonetheless, it is increasingly doubtful that austerity and structural reform will by themselves place Portugal back on a track of sustainable debt, economic growth and international competitiveness. Many think not only that a return to the financial markets by 2013 or 2014 is unlikely but that a haircut on the debt will be needed. The debt to GDP ratio was 107% at the time of the May 2011 bailout but is likely to reach 113% over the next two years due to the debts of regional governments as well as of some state-owned enterprises (Stratfor 2012).

To reduce Portugal's budget deficit to 4.5% of GDP this year from 5.9% in 2011 and to comply with the troika's terms, the new PSD government implemented its first set of austerity measures in November 2011. These include reductions in welfare spending and the health budget and cuts in pension spending. In addition, further cuts to public sector pay have been implemented. Proposals have included a reduction in the number of holidays and the elimination of holiday pay (13th and 14th months of pay, traditionally paid in August and December) for the next two years. Combined with earlier public sector wage cuts and increases in income tax, the take-home pay of many public sector workers is declining by over 22%. By reducing lunch to half an hour, the government has proposed increasing working hours in the public sector.

In the wake of the 2007 onset of the crisis, a number of structural reforms were implemented by the Socialist government. More are envisaged under the troika agreement and planned or carried out by the current government. These include privatization of state-owned-enterprises, reductions in the public administration workforce through adoption of a rule specifying a 2:1 ratio of job leavers to job hires, reduced administrative burdens on business, including the lifting of licensing for some services, and the liberalization of regulated professions (OECD 2012). Actions have also been taken to simplify the tax system and to broaden the tax base in consumption and income taxes while reducing tax expenditures.

Labor market reform is one of the troika's priority areas for structural reform and a number of steps have already been taken. With respect to regular contracts, notice periods for individual dismissals were shortened and administrative procedures streamlined in 2009. 2011 saw the introduction of lower severance payments for new hires. 2012 is likely to see the definition of fair dismissal expanded. Unemployment benefits will become less generous but eligibility will be extended. Both the OECD and the troika recommend that Portugal reduce labor market dualism by better covering the young while easing job protection in regular contracts and reducing the duration and replacement rates of unemployment benefit for older workers (OECD 2012). These reforms are being undertaken during particularly difficult labor market conditions. Overall unemployment stood at 14% in 2011 and continues to grow. Youth unemployment, as in so many European societies, is much higher and young university graduates are not immune – close to 10% of them are currently unemployed (Economist, 2012).

Other priority areas include developing a more efficient court system, long one of the most deficient areas of governance, liberalizing the housing rental market and promoting competition and reducing rents in the energy and telecoms markets (Europa 2012).

If budget cuts, liberalization and a turn to the market have characterized most measures of the government, education has stood out as distinct. Special attention has been paid to addressing chronic problems in secondary school-year repetition, to increasing opportunities for vocational education and training and to implementing a contested national evaluation system for teacher performance (OECD 2012).

In marked contrast to Greece, protests against austerity have been few and never violent. Although the CGTP union has protested the cuts, the UGT union has conceded that cuts are necessary and inevitable. Mirroring the division in the labor movement, a February 2012 poll revealed that although 48.4% of the population thinks that austerity is the wrong solution for the crisis, a sizeable minority of 40.3% believes austerity is needed. A sizeable increase in emigration, to 120,000 in 2011, principally to the fast-growing economies of Brazil and Angola, shows that many people have found and are exercising an exit option, reducing pressure on the government. The government, a stable PSD coalition with the People's Party, controls a safe 132 seats in the 230-member parliament and the principal opposition party, the Socialists, control only 74 seats, their weakest number in two decades. Portugal enjoys considerable international support from the troika (Stratfor 2012). Nonetheless, many of the newest austerity cuts have yet to bite and 2012 will be a year of deep recession: social indicators will worsen further.

Conclusion

To what extent then do the combination of spending cuts and tax increases that make up the austerity packages and the structural reforms rolled out by both the Socialist government in the last two years of its term and by the new PSD-led government under supervision of the troika amount to a rescaling and reorganization of the Portuguese welfare state? To what extent will this recalibration of social policy and social protection alter the distribution of income or the distribution of opportunity in Portuguese society?

It is too early to answer these questions definitively but some points are already clear. Older ad-hoc solutions to long-standing problems are no longer tenable. Employment growth in Portugal was disproportionately concentrated in the public sector and masked anemic employment growth in the private sector. This route of state-supported income is now largely closed off. Inequalities in employment protection and access to unemployment compensation stemming from the dualism of the labor market are being reduced. While there are grounds to support this from the perspective of equity, in the absence of robust job creation this creates a serious risk of increasing precariousness and risk. Although rigid labor laws have prevented hiring of young people on regular contracts, those same rigid labor laws have often ensured job stability and access to generous unemployment benefits for at least one parent in the household. Removing such protections during a recession with no end in sight is likely to increase the number of zero-employment households at a time when social benefits are being cut or frozen. Studies that suggest that Portugal's austerity packages are distinctively regressive are worrying though in many ways sadly not surprising – income inequality has long been high in Portugal, despite and sometimes because of its welfare state. Household and private sector deleveraging of debt will take time, particularly in a context of low growth.

These ominous developments notwithstanding, there are some reasons for hope. Continued investments in education, a well-functioning and well-regarded health system, wage flexibility and structural reforms may provide the basis for productivity increases and resumed growth, when and if Europe – and Spain, Portugal's main trading partner – emerge from recession, particularly if support from the troika or a managed restructuring reduces the burden of public debt.

However the debt crisis may end, in the medium to long-term, population aging will place increasing pressure on health care and the pension system, making the resumption of growth, through increases in productivity, all the more important. Higher educational attainment should help in this regard, particularly if the tradeable sector can attract a larger percentage of university graduates. Despite continuing high rates of poverty, inequality and challenges in educational performance detailed above, it is important to remember how far Portugal has come in the past 38 years of democracy. High quality healthcare, protection against the risks of old age, disability, sickness and unemployment and access to education have been made broadly and in many cases universally available. Citizens have come to expect more and get more from their state. The degree to which they will be able to continue to do so in the future is now an open question.

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