From Consumer to Citizen
Building a social contract for transformation through direct taxation

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ABSTRACT

Externally driven financing of national development strategies has resulted in a serious challenge faced by African States to develop an effective exit strategy from resource rents and aid. This paper seeks to demonstrate that direct taxation, while raising revenues for development, has the added advantage in the makings of a social contract which enables economic transformation. It contributes to the growing debate on governance necessary for development using secondary data on governance and taxation to further investigate this relationship. Initial findings show that over the period 2006-14 a one per cent increase in direct taxation is correlated with a 0.13 per cent increase in accountability, whilst trade taxes are less significantly correlated and indirect taxes and ODA are in fact negatively correlated with accountability. This takes on increased urgency as the Agenda 2030 Sustainable Development Goals – based largely on domestic resources and with a focus on transformation – take centre stage as the new development agenda.

Keywords: Taxation, accountability, social contract.
INTRODUCTION

The recent economic resilience demonstrated in African countries, notwithstanding the international economic crisis and fall in global commodity prices, needs to be sustained and rendered more inclusive and poverty reducing. There is a broad consensus that sustaining growth is a challenge in Africa not only because the right economic policies have to be identified, but because these very policies have to be supported by appropriate governance capabilities. Indeed, based on surveys gauging perceptions of the quality of six dimensions of governance, there is a clear upward trend in which countries with stronger governance achieved faster growth rates. Successful countries had a set of capabilities and political arrangements that allowed capital accumulation, technology acquisition and political stability applied in different national contexts.

Taxation is important, if not crucial, for development (Ranker and Gloppen 2002). The modalities for income collection and redistribution are the basis of policy formulation and credibility (Sindzingre 2007). This has currently taken on increased urgency as many African countries are facing challenges of an exogenous and endogenous nature. The international economic and financial crisis and subsequent drive for austerity and opposition to economic globalization has led to probable drops in aggregate Official Development Assistance (ODA) to Africa and diminished global demand for African commodity exports. Domestic resources take on an even more pronounced role not only in replacing lost external revenues but in positively affecting endogenous institutional development. Indeed, development objectives including the Millennium Development Goals are often criticized for lacking clear ownership and leadership at both the national and international levels, as well as not assigning accountability to any one institution, party, or country (Bourgignon et al. 2008). Indeed, there is clear acknowledgment on this

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state of affairs with the shift towards the global Agenda 2030 Sustainable Development Goals (SDGs) and the complementary Addis Ababa Action Agenda. The focus on domestic resources and domestication of the SDGs at the national level would strengthen the institutional impact on ownership and accountability (UNECA 2012). The alignment of global SDGs to national strategies, as defined in national visions and plans, further reinforces the ownership and accountability features necessary. This has also caused some rethinking on the role of the African State in development, gaining from similar experiences in East Asian countries’ early successes which were partly driven by a State that directed economic development. The developmental State continues to gain consensus as a necessary institution that steers through policies rather than ownership of large swathes of the economy towards growth and transformation. One of the key components that ensures local ownership of the development agenda is domestic resource mobilization (UNECA 2010). Furthermore, it has been acknowledged that a key responsibility of the developmental state is to direct and foster economic and structural transformation. Indeed, concerted investments and interventions by the State are needed to spur the sort of industrialization and building of new competitive advantages that can help African states move away from primary commodity dependence in the manner that has occurred throughout East Asia (UNECA, AUC 2017). State-directed development in adherence with global goals does require what is termed the social compact of ensuring fiscally sustainable programmes and projects and “leaving no one behind” (UN 2015). In this regard the Addis Ababa Action Agenda proposes a revamped progressive tax system, improved tax policy and more efficient tax collection for achieving these global goals. The link between tax and development in this new global agenda becomes critical.

Taxation is an underrated tool not only as a source of finance for development but also as a means to build more capable and responsive states (Ranker and Gloppen 2002). In other words, without the ability to raise revenues effectively governments are limited, if not externally dependent, on providing security, meeting basic needs of their populations and fostering economic development. In addition, taxation has the potential to bolster the

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3 The thematic focus of UNECA (2012) *Assessing Africa’s progress towards the Millennium Development Goals*, is the articulation of a post 2015 MDG agenda based on survey responses from member states, CSOs, Parliamentarians and other stakeholders.
legitimacy of more representative and accountable governments (Bräutigam 2008). This is underpinned by the concept of social contract.

The evolution of the relationship between the State and citizen, an operational definition of social contract, has had a chequered history in Africa. There is no doubt that the current African State is partly a product of a colonial heritage that has shaped not only the formation of the State itself but the relationship between the State and its citizens. The post-independence African nation still has in large measure a neo-patrimonial relationship between rulers and ruled mirroring the previous colonial State. This has given rise to a nation formation that lagged behind State formation and resultant institutions remained exogenously determined and driven (Kawabata 2006). This situation was exacerbated by the shrinking role of the State under the Structural Adjustment Programmes (SAPs) of the 1970s and 80s, raising serious questions about the representativeness and legitimacy of the State. The deepening social crisis across the African continent, including reversals in some of the health and educational gains at independence, also generated concerns about citizenship and citizenship rights which, in some instances, translated into concerted challenges to the entire post-independence nation-State. More recently the social contract has been revamped under the idea of African ‘ownership’ of a development framework, the New Partnership for Africa’s Development (NEPAD), that rallies society around continental development objectives (Olukoshi 2002) and reiterated in the social compact of the new Agenda 2030. In very few instances of Africa’s development was the link between social contract and taxation clearly an economic policy that resulted in improved nation building (Moore 2007).

The relationship between taxation and social contract proxied through accountability in the African context has been investigated through both theoretical constructs as well as empirical studies. This topic continues to be an important challenge in the African context. In a survey on good governance conducted in thirty-five African countries, slight progress has been registered since 2005 in rule of law and better observance of human rights. In addition, economic management and efficiency of the tax system have also
improved. However, access to service delivery remains far from satisfactory, quality remains poor and accountability rather inadequate (UNECA 2009)4.

This paper hypothesizes that the type of taxation that has evolved on the African continent is not conducive to a well-functioning nation State and locally financed transformation. The literature does point to the links between taxation and quality of governance but is rather limited in unpacking the composition of taxation and governance. A central tenet of this paper is that a social contract is a critical aspect in strengthening the legitimacy of the State, hence reinforcing its developmental role. The paper goes on to demonstrate how the social contract’s importance is linked to direct taxation and is undermined by current tax policies in Africa. This has significant policy implications in sustaining and increasing Africa’s economic performance and improving the quality of accountability.

This paper is so structured with Section I a literature review of the link between resource mobilization and governance in the African context. This is followed by Section II that maps out a methodology using secondary data and provides some preliminary results. The paper concludes with Section III providing some policy considerations.

I. LITERATURE REVIEW

The concept of social contract has been increasingly drawn upon to help explain the politics of development across a range of different contexts, political processes and policy areas. Some development practitioners have linked social contract or the lack thereof in a partial definition of failed States. Indeed, State fragility occurs when ‘the social contract is broken due to State incapacity or unwillingness to deal with its basic functions’, including poverty reduction and service delivery (Giorgia 2009: 17). Another stream of literature has used the concept to undertake conflict analysis and advocate for particular approaches to post-conflict recovery (Addison and Murshed 2001). The

language of ‘social contracts’ has been employed to explain the politics of taxation by the OECD and others (for example, Moore 2008), of growth (Haggard et al. 2008), and of well-being (McGregor 2007). The transformation agenda currently in place does address the social compact, mentioned above, in relation to specific social protection outcomes (UN 2015). However, more importantly it is underpinned by a paradigm shift from recipients of transfers to beneficiaries of public services. This in turn re-evaluates public policy instruments including taxation towards an entitlement rights-based approach and the construction of a citizenship for development (See UN 2015; Wit et al 2008; World Bank 2013).

The rise of social contract defined as the relationship between citizens and the State is derived both from a set of concerns within international development and an increased awareness of the importance of politics in shaping policy outcomes. There is now widespread acceptance within development circles that good governance matters for improved development outcomes. However, the specific ways that these interact in African countries remains largely unexplored both conceptually and empirically.

In this paper, a glance at the literature on resource mobilization, both external and internal, as it relates to governance in the African context is the first step to elicit the key elements necessary to evaluate taxation and accountability as sub sets. This procedure is based on a conceptual underpinning that taxation is a crucial element in development finance – as noted in the outcomes of the Addis Ababa Agenda for Action on development financing – and that accountability crystallizes the very concept of the social contract. In addition, time series data availability for African countries of types of taxation and accountability allow quantitative analysis that will address the existing empirical gaps.

**External Resource Dependence**
Financial resources for development have relied to a significant extent on Africa’s interaction with outside actors, whether in the form of loans and grants for development assistance or revenue from trade taxes (UNECA 2010).

The trend of net ODA flows to Africa has increased significantly since its countries began gaining independence. Indeed, from US $1.7 billion in 1970, total net ODA flows to Africa increased to US $47.3 billion in 2009, in current US Dollars (UNCTAD 2012). Furthermore, net ODA receipts have played a substantial role in African central government budgets, at 18.2 per cent of central government expenditure in 1970 and 19 per cent in 2008 (World Bank 2012).

Recent commitments regarding ODA have focused on increasing the effectiveness, accountability and local ownership of these flows, including the 2005 Paris Declaration on Aid Effectiveness and 2011 Busan Partnership for Effective Development Cooperation (UNECA and OECD 2012). Yet rather than tackling the underlying concept of government accountability to citizens through expenditure, these agreements have further cemented the external dependency of public services though renewed commitments to absolute levels of ODA. Aid flows have in some cases provided greater incentives for recipient governments to cater to donor groups, rather than to their own citizens (OECD 2009). While ODA agreements have sought new modalities and solutions for this perverse incentive, the existence of externally-provided budget and project support creates a moral hazard for recipients preventing the speedy exit from aid dependence and shift of accountability internally, as recognized by the current AU Reform Panel chaired by President Paul Kagame. Currently, driven by varying priorities in donor communities – with for example refugee allocation accelerating by 27.5% in real terms from 2015 to reach US$ 15.4 billion in 2016, equivalent to 10.8% of total net ODA flows – ODA transfers to developing countries declined from $56.8 billion in 2013 to $50.2 billion in 2016 (ECA 2017). The unpredictability of ODA flows reinforces the ownership dilemma of development agendas and reiterates the need to resort to domestic resources.
International trade, in particular the export of natural resources from Africa, has played an equally significant role in the collection of revenue by the State. Trade as a per cent of GDP has increased in Africa, from 58.8 per cent in 2000 to 69.5 per cent in 2011 (World Bank 2017). Of this trade, increasing global commodity prices have brought higher returns on natural resource exports from Africa. The relative ease in collecting duties at borders and ports – as opposed to the difficulties in administering other forms of taxation – has led to a reliance on trade taxes and resource rents for government revenue. Indeed, from the 1990s through the beginning of the global financial crisis, resource-related tax revenues had nearly tripled as a share of national income in Africa (AfDB 2010). New South-South partnerships involving resource extraction highlight the increasing role that commodity exports will play in financing Africa’s development.

**Recent Developments in Financial Resource Mobilization**

Discourse on financial resource mobilization in Africa, in particular in the wake of the 2008 global financial crisis and 2010 Eurozone sovereign debt crisis, has shifted towards alternative sources of financing, with a focus on domestic financial resources. The volatility of flows to the continent is the main factor driving this concern. Such volatility arises from unpredictable global commodity prices which have fallen considerably from their peak in 2011, as well as the threat to the quality and quantity of ODA flows (AMDC 2016; UNECA 2010). Indeed, studies have noted that growth volatility is 50 per cent higher in mineral-rich countries, and 100 per cent higher in oil producers than for comparable countries (Venables 2016). Domestic financial resources are thus evaluated as allotting greater independence and self-determination to African revenue generation. Even prior to these recent developments, the adoption of open market agendas by African States had mandated a reduction in trade taxes, placing a strain on many State budgets. Pursuant to the need to fill the financing gap, the 2002 Monterrey Consensus on Financing for Development laid out new means of alternative and innovative financing to be utilized by developing countries. Of these, the first strategy identified involves domestic resource mobilization, particularly through savings, investment and revenue generation, which was elaborated upon in the Addis Ababa Agenda for Action.
The paradigm shift towards innovative and domestic resource mobilization has focused on many means by which African States can raise revenues, a key element being taxation. The challenges facing tax collection in Africa have been well documented. Low levels of income and the prevalence of informal economic activities, poor availability of information, and the political sensitivity of increasing the scope of taxation have hindered the expansion of taxation on the continent (Rakner and Gloppen 2002). Indeed, the informal nature of much economic activity across Africa presents a significant hindrance to the collection of tax revenue, and has further cemented a subsequent reliance on external financial sources. Furthermore, revenue authorities focus on large-scale tax collection, leaving them ill-equipped to deal specifically with small and individual businesses (Moore 2013). Weak tax administration capabilities and significant tax evasion have undermined tax collection and led to a low tax-to-GDP ratio in developing countries in general (Chu et al. 2000). Due to the availability of ODA and resource rents, African States had previously lacked the incentive to expand alternative sources of financing and tax their own citizens, which led countries to under-utilize their own tax potential (Bräutigam 2008).

Yet given the need to enhance innovative and domestic financing sources, African States have begun exploring means by which to increase tax receipts. The most practical form of taxation that African States have been able to adopt thus far has been indirect taxation, with indirect taxes as a per cent of GDP rising from 3.5 per cent in the 1990-04 period to 5.0 per cent in the 2000-06 period (McKinley 2009). Value-added tax (VAT) has been the main form of indirect tax expansion (Bahl and Bird 2008). As opposed to sales tax, which may only apply to the final sale of a product to the consumer, VAT allows taxation at every point of value addition, with the consumer as the final tax payer. VAT, and indirect taxation in general, is an attractive option as it requires fewer administrative burdens than direct taxation. It can additionally be levied at borders and ports in a manner similar to trade taxes, facilitating its implementation (Baunsgaard and Keen 2010). This focus on indirect taxation is evident on a macro level across Africa, as well as in countries on an individual basis. For example, in Ghana, while indirect taxation as a
percentage of government revenue increased by over twelve percentage points from 2001 to 2011, direct taxation increased by only two. (World Bank 2017).

State Formation and Governance in Africa

A review of the State in Africa is critical in terms of contextualizing the present institutional setting based on Africa’s past and also providing a deeper understanding of policy options.

The theory of the African State is embedded in its colonial heritage and its resultant specificity (Young 1988). The colonial experience has been an important historical variable that explains current institutions and governance issues (Bathily 1994). Artificial demarcations of national boundaries, current ethnic divisions incited by colonial powers, and an overall exogenous dependency have all led to a uniqueness of the African State and equally importantly a particular State-society relationship (Kawabata 2006). In fact, the neo-patrimonial State, wherein a personal patronage between leaders and citizens as part of the colonial heritage coexists with the development of a bureaucratic administration, becomes the hallmark of the articulation of the African State (Bratton and Van de Walle 1994). Kawabata (2006) notes that the nation-states formed in Africa at independence took the European model of authoritarian institutions. Furthermore, the governing of the state in the African post-independence context mirrored too closely that of the colonial predecessors (Alemazung 2010).

The SAPs of the 70s and 80s, as stated above, through a set of policy prescriptions including the retrenchment of the role of the State, exacerbated the lack of legitimacy of the State in Africa and catalysed the concept of a ‘failed State’. Government institutions became increasingly dysfunctional as the State’s three functions of sovereign authority, institutional and security guarantor were no longer performed (Forrest 1998; Zartman 1997). This line of thought has had a significant policy impact with failed states as an analytical and specific category in multilateral programmes.
The State and its role in the economy is an important area that has provided some historical insights into State building in the African context. Again the theoretical constructs are diverse and complex but what does emerge from existing research is that the patrimonial administrative State uses the State apparatus to build an economic base for itself (Callaghy 1984, Kasfir 1984). In Africa, the State as a functioning institution has focused more on the executive running of its bureaucracy and administration rather than a comprehensive provision of sovereignty, security and basic functions to the citizens. Furthermore, given the history of State formation following colonization, African States face the unique challenge of an administration and bureaucracy with imposed, rather than developed, institutions (Kawabata 2006). This takes on an important dimension when the concept of the developmental state, mentioned above, is analyzed.

The discussion on the developmental State has centered more on the feature of the State’s role in economic development. Whilst the discussion has focused on the degree to which the State dominates the economy, issues of, for example, on whose behalf the State intervenes and whether previous developmental States have failed, remain a policy argument rather than an academic exercise (Cheru 1989, Gadzey 1992, Leys 1994). This aspect takes on renewed policy resonance due to the call by African countries to transform their economies (UNECA and AUC 2011).

The East Asian success stories were predicated on an active role of the State in steering development (Page 1994). African countries have assessed that a more balanced growth path does require a strong State that performs well through ensuring peace, securing property rights and ensuring public accountability in the use of public resources. The latter function of the State is crucial in testing accountability in public service delivery through an operational definition of the State and its role in development.

**Governance and Financial Resource Mobilization**

The literature on development financing has established that a dependence on external financial resources has implications for governance and the social contract in Africa.
These financial sources have a direct impact on the social contract between State and citizen, which relies on the State utilizing tax resources to provide security and essential public goods. Moore (2007) argues that a government’s dependence on non-tax incomes including oil, gas, mineral exports and foreign aid allows the State to be financially independent of ‘citizen-taxpayers’, making the State less responsive and accountable to these citizens, to the detriment of the quality of governance. Sachs and Warner draw attention to the corruption and bureaucratic inefficiency brought about by natural resource rents, and their study (1997) indicates that countries with higher values of resource-based exports in fact had on average lower growth over the 1970-90 period. This has also been partly driven by a colonial heritage wherein African States’ economic activities and budgets have been based on commodity rents. On ODA, Easterly (2006) highlights the high levels of corruption prevalent in aid recipient countries, and indicators of ‘bad governments’ in fact encouraged by ODA flows.

It has furthermore been proposed that the traditional social contract between State and citizens has been transformed in the African context. Due partially to a continuation of the colonial heritage, the role of external actors in both financial resource supply and service provision leads to a contract between the State and third parties, or between citizens and third parties rather than citizens and State (Ochieng 2010). Indeed, institutional frameworks governing natural resources, for example, have been skewed towards revenue maximization with favourable terms for extraction (AMDC 2016).

As opposed to the potentially detrimental effects of external financial dependence on governance, domestic resource mobilization can be more conducive to improved governance and a stronger social contract. The three central tenets of good governance that are vital for the State-citizen relationship are responsiveness of States to citizens, accountability of States to citizens and capability of States to respond to citizens (Moore 2007). In making State revenue dependent on the payment of taxes, governments will consequently need to work towards the prosperity of their citizens. Thus the government will be incentivised to improve the provision and delivery of public services, in order to

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ensure the continued ability and willingness of citizens to contribute to government revenue. Dependence on taxation will therefore have the added benefit of service provision for the population as a whole, making the State accountable to all citizens, rather than to the taxpayers alone, providing that rather than simply increasing the burden on already compliant taxpayers, efficient and fair systems are adopted (IMF 2011).

The more recent focus on indirect taxation as the means by which African States pursue domestic resource mobilization has implications for the social contract between the State and its citizens. During the low growth time span in Africa up to the late 90s the broadening of the tax base and the need to mobilize resources did implicate the emerging idea of collecting easier tax revenues (OECD ). The idea was based on the need for improved and strengthened revenue collection and a simple tax administration to do so. Whilst the results of increased taxation revenues provided the rationale, the regressive nature of indirect taxation and accountability by citizens was not functional to the introduction of VAT. Indeed, in relying on indirect taxation, and VAT in particular, States have entrenched a link between themselves and revenue generating activities. As this form of resource mobilization relies on formal economic transactions to yield State revenue, there is no resultant linking of the State to the population as a whole, but rather a reliance on consumers (Rakner and Gloppen 2002). Furthermore, VAT-focused reforms have contributed only modestly to Statebuilding, defined in Moore (2013) as increasing the capacity and effectiveness of the state apparatus.

Due to the above mentioned administrative constraints in developing countries, the coverage of VAT is in fact limited to the larger firms operating in the formal sector, particularly those engaging in external trade, implying a welfare-reducing potential of a move from trade taxes towards VAT (Emran and Stiglitz 2005). Indeed, given the level of small and informal economic activity across Africa, relatively high VAT thresholds of, for example, GH Cedi 90,000 in Ghana and TZ Shilling 40,000,000 in Tanzania\(^6\) ensure that the minimum income for VAT registry rests above that of many small business men and women. In Uganda, the VAT threshold of UG Shilling 50,000,000 places the

\(^{6}\) Shah, 2012
threshold above the annual turnover of more than 91 per cent of businesses that employ ten or fewer employees (Uganda Bureau of Statistics 2011). This further narrows the group on which the State both directly depends for revenue, and by extension, the group to which it is directly accountable. Regarding VAT as a means to generate resources, Baunsgaard and Keen (2010) challenge the ability of VAT to significantly recover revenue lost due to trade tax reductions, particularly amongst low-income countries, and in fact note that the presence of VAT is negatively correlated with such revenue recovery for middle-income countries. The IMF (2011) notes that strategies that successfully replaced lost revenue utilized a range of taxation tools, including income tax as well.

**Aim of this Study**

Given the research surrounding the impact of general taxation on governance, as well as the focus on VAT and indirect taxation as means to mobilize domestic resources, this paper will examine the potential of direct taxation as a form of domestic resource generation that will solidify the contract between citizen and State and will finance and promote transformation. An unpacking of taxation will allow an examination of whether current indirect and VAT-focused reforms have strengthened the social contract, and whether direct taxation would be a preferable alternative.

Direct taxation therefore draws firm links between the State and its citizens that are absent in an indirect system of taxation relying on economic transactions alone for revenue. This relationship is also vital to underpin the drive to transform – interventions to spur industrialization and sustainable growth require forward-thinking and consistent policies in the interest of the citizens.

The theoretical importance of direct taxation for the social contract has been suggested in the literature. Rakner and Gloppen (2002) propose that direct taxation is superior to VAT in fostering a relationship between the government and its citizens. A disaggregation of governance aspects is a necessary exercise to achieve an operational definition of social contract. This paper will use voice and accountability as a concept that assesses citizens’
responses to government services. This in turn will adequately proxy the social contract defined as the relationship between citizens and the State. The relationship between resource mobilization and accountability shall be measured both statically and dynamically, due to the potential time lag effects of governance reforms (Kaufmann and Kraay 2004). This paper will introduce quantitative analysis to the literature on the relationship between source of financing and the social contract, examining correlations between different forms of taxation and accountability. This will allow a comparison of tax strategies pursued and the levels of accountability of the State to its citizens, including through promoting transformation, across Africa.

II. METHODOLOGY

The data used in this paper is drawn from the 2017 World Bank World Development Indicators (WDI) with regards to economic growth, taxation and other financial data. The WDI is considered to be a comprehensive database of economic and social information across countries and time.

The choice of governance indicators on the other hand is slightly more complex, given the variety of available indicators. One of the most consensual aspects in describing a well functioning developmental state is public expenditure accountability. This indicator, given its basis on subjective perceptions, is not readily adaptable to direct observation and measurement. Indeed, any indicator of governance is considered noisy or an imperfect proxy and therefore there is some measurement error leading to caution in interpretation (Kaufmann and Kraay 2004).

The Ibrahim Index is the most apt for this study due to its quantitative and qualitative sources of data used, its coherent index construction, and its African specificity. Indeed, this composite index is based on an aggregation of both expert assessments and official data, thus playing a useful role in exploiting the complementarities between different
types of indicators and measuring broad but unobservable indicators of governance. This in turn allows for summarizing uncertainty about estimates in each country by constructing confidence intervals, which the Ibrahim index does. The index is specifically African and thus pertinent to the analysis undertaken. Finally, although the index is composite, its categories and sub-categories provide a more comprehensive set of six indicators that range from prosecution of abuse of office to accountability, transparency and corruption in the public sector, with data collected by World Bank, IFAD and AfDB amongst others (Mo Ibrahim Foundation 2012). This does not deter from an inherent flaw of accountability measures in general and the Ibrahim index in particular that measures government performance rather than processes, and any results from the manipulation of accountability scores are preliminary (Knack 2002).

**Governance and Growth**

The first methodological step is to assess the link between governance and economic growth as amply described in the literature. This paper first looks at a static cross country correlation between governance and growth, with most recent data from 2015. This study reveals that the correlation between governance and growth is slight but positive (See Figure 1).

A dynamic perspective of the same variables is important as intuitively the expected governance reforms may require time to produce impacts. The dynamic time period examined here for governance and economic growth is 2006-15, over which the correlation becomes clearer. The dynamic figure for governance is the change in score over this period, and for growth is the annualized per cent change over the period. The starting point of 2006 is not arbitrary as 2005 was the initial year of the implementation of African Peer Review Mechanism (APRM) in a number of counties and the first comprehensive report on African Governance (UNECA 2005) that used national expert

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7 The unobserved components model, to which the Ibrahim Index belongs, assumes the true level of governance is unobservable and the observed empirical indicators provide noisy or imperfect signals (Kaufmann and Kraay 2004).

8 Data used for all African countries except for Guinea, Liberia and Sierra Leone (due to interacting impact of the Ebola crisis), Eritrea, Libya, Somalia and South Sudan (due to limited data availability).
opinion panels, household surveys and desk research in a unique, empirically sound report. The APRM is citizen-centred, thus allowing citizens to have constructive dialogue with their respective governments in order to overcome national governance weaknesses. In addition, through the APRM, national authorities are accountable to the Forum of African Heads of State and Government to bear peer pressure and to learn from each others’ successes and best practices in order to meet their mutually established commitments. Furthermore, 2006-15 captures the pre-global crisis growth, slump following the worldwide economic downturn, impact of high commodity prices and their subsequent fall.

**Figure 1: Governance and Growth**

![Graph showing Governance and Growth](image)

*Source: Authors’ calculations, based on Ibrahim Index and WDI*

Specific African countries such as Ethiopia illustrate the increase in both governance and growth figures. This data on economic growth and governance is inconclusive in terms of clear and strong links between the two sets of variables used. However, the relationship is of the right sign and direction in a dynamic perspective, and both static and dynamic

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9 The APRM is an instrument voluntarily acceded to by Member States of the African Union as a self-monitoring mechanism. The primary purpose of the APRM is to foster the adoption of policies, standards and practices that lead to political stability, high economic growth, sustainable development and accelerated sub-regional and continental economic integration through sharing of experiences and reinforcement of successful and best practices, including identifying deficiencies and assessing the needs for capacity building.
pictures set the stage for unpacking the growth and governance variables into their domestically inspired sub-sets – taxation and accountability.

The next step in this methodology is to focus on accountability as a sub-set of governance. In unpacking governance in this manner, a key item investigated will be the accountability of the State and its expenditures to the citizens. Within the Ibrahim Index, a clustered indicator of accountability is provided under the general category of Safety and Rule of Law. This is an average score based upon six variables capturing various aspects of government accountability. This can be used to examine the role of financial resources as an input to the State’s growth and development efforts against voice and accountability. The static and dynamic correlations of accountability with growth follow the same positive trends as with governance in general above. It should be noted that scores on accountability are significantly lower than that of other Safety and Rule of Law sub-indicators, and that the aggregate score for Africa has fallen over 2006-15.

In order to examine how external resource dependence is correlated with accountability, fourteen countries are drawn upon for which ample relevant data on revenues and taxation is available. While this narrows the sample size of the study, this set of countries does provide a variety in terms of geography, linguistic background and colonial legacies, natural resource wealth and income-level, and the countries examined account for around forty per cent of the continent’s GDP and nearly one-third the population in 2015.

Hypotheses found in existing literature hold that external sources of financing provide alternative parties to which the State is responsible, diminishing its accountability to its own citizens. This study will examine external resource dependence, and how such dependence is correlated with accountability, through two channels: net ODA received as a per cent of central government expenditure and taxation on international trade as a per cent of government revenue. An examination of the correlation between net ODA received and accountability, both statically 2015 and dynamically measured as averages

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10 Countries examined include Botswana, Burkina Faso, Cote d’Ivoire, Egypt, Kenya, Lesotho, Madagascar, Mali, Mauritius, Namibia, Seychelles, South Africa, Togo and Uganda. Proportion of Africa’s GDP excludes Libya, for which data unavailable.
over the period 2006-14\(^{11}\), reveals negative correlations of -0.3138 and -0.3203 respectively, as can be seen in Table 1. When comparing taxes on trade with accountability, negligible correlations around zero are found. As is to be expected, these figures corroborate the proposal that external resource dependence can have an adverse correlation with accountability of the State to its citizens – as in the case of ODA – or at best no connection – as in the case of taxes on trade.

### Table 1: External Resource Dependence and Accountability

<table>
<thead>
<tr>
<th>Correlation between forms of resource mobilization and accountability (measured by R(^2))</th>
<th>2014</th>
<th>2006-2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>External resource dependence</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net ODA received and accountability</td>
<td>(-) 0.3138</td>
<td>(-) 0.3203</td>
</tr>
<tr>
<td>Taxes on international trade and accountability</td>
<td>0.0007</td>
<td>(-) 0.0048</td>
</tr>
<tr>
<td><strong>Domestic taxation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total domestic taxation</td>
<td>0.0181</td>
<td>0.0254</td>
</tr>
<tr>
<td>Indirect taxation</td>
<td>(-) 0.0076</td>
<td>(-) 0.0062</td>
</tr>
<tr>
<td>Direct Taxation</td>
<td>0.1159</td>
<td>0.1316</td>
</tr>
</tbody>
</table>

*Source: Authors’ calculations, based on Ibrahim Index and WDI*

### Domestic resource mobilization

Given the weak correlation between accountability and external resource dependence, this examination can now turn to whether accountability is more closely correlated with domestic resource mobilization. As taxation is a key input to the State’s actions to further economic growth and development, the link between this instrument of resource mobilization and the governance traits of the State can be tested empirically. Here the data on taxation is represented by an aggregation of direct and indirect taxation, as a percent of State revenue. The results confirm that taxation in both 2005 and over the period 2002-09 very slightly positively correlation with accountability with an R\(^2\) of 0.0181 and 0.0254 respectively – which is positive as opposed to ODA and stronger than taxes on trade (See Table 1).

\(^{11}\) Time period amended due to data availability; only through 2013 for Egypt, Lesotho and Togo.
With the focus of domestic taxation efforts on indirect taxation, in particular VAT, a disaggregation of the taxation variable into direct and indirect will facilitate a study of the accountability implications of these financial reforms. The data on taxation from the WDI is separated into taxes on goods and services as a per cent of government revenue (indirect taxation), and taxes on income, profit and capital gains as a per cent of government revenue (direct taxation). The link between indirect taxation and accountability, both in 2014 and over the 2006-14 period, reveals a negative correlation between the two (See Figure 2 and Table 1).

**Figure 2: Indirect Taxation and Accountability**

![Figure 2: Indirect Taxation and Accountability](image)

*Source: Authors’ calculations, based on Ibrahim Index and WDI*

When focusing on direct taxation, this relationship becomes positive and strong, statically and particularly dynamically (See Figure 3 and Table 1). These correlations reveal the potential impact of differing domestic resource mobilization strategies on the accountability of the State, and by extension, the social contract between the State and its citizens, to be discussed in the results.

**Figure 3: Direct Taxation and Accountability**
Controlling for income

While these correlations reveal a positive relationship between direct taxation and accountability, it is possible that income level could be a significant factor driving these results. Regarding accountability, States with higher incomes may have the resources to improve bureaucracies and government institutions, thus improving the services provided to citizens. In the case of direct taxation, citizens with higher incomes may be more able and willing to pay taxes, and States with higher revenues can establish greater tax administration and enforcement mechanisms. The potential effect of this is evident when examining individual cases in the direct taxation–accountability relationship above. Of the countries examined, South Africa and Kenya are significant outliers regarding direct taxation (accounted for 48 and 45 per cent of revenue respectively in 2014), while for Mauritius, indirect taxes make up over 60 per cent of government revenue.

To examine whether an endogeneity bias exists due to the potential impact of income level on either accountability or direct taxation, this study plots GDP per capita against the role of direct taxes. The results of this indicate that income level is marginally correlated with taxes on income, profits and capital gains as a percentage of government revenue, both statically (with an $R^2$ of 0.11) and dynamically (with an $R^2$ of 0.04). These correlations do indicate the potential of income to be a driving force behind both variables, and in particular the form of taxation implemented by the State. Empirical findings of higher income generally leading to increased tax revenues holds but the
composition of taxation has a bearing in this regard. The structural transformation agenda and the reformulation of a social compact necessitates a strengthening of the citizen-State relationship in terms of accountability. Even at higher incomes, the proportion of direct taxation (see next section) on overall mobilized is important for shifting from beneficiaries to entitlement and from consumers to citizens.

Results

The first unexpected result relating to the aim of this study is that the GDP growth and governance link is relatively weak when examining one year. The correlation does strengthen over time and seems to indicate multiple directions of causality through which these two variables are linked. Observations in this study also confirm the expectation that higher levels of income generally mean higher tax revenues. Thus the level of GDP is an important determinant in increasing economic activity and improving overall taxation. This does, in our preliminary results, demonstrate that improved citizenship is linked to enhanced taxation that occurs at higher levels of incomes.

The inference that can be made in this regard is that growth is a necessary but insufficient criteria for a well functioning developmental State. The character of economic growth of the past fifteen years has reaffirmed the need for an institutional arrangement that goes beyond the neo-patrimonial colonial legacy. Improved accountability is driven by the larger concept of economic outcomes of development, rather than simply growth. This explains to some extent the multiple directions of causality between economic growth and governance and the more positive link between level of income and governance. This seems to be the case from the East Asian miracle countries and their improved governance after various years of positive economic growth in the 1970s and 80s.

The results on the link between ODA flows, trade taxes and accountability have confirmed the literature on the subject matter and provided some preliminary quantitative grounding. Following the recent global commodity boom, there are serious disincentives of the State to increase tax effort because of incomes accruing via commodity export
taxes. This in turn makes the political class less responsive to citizen-taxpayers and creates disincentives to build organizational and political capacities of the State. This negatively affects the formation of a social contract between citizens and the State, as illustrated by the weak correlation between taxes on international trade and accountability.

ODA receipts have a strikingly negative correlation with accountability, as the involvement of donors in providing financial resources to States shifts accountability towards these external actors. External accountability has played a role in initiating and driving tax reforms in Africa, but this has generally taken the form of standards on improving administrative operations of tax systems and quantitative targets, rather than addressing the source of revenue mobilization or increasing the role played by domestic taxation in general. The dependency on foreign aid for African national budgets does create a demand by external agencies of accountable spending by recipients, but de-linked from a government-citizen dynamic. Overall, the incentives to perpetuate these forms of external dependence further undermine the evolution of a nationally owned development agenda.

The expected results show precisely that indirect taxes have a slightly negative and weak link to accountability. African countries have, as stated above, increased their domestic resources through indirect taxes in order to broaden the tax base, lower administrative burdens and facilitate easier implementation. The weak negative link to accountability denotes that indirect taxes give rise to embryonic forms of citizenship, or more positive consumer-State dynamics. In fact and interestingly, despite its growing importance as a domestic source of revenue generation, indirect taxation has seemingly less link to accountability than external taxes.

The correlation between direct taxes and accountability is stronger than all other revenue mobilization methods examined, both statically and over time. This confirms the concept that domestic tax collection reinforces accountability and direct taxes even more so. The
very idea of taxes on income and profit rather than on consumer goods is a closer ‘fit’ to the idea of social contract.

A number of interesting aspects can be inferred from the above results. Firstly, indirect taxation that has been introduced in African countries as a policy option has created a consumer-based model rather than a citizen-State dynamic. Secondly, the above results have a profound effect on the developmental State. The incentives provided by ODA and resource rents combined with the relative ease of the collection of indirect taxes severely hampers the development of a solid domestic resource mobilization that strengthens State capacity and also citizen participation. Such incentives remove the citizens from public policy, revenue and natural resource governing decisions. Indeed, continued extraction and aid receipts require far less investment by the State than do active interventions to promote transformation.

The preliminary results of this paper do point out a number of factors for further investigation. The slow progress in domestic tax revenues, in particular direct taxation, does reflect a serious challenge in the current typology of the African state wherein elected officials do not envisage direct taxation as politically expedient. Thus there is some political interest to limit the implementation of domestic tax reforms. Little analytical or empirical work on this aspect has been attempted and these results point towards areas that require analytical work on social contract and direct taxation.

The impact of institutions on economic outcomes depends on the interaction between de jure – legal norms and frameworks – and de facto – empirically observable facts – political power. The former is determined by political institutions whilst the latter is the equilibrium determined by economic and political organization of interest groups. In African States the historically determined tilt towards de facto aspects has implied that government policies tend to reflect the equilibrium of interest groups rather than in favour of citizens. In addition, the recent observed improvements in de jure factors have not been reflected in policies that link the State to the citizen.
An important element connected to the political economy factors mentioned above is perpetuating time inconsistencies. Time inconsistencies arise when policy makers are unable to commit in advance a steady fiscal policy. The paradox is that time inconsistency is endogenous to domestic political economy but exogenous to investment decisions particularly for resource revenues. Commitment mechanisms are vital to building up the human capital, infrastructure and other enabling factors for industrialization. This gives rise to a short term gain of resource income streams rather than long term investments in revenue administrative reforms. The extent to which a government directly controls resource rents creates incentives to avoid the politically sensitive task of taxing the population. However, the longer term investment in institutional capacity of domestic resource mobilization and direct taxation provides a governance dividend of improved accountability.

III. POLICY RECOMMENDATIONS

The recommendations that result from the above findings relate not solely to revenue mobilization, but rather seek to embed the sort of accountability to citizens’ well-being that is associated with direct taxation and incentivizes transformation. Developmental States actively intervene in the market with public policies that are credible and oriented towards growth. Thus ownership of the development process becomes seamlessly intertwined with taxation both as an intrinsic aspect of State formation and in the capacity of the State to provide public services. The above results contribute to this concept through two distinct mechanisms. Firstly, the African State has been constrained in domestically raising tax revenues due to ODA availability, taxes on commodities, trade levies and ill conceived moves from tariffs to consumption taxes. This has in turn constrained the effective formation of a developmental State, defined by ownership of a developmental agenda. Secondly, the form of taxation has a direct bearing on a State defined as having the capacity to levy a share of its citizen’s wealth to finance its specific agenda. Equally important, the developmental State as a policy option underpinning improved ownership and accountability is also based on a fiscal autonomy in pursuing development objectives. In short, pursuing direct taxation reinforces the social contract
dynamic relationship between the State and its citizens and renders the State accountable and hence closer to the definition of a developmental State.

While African States have acknowledged the importance of financing development agendas domestically, concrete policy actions to ensure that governments are on track to shift the resource burden internally have been either lacking or skewed towards consumption taxes. Therefore significant steps, including for example setting mandatory minimum percentages of central government budgets to be funded domestically, will provide implementable tools to match the rhetoric on resource mobilization. These should involve concrete, implementable elements of the Addis Ababa Agenda for Action but with a particular emphasis on opportunities provided by direct taxation. This is not to ignore the importance that external resources have for financing Africa’s current development strategies, thus short-run actions may include adopting measures for more accountability of ODA-recipient governments to their citizens and national ownership of aid and development processes, while medium and long-term efforts shall cement domestic resource mobilization as the key priority. Given the stronger link between direct taxation and accountability, States should act to implement this important form of taxation, often ignored due preconceived notions that it may be more difficult or costly to enforce. Thus while continuing to pursue all forms of domestic resource mobilization, governments can re-focus tax reform efforts on direct taxation in particular, rather than their current predisposition towards indirect and VAT. A direct taxation agenda, when incorporated into a well administered long-term tax regime, may have the further benefit of being applied in a progressive manner. VAT, on the other hand, tends to be regressive in nature, particularly in its impact on domestic consumers and lower-income individuals. Implementing these measures will link directly to current policy imperatives for economic and structural transformation that are already the focus of many African Governments.

One issue hindering all forms of taxation is the informal nature of much business activity across Africa. Indeed, policy advice focusing on the expansion of direct taxation must acknowledge that the current state of formally registered business would provide a small
base on which to focus such taxation, and new tax regimes may disincentivize registration of small businesses. While States may only be encouraged to promote the formalization of business activities due to the subsequent tax revenues that can be earned, there are additional positive implications for the social contract of promoting such formalization. Incentivising firms to register and forfeit income to the State through taxation will require the government to extend social benefits and business support services, thus bridging a stronger social contract through formalization. This can be undertaken in increments, to slowly bring firms into the tax net, at more reasonable rates given their smaller business turnover, while ensuring these firms receive the benefits of service provision. While governments may, as previously suggested, focus on enhancing all tax administration capabilities in the short-term, with direct taxation a more long-term objective, these gradual formalization efforts should be enhanced now in order to provide a greater tax base and to ensure that a larger portion of the population is within the reach of social protection and business support.

On an institutional level, the adherence to the APRM by a good number of African States as a policy instrument that improves governance is an interesting entry point for strengthening the social contract. While other internationally-agreed mechanisms also monitor the activities of governments, the APRM is an innovative accountability mechanism, seeking to redress the imbalances between the State and society. In the APRM codes and standards, the thematic area of economic governance and management, whilst tackling fiscal transparency in terms of autonomy of the Central Bank and adherence to Medium Term Expenditure Framework, does not specifically address the type of taxation policies. APRM codes and standards should incorporate a specific policy recommendation on direct taxation, not only to provide resources for development but also to reinforce the stated objective of creating a more cohesive and productive State-citizen relationship.

This link is not necessarily causal and further research on the type of taxation and its repercussions on governance and the strengthening of institutions is needed. It is interesting to note that the composition of taxation and social spending, a critical function
of the development state, has outlined quantity and quality of resource challenges in achieving the SDGs. The financing of a larger remit of social services in the new agenda needs to be underpinned on increased analytical work on taxation and the role of citizens in accountability.

References


UN (2015a)


