The Social Bargain for Fiscal Policy and Tax Reforms

August 2024

About this Policy Note[1]

Our August note finds the nexus between the cost-of-living crisis and fiscal reforms in developing countries in sub-Saharan Africa, focusing on Nigeria and Kenya, where the introduction of implicit and explicit tax burdens led to citizens' protests and youth activism. It highlights a crisis of trust and the need for greater engagement in the design of fiscal policies and tax reforms. This is crucial where tax bases are shrinking and spending pressures are rising.

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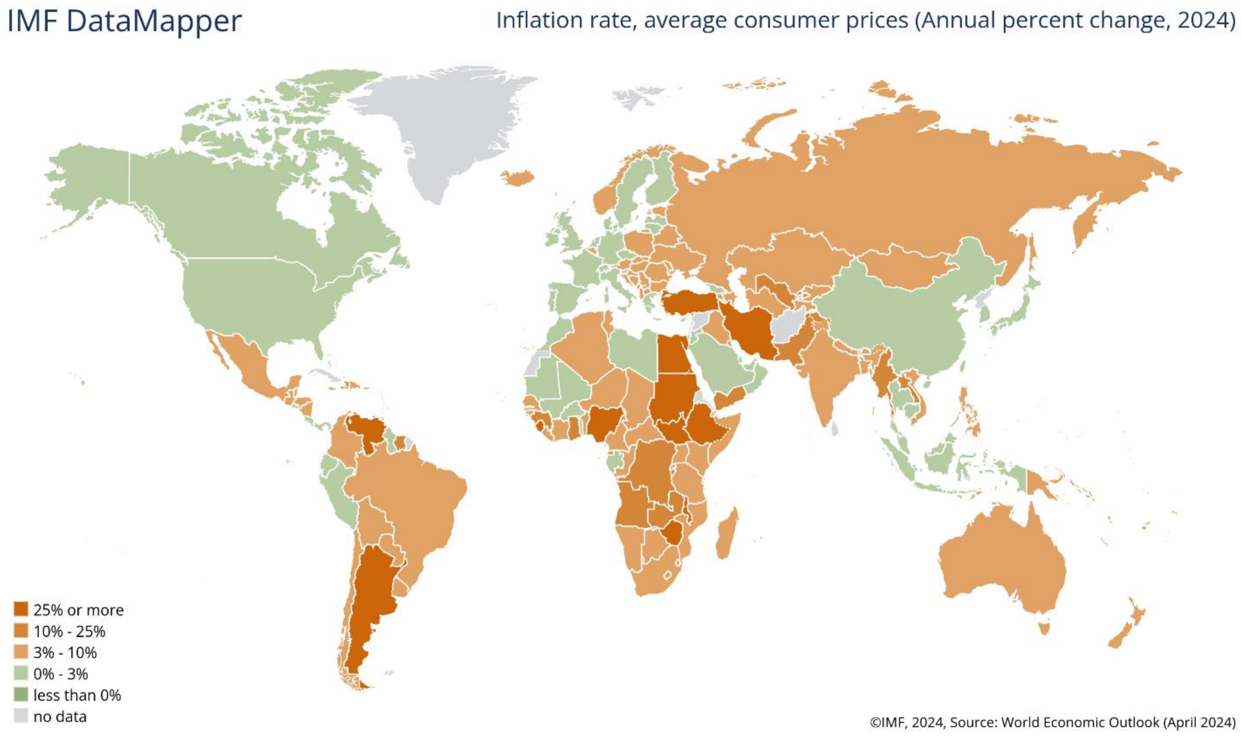
The cost-of-living crisis is persisting in the developing world

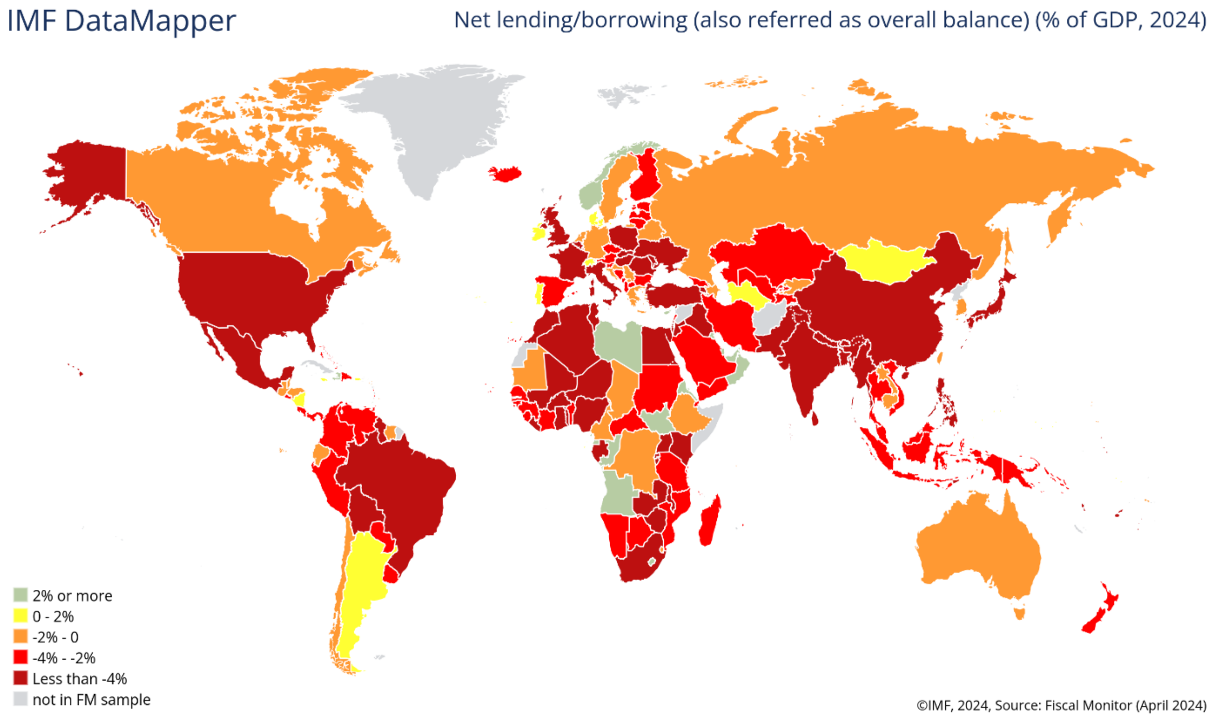
Countries in the developing world are recording a combination of challenges, including soaring food and energy prices, currency devaluation, economic instability, and loss of confidence in governments. The impact is most severe in countries with a high prevalence of poverty, as even small price increases are bringing about devastating consequences, including rising social disorder. While recent economic forecasts and policy documents released by fiscal authorities have provided valuable insights into this trend, they do not capture the real effects on the lives of people.

Figure 1: The cost-of-living crisis is prevalent in the developing world



The persistent rise in prices of essential goods and services, such as food, housing, and energy, above people's incomes has meant that slight or marginal cost increases disproportionately affect the lowest earners. Countries in Sub-Saharan Africa are among the most affected, notwithstanding forecasts by the International Monetary Fund that growth in the region will rise from 3.4% in 2023 to 3.8% in 2024. Last year, 2023, inflation in the sub-region was over 16%, compared to the global average of 7%.

Figure 2: A debt overhang is limiting governments' response to the cost-of-living crisis



Like their citizens, governments in the sub-region have also been hamstrung by the biting socioeconomic conditions. The burden of a debt overhang has limited the fiscal capacity of many of these governments to address the crisis effectively unlike their counterparts in the developed world who have the fiscal headroom to provide large-scale fiscal stimulus packages and social safety nets as seen during the period of the COVID-19 pandemic. A World Bank study[2] prepared by Sebastian Essl, Sinem Kilic Celik, Patrick Kirby, and Andre Proite in 2019 showed that since 2013, median government debt in low-income countries has risen by about 20% points of their gross income. Acknowledging the crippling effects of debt on crisis management, the United Nations during the period of the COVID-19 pandemic had called for a debt standstill and comprehensive restructuring options for heavily indebted countries[3].

Today, faced with unrelenting economic and social pressures, governments have been forced to increase taxes and/or borrow more, as they continue to record budget deficits – a situation where governments are spending more money than they are collecting in revenue. Both options have come with negative externalities. While new foreign loans have come with difficult conditionalities and higher borrowing costs due to tighter monetary policies across the globe, tax reforms have been met by citizens' resistance.

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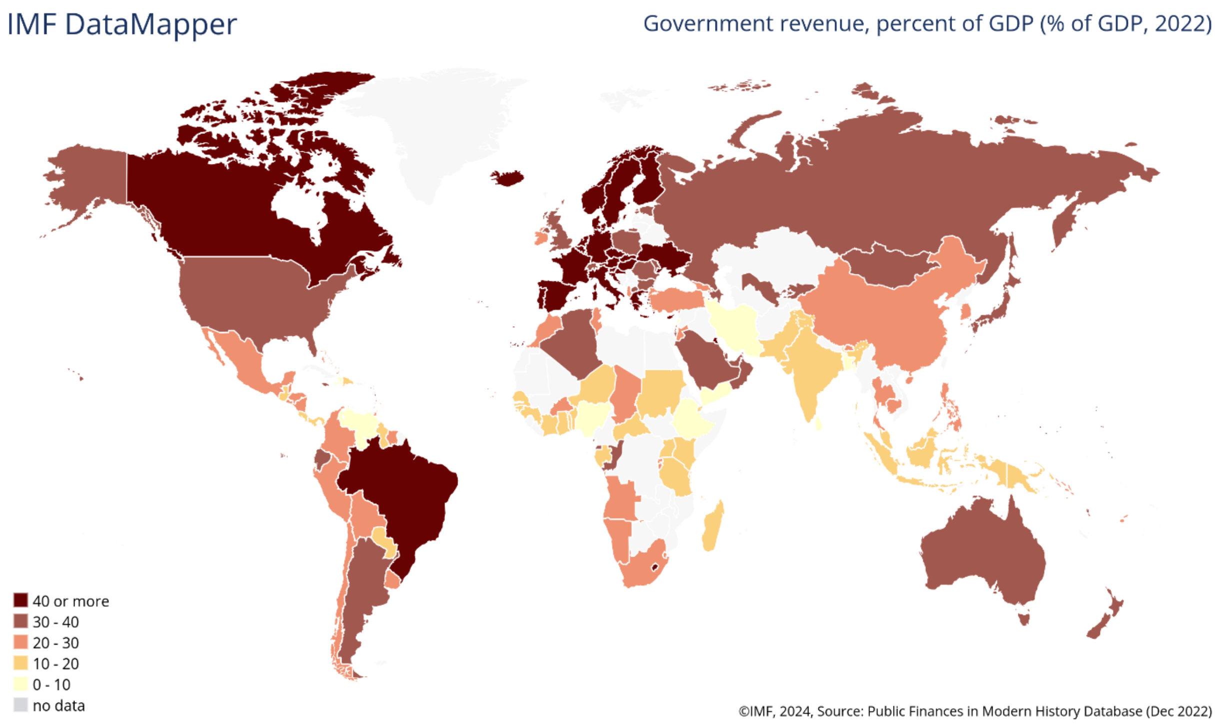
[2] Essl, S. M., Kilic Celik, S., Kirby, P., & Proite, A. (2019). Debt in low-income countries: Evolution, Implications, and remedies. *World Bank Policy Research Working Paper*, (8794).
[3] United Nations (2020, April 17). Coronavirus economics: Debt-laden countries at risk, as financial markets screech to a halt. Available at: https://news.un.org/en/story/2020/04/1062032

The rising scale of budget deficits has been exacerbated by irreversible debt payments and an increasingly oversized cost of general government administration rather than ambitious transformational infrastructure projects which many of them are unable to afford.

Figure 3: Limited government revenues in Sub-Saharan Africa account for the low capacity to respond in times of crisis



The social bargain for taxation

For many citizens in the region, tax obligation is an arcane civic duty that does not fully apply to them and is not central to their lives. This belief is based on the lack of or poor delivery of government services. Many governments, for their part, did not prioritise taxation previously and were content to fund their programmes through rents from extractive resources. Funding public services this way has been based on the implicit understanding between government and citizens that low demands from tax administration meant lesser public scrutiny.

The development bargain is changing today. Public scrutiny has increased, as has the sophistication of dissent, fuelled by the virality of social media, increased citizen engagement and youth activism, as well as to governments' credit, increased transparency on the use of public finances. Citizens being asked to shoulder the tax burden are more circumspect and are demanding greater accountability.

On the 18th of June 2024, Kenya was thrown into tumult as citizens pushed back against a widely unpopular Finance Bill 2024 which would have compounded tax obligations for citizens. The bill which proposed increased income tax rates, taxes on goods and services, excise taxes on fuel, alcohol, and tobacco as well as changes to corporate tax rates was highly controversial and faced significant opposition. The Kenyan experience highlights the importance of citizens' engagement in fiscal policy and tax reforms, particularly through Finance Bills which have become the preferred tool for politicians to introduce sweeping fiscal reforms, including new taxes and tax rates.

In Nigeria, an organic protest tagged #endbadgovernance began on the 1st of August 2024 following the fallouts of the government's removal of subsidies on petrol, exchange rate, and electricity in mid-2023 which saw headline and food inflation rise to 34% and 41% respectively by June 2024. The protests were ignited by the escalating cost of living, with many Nigerians struggling to afford necessities. The removal of subsidies, while intended to ease government finances and stimulate economic growth, had a severe impact on the populace, leading to widespread discontent and calls for better governance.

While the Kenyan experience saw citizens protest against an explicit imposition of new taxes, Nigerian citizens reacted to the introduction of an implicit tax burden brought by the removal of subsidies.

Quite often, taxation is approached legalistically; it is a non-negotiable duty of citizenship; this approach assumes that the government has a moral right to tax and understands the best way to use tax revenues. What is hidden in this approach is the government's responsibility to use the receipts judiciously, but more importantly, it is responsible for engaging, educating, and ultimately securing the reciprocity of citizens. Most bold ideas or reforms are buried in the nexus of citizen engagement and governance. When done right, citizen engagement can increase compliance and inform the responsiveness of fiscal reforms to national and local realities.

Accountability and governance are typically the buzzwords when discussing public finances, and for good reason, but they often belie the responsibility the government has to educate and inform citizens about the use of public finances and also to listen to and learn from them.

Buying the moral capital for tax reforms

The first step for any government looking to raise taxes is to win the moral argument, which is where many governments have struggled. Governments must demonstrate and convince their citizens that they are a trusted steward of public finances and that the programmes they seek to fund are necessary. The fallouts in Kenya and Nigeria showed a deficiency in the moral capital to drive and sustain the fiscal reforms after they were implemented. The public was not convinced that the governments would manage the funds responsibly.

The second step is grasping the political and social environment, which for many governments should extend beyond party politics. This involves engaging with the public and listening to their concerns while informing them of the government's need for taxation and its plan. Understanding the environment may inform a reversal of policy decisions or a change in approach; either way, it would have fulfilled a crucial element in citizen education.

Once these steps have been identified, governments can employ various engagement strategies to educate citizens about public finances. In Tanzania, the Revenue Authority (TRA) adopts regional stakeholder forums. The agenda of these forums are set through feedback received from call centres where citizens comment on the topics that are most important to them. This two-way communication encourages the public to view the relationship as a partnership. In 2023, the Sierra Leonean and Rwanda tax authorities introduced tax dialogues to educate and inform as well as learn and build a two-way education with citizens.

Fortunately, technology tools can be used to bolster engagement and reduce costs. Webinars and online meetings have become commonplace in the post-pandemic world, and social media has broadened the engagement reach effectively. Kenya's President Ruto hosted a virtual public meeting on X (formerly known as Twitter) in the wake of the unrest caused by its 2024 Finance Bill. Holding that level of engagement before introducing the Finance Bill may have significantly altered the reaction to it or informed the government to change tact.

At Nigeria's sub-national level, Lagos State, since 2007, has been known for regularly organising forums to discuss with representatives of the chambers of commerce, professional groups, financial institutions, traditional rulers, and trade associations. In a 2009 speech, the Governor of Lagos State Babatunde Raji Fashola, SAN (2007–2015) quoted: "No matter the effort and sacrifice it entails, peoples' buy-in can be secured when that linkage is vividly established between taxation and development". Recognised as a symbol of tax governance in Nigeria, Lagos State succeeded in multiplying its tax revenues through a combination of increased bureaucratic resources, managerial reforms, public outreach, and cooperation with organised social groups.[4]

These interactions and engagements should provide inclusive experiences that cater to all audiences. Quite often, those with whom the government needs to engage are members of the informal economy. Many governments are still in the process of unlocking the potential of the informal sector, and members of this sector are likely to be the least informed about government programmes and their relationship to taxation. A 2017 IMF report[5] by Leandro Medina, Andrew W Jonelis, and Mehmet Cangul on the informal sector in sub-Saharan Africa suggested that the sector's output ranges from 25% of the economy of Mauritius, South Africa, and Namibia and up to 50 to 65% in Benin,

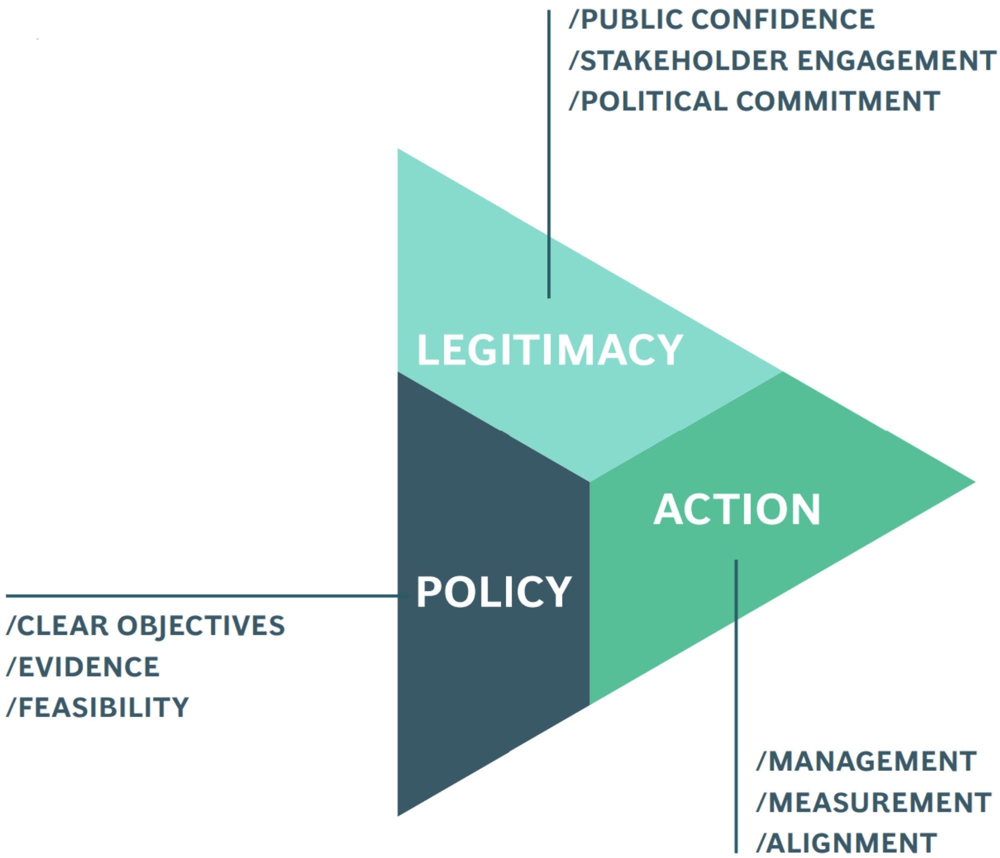
[4]De Gramont, D. (2015). Governing Lagos: Unlocking the Politics of Reform (Vol. 12). Washington, DC: Carnegie Endowment for International Peace.

[5] Medina, L., Jonelis, M. A. W., & Cangul, M. (2017). *The informal economy in Sub-Saharan Africa: Size and determinants*. International Monetary Fund.

Tanzania and Nigeria. The challenge of accounting for the output in the informal sector is one several governments are still engaged with. Information campaigns must be designed to address this gap if governments expect compliance and if they want to influence the tax culture in this space.

The informal sector extends beyond small or low-income enterprises outside the banking sector. Increasingly, the 'gig economy', where labour is contracted on a short-term and needs basis, is becoming a significant contributor to national economies. The digital revolution is expanding the boundaries of the ‘traditional economy’, as citizens have begun to create siloed digital economies outside of government influence or oversight. Already, governments are grappling with how to adequately tax digital creators who are a major part of the gig economy. Kenya's new digital tax on content creators led to a massive outcry from Gen Z, many of whom are digital content creators and employed in the gig economy. How governments approach this challenge will have far-reaching implications for the future of tax administration.

Figure 4: The absence of legitimacy in reforms leads to tensions between government institutions and citizens



Source: The Public Impact Fundamentals Report, (2016) Centre for Public Impact

Ultimately, the success of government programmes hinges on securing public trust and legitimacy which are demonstrated by effective service delivery and robust citizen engagement. Already, initiatives like the Addis Tax Declaration 2025 aim to promote tax accountability through citizen participation and education. For countries like Nigeria, with federating units and decentralised economies, prioritising grassroots engagement and building trust at the community level is just as important. It starts with governance; the government must build the moral capital needed to educate and engage better. For many governments, this is the challenge.

About NGF

The Nigeria Governors' Forum (NGF) is a non-partisan association of Nigeria's 36 governors, working to promote good governance and development at the sub-national level. Established in 1999, the NGF fosters collaboration among governors and stakeholders to address national challenges.

For information about the NGF please visit www.ngf.org.ng

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