Arguments rage about the welfare state – who gets what, to what effect, and at whose cost? But there is still little attention to an alternative, expensive, and largely hidden ‘tax welfare state’. This also conveys considerable benefits on many, reinforcing their efforts to achieve social and economic security, encouraging and supporting particular activities such as saving for retirement, bringing up children, or buying a home, while leaving others, generally on lower incomes, with higher taxes and fewer services.

Like the public welfare state, the tax system is not only government controlled and organised but its workings also effectively shift resources among different groups in society. However, who benefits from these tax benefits and who pays for them can differ dramatically from public welfare benefits, and it has very different visibility and accountability. It is all the more relevant to social policy analysis since it can assist governments in reducing public social spending by financially encouraging the use of alternative private provision without having to account publicly for the costs of doing so. This can undermine the welfare state and invisibly reinforce or widen inequalities, but it is by no means inevitable that this should happen.

**Fiscal welfare and tax expenditure**

The term fiscal welfare was first explicitly used in 1955 by Richard Titmuss, the first professor of social administration in the UK, to indicate benefits available through tax systems (Titmuss, 1958; and in Alcock, 2001). The ‘social division of welfare’ challenged the conventional wisdom of substantial redistribution in modern British society. The use of the term ‘the welfare state’, Titmuss argued, encouraged a limited view of the extent and impact of ‘all collective interventions to meet certain needs of the individual and/or to serve the wider interests of society’ (Titmuss, 1958, p. 42), and this led to mistaken assumptions about the role of the state and the extent of welfare provision across society. In particular it helped to conceal the impact of both the state’s directing of resources through its tax systems and the value of occupational welfare through employment (see Chapter 4).

Fiscal welfare, Titmuss argued, deserves as much analysis as public spending on social services and benefits. ‘Allowances and reliefs from income tax, though providing similar benefits [to public spending] and expressing a similar social purpose in the recognition of dependencies, are not, however, treated as social service expenditure. The first is a cash transaction; the second an accounting convenience. Despite this difference in administrative method, the tax saving that accrues to the individual is, in effect, a transfer payment’ (Titmuss, 1958, pp. 44–5). As a
result tax is foregone that would otherwise have been collected for public spending. The main forms of tax relief are:

- **Tax allowances** – amounts deducted from gross income for particular reasons, such as caring for a child, to arrive at taxable income.
- **Tax exemptions** – incomes excluded from the tax base and so not subject to income tax because paying interest on a home loan or contributing to a pension when some or all of that pension may later be taxed.
- **Preferential tax rates** – incomes taxed at lower rates applied to income from particular sources or used for specific purposes such as savings.
- **Tax credits** – similar to allowances but deducted from tax liability, not from gross income. They may be ‘refundable’, ‘non-wastable’ or ‘non-refundable’, ‘wastable’. With the former any excess of credit over tax liable is paid to the taxpayer, and this has been used to help low income families and workers.

Related to and overlapping fiscal welfare is **tax expenditure**. This term was deliberately introduced to contrast with public expenditure to indicate the cost in lost revenue resulting from tax reliefs by a tax lawyer, Stanley Surrey, when he was US Assistant Secretary for Taxation Policy from 1961 to 1968 (Surrey, 1973). By 1974 the concept had been incorporated into a law requiring the US government to publish a tax expenditure list as a supplement to the annual federal budget. The term is now generally used in the accounting of ways in which tax systems operate as another form of intervention, ‘running spending programs through the tax system’ (McDaniel and Surrey, 1985, p. 6).

Tax expenditures are ‘provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax’ (Anderson, 2008, in Organisation for Economic Co-operation and Development (OECD), 2010, p. 12). Many exist in areas that are not welfare while much fiscal welfare is not recognised as tax expenditure. Because of much disagreement over what constitutes a benchmark tax, what is openly accounted for as fiscal welfare in one country remains less visible, or invisible, in others, so limiting comparative analysis. It is still important to recognise that these arrangements do represent an allocation or redirection of resources, whether officially identified as tax expenditures or not. However, tax expenditures cannot be ignored since most governments only estimate the cost of a tax relief when it is so recognised.

According to one OECD study ‘accounting in many countries suggests the use of tax expenditures is pervasive and growing’ (OECD, 2010, p. 14), but it was only able to make comparisons of their costs across seven of the ten countries surveyed. Including reported expenditure in any tax, and not just income tax, it ranked the UK highest at 13% gross domestic product (GDP), then Canada at 7%, the United States at 6% and Spain at 5% with Korea and the Netherlands at 2%, and Germany less than 1% (OECD, 2010, Table II.29, data between 2004 and 2009). Measured against ‘relevant tax revenue’, Canada and the United States were the highest tax spenders, both at 59%, UK at 39%, Spain at 28%, Korea at 25%, Netherlands at 10%, and Germany at 9% (OECD, 2010, Table II.31). How much of this could be identified as fiscal welfare, and how much of fiscal welfare is included, is not clear.

The scale of tax expenditure related to social policy can be substantial and can also take up a significant part of all tax spending. The UK’s own published data for 2010–11 showed social tax benefits made up 96% of the main 25 purely income tax reliefs listed (excluding the basic personal allowance). Their cost in revenue foregone was equivalent to 21% of the total
income tax collected (HMRC, 2011, Table 1.5). There were other significant tax reliefs in capital gains tax, value-added tax, and the excise duties.

**Tax breaks for social purposes (TBSPs)**

The development of the analysis of tax breaks for social purposes (TBSPs) by Willem Adema and colleagues at OECD provide more evidence on fiscal welfare, although by no means a comprehensive accounting. They have developed the category in using the OECD social expenditure database to reach ‘net total social expenditure’.\(^1\) TBSPs are ‘those reductions, exemptions, deductions or postponement 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’ (Adema, Fron, and Ladaique, 2011, p. 110).

In 2007 the greatest providers of TBSPs among the 27 OECD member countries taking part in the study were the United States at 2.1% of GDP at factor cost, Germany at 1.8% and Canada at 1.6%. France, Mexico, Portugal, Australia, and the Netherlands were around 1%. The only other significant spenders were Korea and Spain at 0.7%, Belgium and Japan at 0.6%, the Czech Republic, Ireland, and the UK at 0.5%, and Italy at 0.3%. The remaining 11 countries were shown as providing 0.1% or nothing (ibid., p. 33, Table 1.4).

Although a valuable addition to knowledge, these analyses lack important elements of fiscal welfare needed for a full comparison. First, Adema and colleagues exclude tax breaks on state benefits such as child benefits, whether they are taxed more lightly or not at all, to avoid double counting because they are included earlier in a different form (ibid., p. 110). This removes a significant area of fiscal welfare in many countries: however, tax allowances and tax credits for children are included as TBSPs.

Next, tax and other reliefs to private pensions are omitted from the full analysis although the authors admit that they are ‘arguably the most important’ TBSPs (ibid., p. 29 and see below). ‘Because of conceptual issues and gaps in data availability’, these are only listed at the bottom of tables as a ‘memorandum item’ and not included in totals (ibid., p. 33, note c).

Despite its often substantial cost, fiscal welfare for married couples is also omitted because it is not ‘considered as social in all OECD countries’ (ibid., p. 112), virtually confining TBSP support ‘for families’ to that for children. In addition, TBSPs provided by sub-national agencies are excluded: in Canada these would increase the total by some 50% (ibid., p. 111, note 1). Finally, other subsidies equivalent to TBSPs, such as exemptions from social security contributions, appear to have been omitted.

There is enough and increasing evidence to indicate that fiscal welfare can be very significant despite the omissions. Yet this and other forms of tax spending continue to escape the regular scrutiny by parliamentary and other bodies to which public spending is subject. Given concerns to reduce, if not avoid, budget deficits, neglect of the scale of tax reliefs for any purpose is all the more remarkable.

**The distribution of benefits**

‘For government, a tax expenditure is a loss in revenue; for a taxpayer it is a reduction in tax liability’ (OECD, 2010, p. 12): so what is the redistributive impact? There is still very little evidence, and so very limited awareness that with few exceptions fiscal welfare is generally regressive. Stanley Surrey emphasised the ‘upside-down effect’ (Surrey, 1973, p. 37) of most tax welfare because the marginal rate of tax which would be paid if the relief were not available...
usually determines the value of a tax benefit to the recipient. For example, a tax allowance of 500 euros or dollars is worth 100 to someone otherwise paying tax at a top rate of 20%, but 150 to the 30% taxpayer and 250 to the 50% taxpayer.

These higher tax rates would otherwise be paid by those with higher incomes. With more income to invest in tax-privileged activities, the better-off are able to draw even greater value from these tax benefits, such as buying their own home or contributing to a pension, since the few ceilings on tax reliefs are usually generous. One independent study in the UK found tax reliefs enabled the top 10% to exploit some 70% of the extra tax relief above the basic personal tax allowance (estimates from Brewer et al., 2008, Table 1). The top tenth of the top 1% had a pre-tax income 31 times the average, but benefited from tax reliefs 86 times the average, enabling those at the very top to ‘race away’ even further at considerable public cost.

As a result, those on higher incomes, conventionally assumed to be not only in less need but also better able to make a larger contribution in taxes to the common wealth, actually derive greater benefit from fiscal welfare and pay even less in taxes. Meanwhile the rest assume the richer are paying more tax, not less, and are unaware that, as a result, their own taxes are higher and/or public services more limited. The upside-down redistribution of most income tax reliefs in the UK contributes to making the incidence of total taxes proportional, not progressive as widely believed (Barnard et al., 2011, Tables B and C).

In recent years there has been some, but still very limited, recognition of the upside-down effect. OECD acknowledged: ‘this incentive pattern might be judged absolutely perverse – giving the most inducement to those who need the inducement least – and yet it is the common practice in at least some countries’ (OECD, 2010, p. 28): the World Bank noted that it ‘violates’ vertical and horizontal equity (World Bank, 2003, p. 2). There is also growing acceptance that this ‘reverse targeting’ is not inevitable. Instead of regressive exemptions or allowances, tax credits help families and low-paid workers in some countries. The credit is deducted from the tax to be paid rather than deducted or exempted from income before tax. As a result all taxpayers can benefit to the same amount, and the credit be made refundable to those whose incomes are so low that they pay little or no income tax. In hybrid schemes, as in the UK, the tax credit has been developed to provide even more support to those on lower incomes.

The uses of fiscal welfare: recognising and supporting the needs of the family

The ways that fiscal welfare recognizes needs and rewards, and encourages and promotes certain activities, reveal both similarities and differences to public spending programmes. Most tax benefits operate indirectly, encouraging more use of the market. Direct support is mainly directed to the family where needs have long been met in forms comparable to and often more generous than public welfare. In most countries the very first income tax arrangements took family responsibilities into account in assessing the ability to pay tax, usually long before any public benefit was available outside the poor law.

Support for children has been a very common tax relief, sometimes varying with the age and/or number of dependent children. The tax benefit may be more generous, continue longer than social security benefits, and exist even where there is no general family benefit in public welfare, as in the United States. In most European Union (EU) countries tax welfare provides part of child benefit packages with tax credits growing in importance (van Mechelen and Bradshaw, forthcoming).
Special reliefs for marriage are also common, whether or not couples are living together, and some continue into widowhood. Tax allowances have also been extended to single parents and are sometimes equivalent to the married couple’s allowance.

Recognition of marriage and family is so institutionalised in many countries that reliefs are part of the benchmark system and so not regarded as tax expenditures. Nevertheless their addition to family income needs to be taken into account in assessing the extent and distribution of fiscal welfare. France ‘considers the household as the tax unit: favourable tax treatment of families’, including the quotient familial and quotient conjugal, ‘is thus an integral part of the tax system’ and not a tax expenditure. Yet its support to children was ‘reported to be around 11.5 bn euros in 2007’ (Adema, Fron and Ladaique, 2011, p. 112 and n19), much more than any published tax expenditure. With the quotient conjugal also costing half as much, the whole range of family-related tax reliefs may exceed total public spending on family benefits. They constitute a very considerable demand on the overall budget and benefit high earners substantially more than other families in both absolute and relative terms (Terra Nova, 2009, pp. 24–6).

In Germany married couples are jointly assessed with income splitting, a particular advantage with only one earner or a great difference in the level of earnings, both common in that country. This is also regarded as part of the basic tax system. No regular data are provided on the considerable cost which may exceed all published tax expenditures.

In one country at least income tax and social security systems have been used to promote differential family policies. In Singapore generous tax incentives are provided to encourage women university graduates to marry and have more children while less educated women are urged to have only two, preferably one, child by a cash grant to their social security savings fund.

Fiscal support for other dependent relatives has been available in many countries, particularly when they are living in the same household. These have included special relief for the cost of a housekeeper or caretaker for a dependent with specific disabilities. Much support to the wider family has been removed, but there have been new schemes. In Hong Kong a tax deduction is available for ‘elderly residential care expenses’ to the taxpayer when his/her or a spouse’s parent or grandparent lives with them or support is provided for them in a care home. Singapore also encourages taxpayers to support parents and grandparents.

The upside-down impact can be considerable but in most countries remains little discussed and analysed alongside public welfare benefits. However, tax credits have recently been deployed to help some, particularly families, on lower incomes provided that they take jobs (OECD, 2010, pp. 34–43). In 1975 the United States introduced an earned income tax credit ‘as a minor amendment to a forgettable tax bill’ which ‘became in the 1980s one of the most popular programs in Washington’, and ‘by the early 1990s … the policy equivalent of penicillin’ (Howard, 1997, pp. 404 and 405). ‘Making work pay’ credits for low-paid workers and additional ones for children mean that support through the tax system exceeds means-tested support to poor families and workers.

In countries where ‘welfare’ carries a stigma, payments through the tax system are seen as more acceptable both to recipients and the wider community as well as reducing public spending totals (only tax paid out is included, not the tax waived). Canada, New Zealand, Australia, and the UK followed the American example to help make work pay, especially for families, but with varying success with the professed aim of reducing poverty.

Some continued to focus tax help on families with at least one earner and adding childcare subsidies, while others made support available for most or all children, irrespective of anyone in the household working. Some also provided it to low-paid workers without children. Canada has since abandoned tax credits to direct help through social security and the UK is planning to do the same.
Providing for retirement

Some countries help older people with higher tax allowances: often phased out at modest levels, these help taxpayers on lower or average incomes. However, in most countries the most generous tax benefits are regressive and related to private pensions. Most commonly, while the pension in regular payment is taxed, no taxes are raised on pension contributions made by employee and employer (often with a maximum level for employee); on investment income from funded arrangements (or tax at a preferential rate); and on any lump sum payable on retirement (but usually tax-free to a certain level only).

The revenue loss has generally been increasing, exceeding 1% of GDP in five countries in the OECD TBSP analysis (although, as indicated above, omitted from their main accounting). In some English-speaking countries net pension tax expenditure has exceeded the cost of means-tested and non-contributory pensions for the poorest old people and rivals the cost of social insurance pensions (Hughes and Sinfield, 2004). In the UK the cost doubled in the decade up to 2008–9 (UK Treasury, 2009, para 2.14). Only in New Zealand, with a minority of workers contributing to non-state pensions, has most tax support been removed.

With the tax benefit usually available at the marginal rate of tax, the inequality is further compounded by the fact that the higher the status and pay, the more likely a taxpayer will be contributing to a non-state pension, and the more s/he will be able to pay in. In most countries women derive less benefit from this fiscal welfare because of their weaker position in the labour force with lower wages, less security and the greater chance of part-time work (Ginn et al., 2001). Without the protection of tax-assisted pensions their greater longevity makes the risk of prolonged poverty all the greater for women.

Distributive analyses have been scarce, but the UK Treasury recently revealed that ‘the top 2% of pension savers … receive around a quarter of all pensions tax relief on contributions’ alone, 20 times more per person than basic-rate pension savers (UK Treasury, 2009, para 2.14). Directors and senior executives take particular advantage of the tax reductions, especially in the financial sector.

Amid increasing labour market insecurity, many countries in continental Europe have been planning to encourage greater reliance on non-state pensions with tax reliefs despite experience elsewhere of their large, regressive, and long-term costs. Given heightened concern to reduce budget deficits and gain ‘value for money’, governments might be expected to cut these subsidies without clear evidence of real public spending savings. But the interests benefiting from these tax benefits are very powerful including top management, the pension industry and the funds benefiting from its investments.

However, there have been some restraints, and these might be increasing. In recent years successive UK governments, for example, attempted to reduce the revenue loss. The initial effort by Labour may have led to greater losses, but later changes by it and a Conservative-Liberal Democrat coalition, more committed to reducing the budget deficit faster, could be more effective.

Other forms of fiscal welfare

The promotion of home ownership is probably the next major area common to most countries, despite much debate over what the main tax expenditure really is – the deductibility of mortgage or loan interest on an owner-occupied home or its imputed rental value. Where a figure is given, it is usually the former, and this is generally among the most expensive tax benefit to governments and the most valuable to recipients. In addition there is often exemption from capital
gains taxes on the sale of an owner-occupied home and sometimes full or partial exemption from property taxes or rates.

In the UK the cost of mortgage interest relief became so considerable that a Conservative government decided to phase it out because this subsidy to home-ownership was seen as both contributing to a housing boom that created problems for the economic cycle and diverting more savings into housing at the expense of industry. The fact that this regressive relief cost more than public spending on housing benefits for low-income households apparently weighed little in the decision.

The subsidy of private health services is another important area in some countries including Germany, Canada, and particularly the United States with especially large reliefs for employer contributions to medical insurance premiums and medical care. Education and the work of charities have also been areas to benefit from special tax privileges in many countries.

There are many other ways in which taxpayers and/or their employers can take advantage of the tax system to improve their welfare. Many other employee benefits in kind are not taxed, or not as much as wages, such as company cars, which can also be used privately, personal and concierge services, loans at reduced rates of interest, childcare tax vouchers, and severance payments. The main beneficiaries are those who receive greater occupational welfare (cf. Chapter 4) are those liable to higher tax rates take particular advantage of the tax-reductions. Directors and senior management may receive financial advice tax-free to maximise tax-mitigating opportunities in their fringe benefit packages including further tax saving through tax havens (Kohonen and Mestrum, 2008).

In the mid-1980s New Zealand and Australia sought to reduce the revenue loss by levying ‘fringe benefit taxes’ on employers providing the benefits. At the time these created much controversy but became accepted within a year. The tax authorities benefited by only having to pursue the much smaller number of employers providing than taxpayers receiving, especially as larger companies were more likely to offer fringe benefits. How the tax charge is shared between employer and worker is unclear.

The political economy of fiscal welfare

Fiscal welfare and tax expenditures have rarely been the specific focus of policy, but the worldwide move towards lower taxes in the mid-1980s was accompanied by measures to broaden the tax base that abolished some and restricted other tax benefits. Lower tax rates also reduced revenue losses, but the long-term impact on fiscal welfare was generally smaller than claimed with most cuts to little-used reliefs.

The development and significance of the politics of fiscal welfare has been particularly well brought out by two major historical studies examining ‘the prominent place of tax expenditures in the provision and subsidization of private social benefits’ (Hacker, 2002, p. 294) in health and pensions in the United States. In The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States Jacob Hacker analysed ‘subterranean’ politics and policy development, building on Christopher Howard’s innovative study, The Hidden Welfare State: Tax Expenditures and Social Policy in the United States (1997). The two books complement each other well, with Hacker taking greater account of ‘the heavy distributional skew of tax breaks for private benefits [that] must be placed at the heart of any explanation of the distinctive political dynamics that Howard’s study identifies’ (Hacker, 2002, pp. 39).

Republicans’ exploitation of the tax route to welfare was shown by the trends in direct social spending and indirect, largely fiscal, welfare from 1967 to 2006. While Democrats largely developed public welfare, ‘Republicans use policy to allocate resources and jurisdiction to private
markets’. This resulted in government subsidy ‘shifts from more vulnerable to more privileged constituencies’, reinforcing inequalities (Faricy, 2011, pp. 77–78). ‘More than just the innocuous selection of a policy tool, it is essentially a choice about altering the balance between public and private power in society’ (Faricy, 2011, p. 74).

In Australia scrutiny of ‘social tax expenditures’ (STEs) revealed ‘a more expansive, but less equitable, conception of the Australian welfare state’ (Stebbing and Spies-Butcher, 2010, p. 586). ‘In a context of fiscal austerity, [they] provide a route to extend welfare with low political resistance’ and also reduce that ‘resistance by reducing public accountability’ and ‘minimising state bureaucracy’ (Stebbing and Spies-Butcher, 2010, pp. 593, 594, and 596). This use of a policy ‘back door’ supports the privatisation of welfare services (ibid., p. 595). While the conventional welfare state may appeal to the poorer and average workers, ‘STEs provide a political framework for uniting the interests of middle- and higher-income earners’ (ibid., p. 599).

Developments in Denmark and the UK confirm the subterranean operation of fiscal welfare. Generally change was to individual tax benefits, and their cost rather than their inequity provoked reform by governments both left and right (Kvist and Sinfield, 1996 and 1997). Denmark appears to be the only country that has withdrawn publication of tax expenditure statistics.

In the United States market economists’ attacks on the concept of tax expenditures led to increasing scrutiny with the Joint Committee on Taxation proposing a revision into ‘tax subsidies’ and ‘tax-induced structural deviations’ (Kleinbard, 2008, p. 9). Tea Party and other groups now advocate scrapping or radically reducing tax expenditures to reduce the budget deficit, some stressing the need to do so alongside cuts in public welfare.

Investigation of fiscal welfare and TBSPs has paid little attention to new market economies or Third World societies although international advisers and consultants often build in standard tax reliefs from their own countries with little, if any, indication of revenue loss or distributive implications. Some international agencies press for tax reliefs to stimulate private pension markets while pushing for more targeted public assistance. In consequence expensive elements of fiscal welfare benefitting the better-off become institutionalised in taxation as universal public welfare is cut back.

**Conclusion**

Despite the use of tax credits, fiscal welfare remains an alternative and little known welfare state generally providing more support to those with higher incomes. Amid increasing spending cuts, this form of backdoor spending may be becoming generally accepted as part of a new ‘realism’ of lower taxation, greater privatisation, increased citizen choice and the end of budget deficits without understanding of the longer-term implications.

Higher unemployment and job insecurity increase those who cannot access most forms of fiscal welfare and subsidy, while reduced revenue from these privileges further limits funds for public welfare for these outsiders. The more the limit, the more that stimulation of private welfare via fiscal welfare compounds the problem as it enables those with the resources to make use of tax opportunities to buy more support.

This weakens the support for and so the legitimacy of ‘the welfare state’, as well as its extent and quality. Those providing for themselves by means of fiscal welfare are little aware of the scale and inequity of the subsidy and are often among the most vocal in attacking welfare dependency and weakening collective support for pooling risks and promoting solidarity. Posing policy alternatives as either universal or selective ignores the selective privileges to some through less visible and less accountable fiscal welfare. In consequence inequalities are widened while universal policies are threatened and often cut back.
Analysis of shifts from more solidaristic and collective systems to more individualistic models with hidden upside-down redistribution through the tax system needs to take account of the power of the various interests involved including the pension fund industry. ‘The invisibility of tax expenditures represents both a democratic problem and a problem of political steering’ (Ervik and Kuhnle, 1996, p. 93).

‘Tax expenditure programs are lobbied for on the supply side and “off-budget”’ by private providers (Faricy, 2011, p. 82, emphasis in the original). Future research in fiscal welfare should give more attention to identifying not only its full scale and distribution but also the supplier beneficiaries in the market and their lobbying within and across countries and agencies. This could show how welfare debates are being reframed in ways that conceal the scale and distribution of inequitable tax benefits while undermining support for the welfare state. ‘Though evaluation of tax expenditures may be difficult, a more serious problem may be the failure to try. … An out-of-sight, out-of-mind attitude can arise and continue to insulate inefficiencies from scrutiny for periods of years’ (OECD, 2010, p. 29) – and, it should be added, inequalities.

In some countries the ‘heavy distributional skew’ of fiscal welfare (Hacker, 2002, p. 39) is receiving more attention in analysis and even some changes in policymaking, but it is more than half a century since Richard Titmuss drew attention to its inequitable growth. Today welfare states and the majority of their people are suffering the consequences of not paying this warning enough attention.

Note

1 Curiously this work which has been developed for more than a decade receives no mention in OECD, 2010.

References


