

TAXATION, THE WELFARE STATE AND SOCIAL DEVELOPMENT: A THEORETICAL DISCUSSION

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ABSTRACT

Nation states are able to make progress in development if among other things, they have the capacity to collect tax to finance various state-led activities. Tax revenue is an important development resource that facilitates social transformation. Without it, it is difficult to attain a radical qualitative and quantitative change in the society. Given this, it is critical that the government have in place a good tax collection machinery. In the recent past, a discussion has emerged over the willingness of companies to pay tax when foreign investors are enjoying tax holidays. The incentive given to foreign investors is now discouraging local investors who have no tax relief. Using examples from different economies, times in history and theoretical analysis, the paper weaves together arguments to valorise the centrality of tax revenue as a development resource that needs to be looked at and why efforts are needed to promote compliance.

Key words:

Taxation, Welfare State, Development.

INTRODUCTION

Nation-states are able to make substantial progress in development if they have adequate capacity to collect tax to finance various state-led activities. Developing countries need to invest in building the local capacity to collect tax revenue as a key development resource in order to expedite development processes. Inability to collect tax is one of the key challenges facing developing countries and thus any meaningful transformation that has to take place in these countries has to take on board the question of revenue collection. This paper is about the relationship between taxation, the welfare state and social development, important business of any serious government. Development in any society is determined by the ability of the society to change and that change has to be a progressive and meaningful one to touch, among other things, the social aspects of the society. These include the quality of human resources, health and wellbeing, productivity, efficiency, organisational capabilities, behaviours, social institutions and governance, among others.

Development requires steady financing and continuity and this is one of the challenges facing developing countries today. Resources are required to pay for the cost of setting up infrastructure, and

serving and paying the human resources involved. One of the shortfalls facing developing countries is resources to foot the cost of development projects and programmes, a situation which has pushed these countries to rely on foreign aid and loans. While aid and loans are short term measure, a country needs to have in place ways of raising its internal revenue to finance its own development projects with the goal of attaining not only economic development but social development as well. Internally generated revenue would allow a government to address various macro and micro development problems which have multi-sided implications in development processes.

Meaningful development should not be divorced from the people and one of the ways to ensure that people benefit from achievements made in the society is the provision of welfare benefits to the general public. These may include health insurance programmes, food, education, retirement benefits and housing programmes. Such provisions allow the disadvantaged members of the society to enjoy the benefits of development outcomes via the state window. Welfare programmes are thus important for developmental equity reasons in the society because when one group in a society is very advanced and another one is left too far behind, the latter might

compromise the former and hence compromise social development in general.

Social development is more than the social welfare of the citizens; it is about the qualitative changes of the lives of the citizens as a whole, that is, improvements in the quality of health services, education, housing, food security, water supply, income, work ethic and cultural changes. In a way, social welfare is a means to social development because development of a society is more than the welfare of the people. While social development programmes are radical initiatives for change and are transformative in nature, welfare programmes are social justice initiatives in design and they are not radical. For all these to happen there must be in place a solid taxation system capable of raising the required resources. In this paper, we specifically examine the significance of taxation for social development in developing countries with examples drawn from Tanzania.

THE PROBLEM

In the recent past, a debate has emerged in developing countries in general and Tanzania in particular over the question of tax evasion and tax holidays. Development partners and international financial institutions have been calling for developing countries to strengthen domestic revenue sources and in particular to enhance tax collection. A number of statements have been made over the long-term tax holidays enjoyed by investors in the name of investment promotion. The main argument by opponents of tax holidays is that excessive tax holidays are robbing Tanzania of key development resources (various types of tax revenue) which should be used to finance different development projects. Besides tax holidays, some investors are accused of tax evasion, a practice that further denies countries their development resources. There is a critical link between revenue collection and the capacity of the state to deliver; this has not been articulated thoroughly to dilute argument for tax holidays in favour of strengthening tax collection initiatives. Consolidating tax revenue and removing excessive tax holidays are critical and fundamental steps towards attainment of the ability to finance welfare initiatives and social development in general. However, that articulation has not been

done eloquently, a situation that provides room for advocating more tax holidays at the expense of welfare programmes and social development.

METHODOLOGY

In this study, we use the historical method of doing research to approach the problem under discussion. Newman (1994) points out that historical research methodology uses available data such as public documents, official records and private documents to search for explanations of a phenomenon, examine specific outcomes and hence reveal hidden connections or implications. The method helps conceptualisation and thinking through by looking across historical policies, directives, laws and regulations, a process that helps to inform decision-making processes. This methodology fits well in this study because by examining the performance of other communities we are able to learn the implications of various policies and decisions being made at present.

Information was collected from books, journal articles, government reports, research reports, media and policy briefs which allowed us to cross-examine facts and policies and afterward put together information for this paper. The approach allowed us to trace the historical development and significance of welfare programmes, their functions and the reasons why they were promoted by states. Through this approach, we were able to not only demonstrate the relevance of tax revenue for social development but also review the arguments for taxation and tax holidays and comment on the growing gap. The fact that the approach allowed the assembling of information from different sources and time periods provided space for joint reading and cross analysis of the collected evidence and hence a base for drawing some of the crucial conclusions that are informed by historical facts and realities.

THEORETICAL ORIENTATION

This paper is organised around standard public finance theoretical orientation in which it is considered that the distribution of the tax burden should be equitable in the society (Musgrave and Musgrave 1980, Herber 1999). The term equitable is a relative term - no society can be a perfect homogenous unit. The distribution of

tax burden needs to be equitable because in theory it encourages members of the society to continue paying tax voluntarily. Along the same vein, everyone should be made to pay his or her share of tax in order to allow all members contribute for the common good. When individuals and companies are allowed to not contribute to the common good (the resource basket), the capacity of the common resources for the general population will slowly be eroded, and this will lead to the tragedy of both the common good and the people.

Related to the above view is the argument that when tax policies are used to achieve different goals, for example to offer investment incentives as a way of promoting local industry, employment, stimulating other forward and backward sectors of the economy and hence growth in the economy, efforts to minimise interference with the equity of the system must be put in place. The best way of computing the cost of these incentives is to compute the opportunity cost for the whole time period. Inability to minimise these practices has the effect of compromising the equity principle of a good tax structure. As noted earlier, excessive granting of tax holidays will also affect the common good.

CONTEXTUALISING THE TAX-DEVELOPMENT LINKAGE

Freedom and development are as completely linked together as are chicken and eggs! Without chicken you get no eggs; and without eggs you soon have no chicken. Similarly, without freedom, you get no development and without development you very soon lose your freedom. J. K. Nyerere (1968).

Tax revenue is an important development resource that facilitates social transformation; without it, it is difficult to attain a radical qualitative and quantitative change in the society. The above quote from J. K. Nyerere can usefully be applied to the relationship between tax revenue and social development. Tax revenue strengthens development initiatives/activities and similarly development initiatives/activities strengthen tax revenue. From this we can say that

‘without tax revenue we get no social development and without social development we will soon lose our tax revenue.’ Tax is collected by governments/states for a purpose and not because others are doing so. Tax is used for financing goods and services that are, economically, efficient if produced by the state and consumed collectively by the general populace.

In theory, it can be argued that tax revenue is a varied form of collective savings used to finance collective investments in a society or any other activity as specified (pension, social security, health insurance).⁵⁰ Musgrave and Musgrave (1980) point out that goods which are collectively consumed are social goods in principle and the benefits are externally enjoyed. Economists have over the years argued that, for an economy to grow at a good pace, savings and actually substantial savings in the society are important. Such savings must be invested back into the economy so that they can further contribute to growth (Livingstone and Ord 1980). When savings are equal to investments in an economy, meaning that all that is saved is invested, its implications would be seen in the output. It will influence total output in the society in that there would be an increment in capital for further production. The bigger the savings, the bigger the investments in the economy and hence the higher the output. Higher output means that the society is better off. It is investments that call for development and where there are no investments (industries, schools, colleges, railways, power systems, water, housing, irrigation systems, airports, etc) development would not come and subsequently potential tax revenue will be lost. In theory then, it is important to develop a culture of collective saving and investment in the society because it is a culture that sustains growth and development. That culture has to be developed at the individual level and community level through education.

In this paper we advance two main arguments: the first argument is that for people to pay tax, they need to understand why it is essential for them to do so. This is to say they need to be educated on the significance of tax for social development and

50. In a recent seminar with Danish researchers from the University of Copenhagen, it was pointed out that tax in Denmark is about 40% of income. Although it appears high, people pay tax because public services are offered by the state - social housing, road maintenance, water, power, education and similar social services. It was also noted that budget and expenditure transparency are very high and this is a source of citizens' check and balance on their government.

why by not paying tax it affects their own personal social wellbeing and collective social development in general. The second argument is that a good taxation system is key to social development because such a system will yield good revenue which will allow the government to do the corresponding investment in social services production of social goods. In this, we argue, when the government is not able to collect taxes, it is in danger of failing and ultimately collapsing because it will not be possible to produce social goods. Adam Smith in his popular book *The Wealth of Nations* (1776) in Herber (1999) listed four reasons for the state to receive resource allocation (in fact these are arguments in favour of taxation). According to Herber (ibid), the four classical reasons given by Adam Smith are:

- The duty of protecting the society from violence and invasion by other independent societies
- The duty of protecting every member of the society from the injustices or oppression of every other member of the society
- The duty of establishing beneficial public institutions and public works
- The duty of meeting the expenses necessary for support of the sovereign.

It can thus be noted that tax revenue has a critical function in a nation-state and effort has to be made to make sure that people pay tax and tax is accurately collected.

The discussion in the paper is organised around the two arguments and the attempt is to show that it is important for the revenue authorities to invest in educating not only the tax payers but also those in the government who plan and spend the collected tax revenue. If the understanding of those in the government who spend tax revenue on development activities is different, it will affect tax payers. The critical aspect in this is that spending should encourage people/citizens to pay more tax and go even further to be proud of paying tax in the society. If in a society, those who pay tax are laughed at and ridiculed, their patriotism and trust in the government will be eroded. In the extreme case, this will promote organised crime, underground movements and tax evasion as a heroic thing to do in the society. As noted at the beginning, savings and

investments are like the egg and the chicken thing: no eggs without chicken; no chicken without eggs. There is no development without investment and if there is no development soon there will be no further investment. Thus it is critical for governments to make sure that tax is collected accordingly and culprits, i.e. the evaders, civil servants who assist them and those who embezzle the collected revenue, are dealt with accordingly as well. Unnecessary tax holidays and tax evasions are costly to the society in many ways, as pointed out in the arguments by classical economist Adam Smith for taxation and in particular for social development.

TAXATION AND SOCIAL DEVELOPMENT

Social development in any country is influenced by critical investments made by the state which are financed by tax revenue. It is clear at this point, that the government needs to raise revenue which will be invested in areas that need collective resources for collective consumption. Some of the investments like roads, grand bridges, ports, railway lines and dams require long term investment because the payback period is long. It is difficult for an individual or a company to invest in a national road system, railways or the network of airports. These are investments which open up different development opportunities that are a catalyst in national development. Infrastructural investments open up economic opportunities for local people as well as investors, create employment opportunities, and develop new sources of tax revenue to the state. All these transform the quality of life of the people and the level of development of the country.

Similarly, it is difficult for private firms to invest in unemployment benefits, old age pensions for all seniors, sickness benefits or other such programmes at a national scale. A pro-people state would not only develop people-centred programmes but it will also spend revenues wisely to meet development goals. Pro people initiatives taken up by the state would guarantee the people a minimum standard of living in which they are able to get the basics - food, shelter, clothes, medical care and education. All these can be paid for by the developmental state through various welfare programmes. The money is obtained

through taxation and thus it is tax that defines the achievements. It follows from the above discussion that the state that is able to have more programmes of this nature is the one which is able to raise more money, and spend every single cent wisely. Looking back at tax as collective savings, the more the savings are transformed into investments, the quicker the country gets its corresponding benefits back as well as the more the society is further transformed.

However, the amount of tax collected needs to correspond with the quality and quantity of services provided by the state to the people. Tax payers are keen and follow the main argument raised to support paying tax which is a valid social contract. In fact they are concerned with the use of the money deducted from their incomes, profits or levied on imported products which they could have spent on their personal development/satisfaction.

One of the magic things about tax and the willingness of the people to pay tax is that, when taxpayers see the benefits and are able to enjoy them, they pay tax with little resistance. They directly and indirectly benefit themselves and they have a lighter burden of looking after their neighbours. In fact, even the well-to-do are better off with their wealth if the state is there to care for the poor. The poor are able to offer their labour in the market if they have some education, food, shelter and good health. Incidents of crime and victimisation are relatively low where the state has guaranteed a certain minimum standard (in countries where unemployment benefits are offered, there is a social stigma attached to it, which pushes people to work hard and get out of it). Thus, it is tax that pays for the bridges, roads, social security and similar programmes. It is enough to say here that it is tax that promotes development in the society. The more the government is able to collect tax and invest in development projects, the more advanced will the nation become.

The above understanding is instrumental for both policy makers and taxpayers. For the taxpayers, tax is a collective saving that is later transformed

into investment which will produce social goods to be consumed by the general populace. In order to finance goods that are collectively produced and consumed, tax must be paid accordingly. For development policy makers, tax is collective saving and not just government revenue waiting to be spent. For a country to make quick advances saving must be equal to investment and thus tax money needs to be invested back in the economy⁵¹. Poor spending of tax money does not only discourage taxpayers, but also it delays their development and reduces their future ability to pay even higher tax. Wise spending of the tax resources is therefore beneficial to all.

RATIONALE FOR GOVERNMENT EXPENDITURE

The rationale for the state to spend can be looked at from two main perspectives, the welfarist perspective and the social justice perspective. The social justice perspective emphasises that public spending is important because the public has a right to social goods such as education, food, health and others all the time and that if all is left to the market, it will not guarantee everyone equal service (Musgrave and Musgrave 1980). The welfarist approach, which is central to this paper, advocates for public spending to correct market failures, bring about more efficient allocation and distribution of resources and reduce poverty. Sources of market failures include absence of competitive markets, presence of externalities, undersupply of public goods by the market, imperfect information on production and consumption, and coordination failures (Musgrave and Musgrave 1980, Coady and Fan 2008).

Further, governments do spend money and other forms of resources in areas where other stakeholders, particularly the private sector, would not invest as they are not profitable or the payback period is too long. In such situations, the government has to invest as a mechanism of both reaching out to the people, but also reducing the cost of investing and hence attracting the private sector to move in. Government intervention in such areas attracts medium sized and small scale investors who have a rapid multiplier

51. When savings are not spent on investments, it implies that what remains for investment will be very small and the social goods produced will be small as well. This affects everyone in the economy as they will have little to consume.

effect in terms of job creation, income generation and later on tax revenue for the state.

The other rationale of public spending comes from the need to stimulate the development process particularly at times of economic stagnation or crisis. As noted in developed countries, governments are injecting money into the private sector as a way of stimulating growth and retaining jobs. The economic crisis facing the corporate sector is huge and if left for the market to correct it, the people will suffer for a long period. In such a situation, the government has to take action, including policy reforms and direct intervention in the market to sway things back to the desired trajectory. Government spending is thus important particularly in the areas of education and health so as to allow the working class to survive the crisis and prepare to participate in the growth process.

Given the above discussion it is important to note that tax evasion, tax holidays and tax avoidance are detrimental to the welfare of the people and social development in general. This requires an examination of the debate on these issues to help firm up some of the arguments.

TAX EVASION, TAX HOLIDAYS AND THEIR COSTS: THE DEBATE IN TANZANIA

For quite some time now, there has been a discussion in Tanzania over tax evasion and tax holidays (Uwazi 2010, Policy Forum 2009, TEC et al 2012, Curtis & Lissu 2008). This debate has received a lot of attention among parliamentarians, activists, academics, politicians, development partners and the media (print, electronic and social). The central and controversial issue is that the country is losing a good deal of money due to tax exemptions and this amount could have been used to finance key social development projects (school laboratories, health centres, road networks, water systems and the like). It is true that the government of Tanzania has several categories of tax exemptions as an incentive to attract investments and hence stimulate economic growth. Current exemptions range from non-taxation of imports of capital goods to deferment of VAT on the same. The concern, however, is that the incentives are too generous and are compromising social development initiatives.

Available information indicates that exemptions are granted in two categories- lead sectors and priority sectors. The former includes agricultural, agro-industries, mining, economic infrastructure, tourism and petroleum. The latter includes manufacturing, natural resources, commercial buildings, financial services, transport, broadcasting, human resources and export oriented projects (Kassera 2006). The central concern over tax exemptions in all forms is that for a country that is poor, donor dependent and developing like Tanzania with many social problems, generous tax exemptions are uncalled for. The amount foregone would go a long way in addressing some of the key problems facing the community rather than helping multinationals which are not even local.

In their policy brief, Uwazi (2010) provides nine facts about the exemptions:

1. A significant amount of revenue is foregone; in the 2009/10 budget, the amount foregone was about 40% of the education budget;
2. Tanzania grants more tax exemptions compared to its neighbours;
3. Exemptions in the present period are growing;
4. Large multinational investors receive most exemptions;
5. Exemptions on imported goods constitute 75% of all exemptions;
6. Zanzibar government grants twice as many exemptions as the mainland;
7. Over time, exemptions have started to decline;
8. Reducing exemptions further would reduce dependence on aid;
9. Exemptions for NGOs and large investors declined but increased for donor-funded projects and government institutions.

The premise of the nine point policy brief is, in short, that tax exemptions are eroding the capacity of the state to deliver and are making the nation aid dependent.

In another policy brief by Policy Forum (2010) it is argued that Tanzania is losing a lot of money in tax revenue through tax exemptions, mis-pricing, illicit trade with foreign multinationals and low royalties.

For example, while other companies are getting tax exemptions in their investments, mining companies have tax exemptions in local government taxes, withholding taxes and fuel levies (Policy Forum 2010). Similar concerns are also raised in another report (TEC et al 2012). In this the concern is over tax incentives, trade mis-pricing, capital flight, tax evasion and revenue loss. All these issues are about lost tax revenue and its implication for the society. It is about what all this lost revenue could have done, if it was collected and used accordingly. As noted from classical economists, the wellbeing of the state is important business that warrants resource allocation.

TAX AND THE WELFARE STATE: WHY PAY TAX?

On the one hand, people pay tax because they expect to get back services which are efficiently offered by the government. On the other hand, taxes are the main source of government revenue which allows the state to spend on development and regular expenditure. The best and simplest starting point to discuss the importance of tax for the state and ultimately for the general citizenry is to review the notion of the welfare state and its role in social development. Welfare states play a critical role towards achieving social development. These are states that invest in improving the wellbeing of their citizens through centrally developed programmes as a way of helping citizens to participate and benefit from the outcomes of social development. Typical welfare programmes include free education, free health service, low cost housing and food programmes. Welfare programmes are centrally financed because they open up opportunities to all citizens regardless of their sex or social standing. The programmes are financed through tax revenues collected by the state. In principle a welfare state is a state that takes a prominent position in promoting the wellbeing of its citizens collectively; it has multiple large scale social programmes financed through the taxation system.

It has to be emphasised here that the interest of the state is to develop the whole society and not subgroups of it.

State revenue is an important governance tool as well because at times of economic crisis or boom, states may introduce certain measures aimed at stimulating the economy or redistributing income and hence restoring the confidence of the people in the economy⁵². The confidence of the people in the state is very significant because when there is no confidence in the state, citizens would not pay tax, invest in the economy, or work; they would emigrate to work and invest outside; banks would have no savings; and the conditions would promote capital flight. All these are possible if the government has no resources to finance its activities. The chief source of finance for the government is tax and when the government is unable to collect tax, it will not be possible to finance such kinds of activities. It must be noted here that when there is a corrupt and dysfunctional government which is not able to raise revenue or one which raises revenue and misuses it, that state will not be able to pay for its own expenses. The consequences of that inefficiency have far reaching effects in that the inability to finance large scale infrastructure and welfare programmes affect the quality of life of the people, and raises the cost of doing business for the investors. This may leave the country uncompetitive in attracting investments and hence reduce the perimeter of the tax base. The connection between current tax revenue, spending on public infrastructure and attraction of investors to the economy, resulting in more tax and hence promotion of social development needs to be underscored.

In most societies, besides the middle and the upper classes, there are struggling low-income individuals who earn very little per day. Low income earners or those without stable income may find it hard to move out of the poverty circle (the underclass is a good example in this as they are trapped in poverty for several generations). It is the role of the state to search for ways of moving such people out of poverty and improve their wellbeing through large scale tax-money financed social programmes that target the poor. Historical accounts show us that the development of the welfare state and welfare programmes in the western societies was a response

52. In the United States of America, President Obama injected taxpayers' money into private companies such as General Motors as well as banks as an attempt to bail them out from financial crisis. This was a way of protecting companies from collapsing, which would have had multiple effects – for the government, loss of tax revenue and for the companies, unemployment, loss of market share, loss of competitiveness. The same was the case in the United Kingdom

of the state initiatives to better serve residents and assure them of a minimum standard of living. It must be recalled here that states exist because there are citizens who service them and thus it is the interest of the state to look after the welfare of its subjects so that they can continue to service the state. Through the support of the state in the western welfare governments, citizens were able to access minimally accepted decent housing facilities, food, education, income, medical services and clothes to mention some. The state made it possible for the majority of the residents to be able to get these as a way of enhancing the quality of life of the people and hence the comfort of the state as well. It is palatable to say that welfare states are developmental states because they invest to develop the people and improve their quality of life. Citizen centered states are welfare states in principle and they struggle to improve the welfare of the average citizens rather than just a few privileged ones.

The state may also want to redistribute wealth by using fiscal policies where the wealthy people are taxed accordingly and the revenues are used to subsidize social services for the working class. Though it appears as tax on the face of it, in reality this is wealth transfer from the rich to the poor and it can be done more harmoniously via the state. Although private companies, faith based organisations and some individuals have been helping the needy in various forms, it must be noted here that such isolated and uncoordinated initiatives have multiple disadvantages. These include duplication of efforts, un-harmonised initiatives and incomprehensiveness. They also tend to miss economies of scale and agglomeration. In terms of geographical coverage, uncoordinated plans tend to leave out some areas where providers have no economic, political or social interests.

The rise of the welfare state as we know it today has its origin in efforts to re-distribute income and alleviate poverty (Samuelson and Nordhaus 1989). Towards the end of the 19th century leaders of Western democracies made decisions that produced the modern welfare state or welfare policies and programmes. The decisions were to introduce the concept of government responsibility for the welfare

of the people. What this means is that the government has to take a central position and act to not only protect the wellbeing of the people but also take steps in advancing their condition, improving their quality of life and cushioning them from any contingencies regardless of their socio-economic condition in the larger society. Samuelson & Nordhaus (ibid) notes that welfare states guarantee people a minimum standard of living irrespective of their market incomes. This can be achieved through provision of public pensions, accident and sickness insurances, unemployment insurance, food and housing support, family allowances and income supplements for certain groups of people (the disabled, for example).

Besides the provision of the above benefits, welfare states concentrate on building roads, bridges, ports, railway lines and all investments that help to make business possible. Under this, the state also invests in human resources development, provision of education for the present and future generations as well as guaranteeing rights of workers at the workplace (Kornblum 1998). All these are possible if the state is efficient in collecting revenue to meet the expenditure. The tax collected is aimed at providing citizens with collective goods on a non-commercial basis (Livingstone and Ord 1980). Since a government ought to be there for the people and do all that it does for the people, it thus collects tax and provides the goods and services on a non-commercial basis for the people.

THE NEO-LIBERAL STATE AND SOCIAL DEVELOPMENT

Unlike a welfare state, a neo-liberal state favours individual private property rights, the rule of law, free trade and institutions of freely functioning markets (Harvey 2005). Market forces determine to which sector investments should go, at which locations and at what cost. The market of the produced output is further determined by the market forces, as is the size of the profit. In neoliberal economies, each individual is held accountable for his or her own success or failure as matters are decided by market forces and not the state. Everything is essentially determined by forces triggered by the market or determined by the invisible hand of the market. Harvey (2005) notes

that these principles of the neoliberal economy apply in all areas of social welfare, including education, health and pension services,⁵³ and as such families need to plan in a timely manner on various aspects. It must be noted here as well that neoliberal theorists argue that democracy and governance by the majority are not necessarily popular in the neoliberal model.

A neoliberal state system is good in societies that have a strong middle class and an elite. In societies of this nature, the vast majority of citizens are able to adequately access all social services, and they are relatively independent and informed. They do not depend on welfare resources and as such being on the list of those receiving welfare support is a shame. In theory, in such situation, welfare programmes will be small as the general population is able to access services. The only challenge is that the economy is driven by market forces and in the event of crisis, many families are affected and governments have to have plans of influencing the market. This discussion suggests that developing countries are expected to tilt more towards a welfare state model than the neoliberal one because they do not have a strong middle class at present and the market conditions are not perfect. The majority of the population in the developing world are still in the working class category and if they are not supported through state-sponsored welfare programmes, their effort to move out will take a long time. Given the nature of developing economies and the level of class development (the peasant class is big and at the bottom), leaving market forces to determine the social development trajectory is a very risky course. Leaning on the neoliberal model would thus delay social development in developing countries.⁵⁴

Despite all their achievements over the years, in the recent period neoliberal states are experiencing a serious challenge. The euro zone crisis and the rise of the *Occupy* movement in America are good examples of the challenges to the neoliberal state. The market forces are not doing very well and the state has had to move in several times in attempts to rescue the situation. Banks and financial houses are in crisis, companies

are closing branches and downsizing employees, the middle class is not enjoying its privileges and some are sinking down to the working class. Governments have announced austerity measures as an attempt to cut down expenditure and survive the situation. In the United States, there is the development of the Occupy movement, the movement of the 99% versus the 1%. The theory behind the Occupy movement is that it is only 1% of the population which is benefiting from their economic condition. This is a reflection of the failure of the market to distribute economic benefits to the general population; the majority of the people feel that they are sinking back into poverty. They are not able to pay for their mortgages, buy adequate food, service credit cards, and maintain their standard of living. Who is benefitting and who is losing is determined by the market.

WHY WOULD A GOVERNMENT FAIL TO COLLECT OR EXPAND TAX REVENUE?

It was noted in the previous sections that some goods have a collective consumption behaviour (social goods) and they can only be provided at the national level or at least at sub-national level. Further, different infrastructure needs were mentioned as well as social services. The list can be extended to include national security and policy making processes. All these are covered for financially by tax revenues. Tax revenues are also used to stabilise the situation when markets are not able to address challenges immediately. Furthermore, tax revenue is used to help those trapped in the loop of poverty so that they are able to enjoy upward social mobility. The benefits of tax particularly from the welfarist point of view are clear. Indeed tax is both a development resource and a social development tool. With such a clear picture, why would a government fail to collect tax? Put differently, why would a government advocate for tax holidays that reduce its ability to deliver?

The following sections provide some of the reasons for such a state of affairs.

Excessive Tax Holiday Policies and Tax Evasion

Tax holidays are special incentives extended to

53. Harvey 2005 notes that social security has been privatised in Chile and Slovakia; this is a core area of welfare states used to finance senior citizens in the general population.

54. In this case, welfare programmes are important to jumpstart sections of the population trapped in the bottom rungs.

investors for a period of time so as to facilitate their start-up activities in the economy before they start paying tax. In this, investors are granted a specified period of time in which no payment is made to the government as tax. The rationale behind such grants is that, for a new investor, the cost of starting up a business may be prohibitive⁵⁵. By getting some time in which they do not pay tax, they have time to compensate for the cost of starting up the business. When these holidays are excessive, they become a problem rather than an incentive. This is clearly captured in the views expressed in Habari Leo, a local government daily:

Takwimu zinaonyesha kwa sasa tunapoteza kiasi kikubwa sana cha rasilimali bila kibali na hii inatokana na makampuni kukwepa kodi kwa njia mbalimbali ikiwemo kudanganya katika bei ya manunuzi na uuzaji.

“Tunakoelekea kwa sasa Tanzania kama nchi tumegundua mafuta na gesi, hivyo kuna uwezekano wa makampuni mengi kujitokeza hivyo kama hatutajiwekea misingi mikubwa tutapoteza fedha nyingi.” alisema Kulaba. *Habari Leo 8th May 2012.*

Statistics indicate that we are losing a lot of our resources due to various tax evasions, including mis-pricing, by multinational companies. Where we are heading, Tanzania has discovered oil and gas and more companies would want to invest and if we do not set up a sound foundation we will lose a lot of money, said Kulaba (own translation). Habari Leo 8th May 2012.

The point that is being raised above is that the country is losing money due to tax evasion of different kinds. When the government overdoes this, it will not be able to collect adequate revenue and hence will not be able to pay for its expenses and invest in development projects that will help change the quality of life. This is an area that demands careful planning because investors and government officials may collude to

evade paying taxes, a practice that affects the entire society.

Corrupt Practices, Weak State Capacity

Corruption and weak state capacity is another reason that may lead to state failure in collecting tax revenue⁵⁶. Widely spread corruption particularly among civil servants leads big tax payers to collude with some officers and evade all or part of their taxes. When big tax payers have colluded with civil servants, huge tax evasions occur and in some situations they simply refrain from paying tax⁵⁷. The situation is worse if civil servants have companies and business units which are expected to pay tax. Corruption develops very rapidly in a situation where the state has little or no capacity to monitor it and where individual civil servants tend to maximise their personal benefits. Along the same lines, holders of public office abuse their positions to accumulate wealth. When the state becomes the source of accumulation, the capacity of the state to deliver is compromised. This affects the capacity of the state to collect tax from its people.

Policy Makers not Sensitive to Developmental Function of Tax

Tax revenue collected by the state is used to finance development and recurrent expenditure and at times more priority is on the recurrent activities. This has a long term effect particularly in building the capacity to generate even more tax in the country. Policy makers and government bureaucrats need to recall the development function of taxation so that the money collected is also spent on development activities rather than on recurrent ones alone. This is critical because insensitivity to the development function of tax revenue results in spending in unproductive and counterproductive activities which do not add value to the quality of life of the people.

However it must be pointed out that that the level of understanding is not the same across the board and thus the way in which they plan the use of tax revenue is not necessarily meant to benefit the people in the

55. One of the chief complaints in the area of excessive tax holidays in Tanzania is that investors who have a period of enjoying the benefit, resell their businesses or change names and then request for a new tax holiday.

56. See the story in Habari Leo 1st December 2011: JICA to Support Capacity Building for TRA Officials. According to the news JICA aims at helping Tanzania to reduce aid dependency and build its own capacity to generate internal resources for its own development. See also the story in Habari Leo 30th May 2009: Wabunge walina TRA; in which Parliamentarians complained that TRA officials stationed at the port take bribes and negotiate about tax to be paid by importers.

57. See the story in Nipashe Jumapili August 19, 2012: Migodi yakwepa kodi Sh. Billion 40.

short and long runs. As we have argued above, tax revenue is a development resource and for it to give the best returns, it must be properly planned for and used. Given the scarcity of development resources versus competing demands, government officers must refrain from spending tax revenue on luxury items such as expensive cars, overseas travel, workshop allowances, celebrations and show of authority. When such things are overdone, the consequences are that people are demoralised and see no reasons to pay tax.

Absence of Sources of Revenue

The government may also fail to collect tax or expand its revenue collection if there are no sources of revenue to tap from. During the budget speech in the National Assembly, the Minister of Finance presents the state budget and describes all the sources of revenue, new and old. Where the new sources are not able to raise the required amount of money, the tax levels in the old sources are raised to cushion the gap. As a country develops, its sources of revenue expand from peasantry-based agrarian sources to postmodern knowledge-based sources. The country is able to achieve these if there are adequate savings in the economy which are translated into investments. What needs to be emphasised here is that investment in the society should be sustainable and predictable for a country to expand its sources of revenue from time to time.

People pay taxes to the government out of their incomes, their daily transactions, property and other sources of revenue and in return they expect a good use of their money. The general public expects that their tax money is used to develop economic and social infrastructure so as to reduce not only the cost of doing business but also the cost of living. When revenue from tax is put into good use and the general public is able to see tangible outcomes, they are mobilised to continue paying tax and even more tax. However, if the tax money is misused and the general public does not benefit from the collective savings and investments that ought to be done by the state, they will not only be discouraged from paying tax but also they would not be able to expand their economic investments, which are new sources of tax revenue for the state.

Underdeveloped Human Resources

One of the main sources of tax revenue is individual income; and in a progressive tax system those who earn more pay more. For people to pay more tax to the state, they must be developed so that they can produce more. It is important to note also that well-developed human resources are responsible for higher levels of productivity, research and development activities and innovation. These are activities that do not only expand productivity and income hence providing a good tax base, but also they create more job opportunities in the economy which is essential for more people to contribute into the economy. As a country there must be a good plan of investing to develop human capital as a way of creating sustainable sources of revenue to the state. These investments are in the form of education, health and shelter to the general population which are essential for them to engage meaningfully in economic activities.

Dominance of the Peasantry and the Informal Economy

Peasant economies are characterised by small holder, non-mechanised or semi-mechanised farming. Usually the productivity is small and thus the potential tax base is also small. Furthermore, due to their wide dispersal in the country, tax collection may be difficult and more expensive, and some units/households may be easily missed. The contribution of each peasant to the national output (value added) is small. In a country where the peasant economy and the informal sector are the dominant sectors, the state may have a challenge in terms of getting adequate revenue. The situation is also a challenge for the revenue collecting authority because efforts that will be required to collect tax are relatively substantial compared to what is actually collected.

Unlike the peasant economy, industrial or plantation economies have a few large scale companies which are well known and their tax is readily available and paid. The cost of collecting tax from the few corporate units is relatively very small. The revenue authority needs to expand to include those in the informal and peasant sectors.

The Collapse of the State

State legitimacy is very important and it needs to be very clear to civil servants and the people in public office. The state and its respective organs have to exist and state legitimacy has to be valid for people to continue paying their taxes. In any country the state has to have the supreme powers which no other institution can have and hence it is respected by all other organs, institutions and individuals. As argued by Adam Smith (1776) in his classical writings, the state provides services which others cannot provide to the residents. When the state is able to discharge its core functions, it preserves its legitimacy and sovereignty. The more it is able to discharge, the more it consolidates its legitimacy and sovereignty. When the state has collapsed, as was the case with Somalia after the leadership of Siyad Barre in 1991 or weakened as is the case with Democratic Republic of Congo, its legitimacy is no longer valid and hence people will not continue paying tax. The decision to not pay tax triggers a multiple round of effects and counter effects. In such a situation, the institution that will be serving in place of the state will have a hard time delivering its core services because people would not be ready to pay tax, which is the source of the capacity of the state to execute its duties. It is important to note that people pay tax in exchange for public services and where they are not getting those, they will not continue paying tax. The fear is that their money will be wasted - used for private gain, wars or protection.

Preferential Trade Arrangements and Associations

Preferential trade arrangements and associations are gaining ground in the modern business world and countries are increasingly attracted to join them where they exist or form them where they do not. When a country is in several preferential trade arrangements with multiple other countries, it loses or reduces its revenue base as goods from member states are allowed to enter the domestic market without paying tax. Depending on the level of agreement, a country may lose a substantial source of revenue,

which compromises its ability to finance welfare and development programmes. Moreover, such agreements and associations may cause a member state to miss tax revenue from the rest of the world because of the common protection tariffs applied in the region. In some situations associations divert trade from certain countries, thus affecting revenue collection in the form of tax (Chacholiades 1978).

Although trading arrangements are attractive, before a country decides to join a particular trading block it needs to critically evaluate the gains and losses of joining. Where losses outnumber the gains, it is prudent to reconsider its position. The analysis needs to be done carefully, examining the forward and backward linkages associated with the nature of the decision which will be made. Looking at the losses and gains from a development perspective, it is essential to examine the development benefits of joining and or not joining such a club.

Absence of Effective Institutions for Tax Collection

The state may also fail to collect its tax revenue if there are no effective institutions and a system to do the job⁵⁸. Effective institutions to collect tax are important because they do not only collect tax professionally but also efficiently. Such institutions have the required expertise to consider the size of the tax, when to collect it and where. Tax collection is a noble exercise that demands a well-coordinated system. Further, the process of paying tax should be easy, convenient and the institutions entrusted to do so should be able to smoothly collect tax as planned. Where the existing agencies are able to collect tax, the government will have the required resources to finance its activities. Experience shows us that when the state is not able to collect tax, such situation threatens even its own existence. The government, in the extreme case, will collapse because it cannot pay and provide for the collectively consumed goods. Policy making processes would stop, provision of all welfare programmes would be withdrawn, investment in education would not be possible and protection of the country would be difficult.

58. A good example here would be the collection of property tax in Tanzania, which is paid to the local governments. It is one of the difficult sources of revenue and is not well done. In the city of Dar es Salaam, the government has moved this activity to the Tanzania Revenue Authority which is also using private sector companies to enforce compliance. Outsourcing revenue collection is a common practice in most Local Government Authorities. Although through this practice revenue has increased, the practice confirms that the state at that level was failing in tax collection.

Moreover, administration of justice and legislative activities in the country would all be affected and hence weaken the state.

WHY WOULD CITIZENS STOP PAYING TAX?

Indeed, at this point, it is obvious that the benefits of paying tax are clear and that all parties should be happy to pay tax. The government would, on the one hand, spend the collected revenue decently to stimulate economic and social development. On the other hand, not all citizens are happy to pay tax and at times, even those paying tax may stop doing so. The fundamental question thus is *why would people stop paying their taxes to the government?*

Tax represents an outflow of money from the payer to the state and it is not as pleasant as receiving money. People would hate to pay tax not because they do not want development benefits but because they do not get adequate and comparable benefits/returns from the tax they pay. People would be happy to pay their taxes if the money is spent in a responsible manner. Despite having in place an equitable tax system (Musgrave and Musgrave 1980) that encourages people to pay tax, there should be visible and tangible development outcomes that can be identified. The government has to have the culture of spending tax money according to plans and mechanisms that show tax payers that their money was well-spent. Controller and Auditor General (CAG) reports are good but you need several other systems to do the job and not just the CAG. As noted in the previous section, states may fail to collect tax due to a number of reasons itemised earlier. However people may stop paying tax as well and the reasons may not necessarily be the same as those of the state although in most cases they overlap.

In the extreme case, people would stop paying tax anytime there is a feeling that the state has collapsed. As discussed above, when a state collapses, members of the general public would not be ready to pay tax as there is no effective organ that is able to discharge the function of the state. They do not know where the revenue is going, they cannot demand accountability and they do not get any benefits. Economic opportunities may close and the people may experience hardships - lawlessness, crime and dysfunctional state

organs such as the police, courts, legislature, local government and other government agencies.

In a democratic society, when the state begins to show signs of weakness and inability to deliver, citizens would vote out the government in office and replace it with a more serious one – one that is able to provide the collective goods and discharge functions of the state effectively. When the state is not able to collect its own tax revenue, it is a critical sign that the state is beginning to fail. It is tax revenue that pays for the salaries of the civil servants, government expenditure, security services and development projects. Thus it is very important for the tax payers to be informed and to hold their government accountable.

In a dictatorial society, where rulers cling to power even when things are crumbling and the state is unable to deliver, the people will go without adequate services from the state and they will begin to feel uncomfortable under the regime in power. Such regimes are riddled with corruption, nepotism, and personal interest. Over time with the rising dissatisfaction, there may be outbreaks of civil wars in an effort to change the regime. Tax is thus a critical source of not only development in a country but also peace and order. The state will not be able to enforce peace and order if it has no revenue to spend. The people would not be happy with their government if it is not making any development progress and advancing their quality of life.

When the above conditions have reached the extreme case, individuals will not only hate to pay tax, but they will stop paying tax and use the money for other options, including getting private security, buying justice and building their own bridges and charging (Somalia is a good example where, following the collapse of the state, war loads are mounting road blocks and charging tolls; and pirates are hijacking ships in the Indian ocean for ransom money]. Conditions of this nature do not allow collective saving to happen and thus collective investment and later collective consumption. The result of this is growing levels of poverty and chaos in the country. It is a condition that limits social development from happening and thus poses a threat to the life of a nation.

CONCLUSION

Should citizens pay tax to their governments? The preceding discussion points to an affirmative response. Governments need tax to deliver their expected outputs. Tax is a development resource - it is needed for a common good and common development. Welfare programmes, financed through tax are important stabilisation initiatives to ensure that the whole society develops together. Inability to collect tax signals that the state is failing and will not deliver its promise to its people.

This paper is about taxation, the welfare state and social development. In this paper we provide a theoretical argument to show that tax is a critical development resource in any country. Using welfare state arguments, it is demonstrated that the state is able to invest in social development and influence the quality of life of all citizens and uplift their conditions. In this, it is argued that tax is a form of collective saving and for it to have a positive impact, investment has to be made.

It is further noted that such investment contributes to expanding the tax base and hence the development potentials. This is because the capacity of the state to invest in development programmes grows with more resources. For all this to happen, it is argued that tax payers and policy makers have to be equally made aware of tax revenue and its use. In the second part, the paper looks at the factors that prevent the state from collecting tax revenues. It is noted that in the extreme case such a state will collapse as there will be no resources for collective activities.

It is demonstrated that people would stop paying tax if the state is not delivering the expected goods and services. Similarly, the government should stop subsidizing companies that are investing in Tanzania in a variety of tax exemptions- both national and local government taxes.

Musgrave and Musgrave (1980) provide six qualities of a good tax system. These are:

- The distribution of the tax burden should be equitable. Everyone should be made to pay his or

her share.

- Tax should be chosen so as to minimise interference with economic decisions in otherwise efficient markets.
- Where tax policy is used to achieve other objectives, such as to grant investment incentives, this should be done so as to minimise interference with the equity of the system.
- The tax structure should facilitate the use of the fiscal policy for stabilisation and growth objectives.
- The tax system should permit fair and non-arbitrary application and it should be understandable to the tax payer.
- Administration and compliance costs should be as low as is compatible with the other objectives.

What Musgrave and Musgrave (1980) are advocating in the first and the third qualities are exactly the main issues in this paper - that the tax burden should be equitable, everyone must pay their share, and any use of tax for other objectives should not compromise the equity of the taxation system. It is clear from this discussion that there is a clear link between taxation and social development and thus nation-states need to valorise this link so that citizens can see it and participate in paying tax as well as mobilising fellow citizens to do so. The benefits of valorising the link are multi-faceted and they do not end with the ordinary citizens only. All members of the society, including corporate citizens, gain, including state institutions, which are able to get the required resources and execute their expected functions.

RECOMMENDATIONS

Governments and revenue authorities in Africa and Tanzania in particular, should critically reflect on taxation, the tax system and its established culture in connection with socio-economic development. We are recommending this because domestic revenue is a critical and crucial window for national development and thus efforts must be made to strengthen this source of local development.

Development policies in developing countries need to reflect and invest in enhancing domestic revenue capacity as a basis for national development. This is

because a good foundation and efficiency in this area have embedded benefits that come with increased capacity of the state to develop infrastructure.

It is also argued here that that there is a need for developing countries to invest in developing their tax base so as to increase the capacity of the state to generate revenue for financing development activities. A broad tax base plus the ability to collect tax revenue create opportunities for the states to not only get more tax but also resources for financing collectively consumed services. Internally generated revenue has multiple effects in the economy in that besides building up the stock of resources in the country and reducing aid dependency, it also promotes investments, opens up more opportunities for people to efficiently engage themselves in the economy, improves the quality of life and eliminates disparities.

Given the eminence of tax and the necessity of every citizen's participation in paying tax, the government should think of expanding the tax base to include the informal sector. This will not only generate more income and enhance the capacity of the state to deliver and cut down aid dependency, but also plant a new culture of paying tax among the citizens. However, this goes with good accountability on how tax money is used by the state.

To reduce tax evasion and avoidance, there is a need for the government to do extensive consultations on proposed new taxes and their levels. Consultations will allow the stakeholders to own the process and improve their willingness to comply. This is also important in preventing capital flight as a response to high tax and un-consultative tax regimes.

The general population should also be educated on issues of tax exemption, which should initiate wider national discussions on tax exemption, what it costs and what are the benefits. This has multiple advantages in that it will stimulate citizens to take corrective measures and informed decisions about paying tax and revealing culprits and dishonest civil servants.

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