# The effects of mineral discovery on fiscal capacity building: Evidence from the British Cape Colony's fiscal evolution, 1820-1910.

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Abstract

The literature on fiscal capacity in Africa has been very generic in the sense that most of the panel studies, which investigate factors that determine shares of tax revenue in GDP, reach somewhat of a dead end. The literature identifies the usual determinants of tax levels such as population density, share of manufacturing and value addition, share of agriculture and urbanisation among other factors. These are linked to typical Musgrave's 'tax handles' that determine the expected taxable capacity. In Africa, the problems of inadequate taxes are not necessarily only emanating from current economic challenges but colonial histories of each country matter – a conclusion that is inadvertently reached by cross country fiscal studies as they stress that other socio-political factors are important. This paper uses the Cape Colony case to go back into the 19th century history of Africa's prime example of how minerals affected the tax regime pursued by the state. Through an OLS regression, we confirm the usual economic factors to be relevant but this is done only to foreground the paper rather than making it an end or 'hard' results as cross country studies do. For instance, foreign trade sector positively affected the share in tax revenue in GDP. We go further to the political economy of mineral regulation and how the government lost the opportunity to be assertive on its tax regime relating to the mining industry. Mineral discovery shifted the focus of the state from fiscal capacity building onto an unsustainable reliance on revenue from state owned entities such as railways, post office and telegraphic system. This has contemporary implications because resource-rich countries need a strategy when dealing with their fiscal regimes if no direct revenues are transferred from the mining industry directly to the state coffers.

Key Words: *public revenue, fiscal capacity, mineral discovery, fiscal history*

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## 4.1 Introduction

In trying to understand why some African countries perform better than others in raising tax revenue, there has been a proliferation of studies on tax efforts in Africa (Mkandawire 2010; Teera & Hudson 2004; Stotsky & WoldeMariam 1997). Two attributes of this literature, which makes it not very helpful, are that it focuses on the post-1960s period, the post-colonial period, and that it relies on cross country panels. While the studies in this kind of literature help, parsimoniously, in bringing out several determinants of fiscal capacity, they end with blunt conclusions. By including many countries at once, arguably for statistical power, the literature inevitably, and implicitly, conclude that each country has to be treated as a unique case and that there is no 'one size fits all' when it comes to policy advice on improving tax revenue performance. In other words, the literature implicitly argues that there is no single path towards achieving fiscal efficiency and goals in each country should be considered in the context of their unique economic and socio-political environment – i.e. there is need for complementary country case studies alongside cross-country studies for better hypothesis formulation (Nunn 2009).

The focus on the post-independence period also leaves a question of whether some challenges in current fiscal capacity development can be traced back to the colonial history. Once the time frame is pushed back into history, the panel approach is even more problematic because there were no homogeneous colonial states and this renders historical comparison of the colonies on an equal footing imperfect if not impossible. The homogenising and classification of settler vs non settler colonies (see Acemoglu et al. 2001) has been found wanting not only for taxonomic difficulties of finding what constitute a settler colony in Africa but for 'compressing history' (Austin 2008b) and being counterintuitive since institutional arrangement in Africa's so called settler colonies were actually extractive (Frankema & van Waijenburg 2014). Another problem of the colonial fiscal states literature is the 'tall' assumption of constant empire effect – i.e. investigating the colonial states as if they were natural states whose evolution was not significantly influenced by imperial connections (Ferguson & Schularick 2006; Flandreau & Zumer 2004).

This paper does not take away from the present literature highlighted above but it seeks to take the broad generalisations further by tracking the evolution of fiscal capacity and revenue generation of the Cape Colony in the 19$^{th}$ century. Many British colonies, the Cape included, changed their statuses from being crown colonies, garrisons, convict colonies to become self-governing colonies and eventually independent countries and federations. It is therefore necessary to complement cross colony/country studies with cases of each colony as their experiences were *sui-generis* – there was never a single path that all colonial settlements followed. The Cape's fiscal evolution provides important insights since it was the first major settler colony on the African continent. There is no doubt that the interior developments in British Africa in Southern Africa were partly an outcome, intended or unintended, of administrative, economic and political successes and failures at the Cape. The British Empire itself was not static and it accumulated lessons through successive occupations of different territories from the North American colonies and any study on any colonial period has to take these changes into account. Changes were also influenced by economic fortunes, for the Cape Colony, for instance, Good (1976, p.601) argued that discovery of diamond changed the Cape from a mere half-way house' to India into a "developing powerhouse and a true cornerstone of the empire."

### 4.2 Determinants of tax and non-tax revenue

Mkandawire (2010) is the one who has tentatively pushed the boundaries backwards into colonial history, following Amin 1972, by dividing Africa into three distinct regions – Africa of the labour reserves, Africa of the colonial trade and Africa of the concession companies. His conclusion is that the current relative success of the former 'Africa of the labour reserves' in raising tax revenues depends largely on the inherited practices that constitute 'initial conditions' of the structure of the economy, degrees of formality of economic activities and politics. Mkandawire (2010) gave the need for security by settlers as possible explanation of why settler colonies, included in his 'Africa of the labour reserves', have higher tax levels in the current period. With lower levels of informalisation in labour reserve economies, the 'exit options' were minimal than in cash crop economies (Mkandawire 2010, p.1653). He argued that settler colonists had a Faustian bargain with the colonial state given that they were constantly at war with the indigenous tribes and this led to them accepting higher taxes which persisted into the modern day tax structure. This is the fiscal 'inertia' argument that argues that taxes tend to outlive their initial reasons for which they were introduced (Peacock & Wiseman 1961; Zolt & Bird 2005).

An implicit assumption in such a conclusion is that the imperial influence, direct or indirect, is held constant meaning that the imperial government's relations with colonies did not matter in how tax revenues were raised. This is problematic because the legislature behind the tax regimes of British Africa was indirectly influenced by capital from London capital markets and imperial diplomacy. To assume that the colonial tax system was an outcome of entirely colonists' wishes and other purely local economic determinants is problematic. Even the so called self-governing colonies or dominions had to have their bills assented to by her Majesty's government – the so called signification. Once this assumption is relaxed it is clear that what is referred in literature as 'colonial states' are actually mere colonial territories whose status in sovereignty is less than that of an ancient village with a king – a 'colonial state' should be understood as an unnatural state.

Before considering the complicating imperial effect and other political economy issues on the revenues raised in colonial territories, it is important to briefly look into the general factors considered to affect the overall tax performance. These are key factors which in theory should bear on the tax base of any economy, whether it's a colony or a sovereign country. Musgrave (1969) has been highly influential and informed most studies on tax efforts. His argument is that structural variables (or tax handles), other than the efforts of government, such as the extent of economic diversification, and the character of economic activities, determine the taxable capacity and hence expected tax performance. For instance, agricultural economies, especially those with predominantly peasant farming are very difficult and even irrational to tax but overtime the expectation is that industrialisation brings more taxable capacity through different avenues such as manufacturing, trade and increased consumption. The literature shows that usual formal testable model for tax revenue across countries has taken the form of:

T/Y = Tax to GDP ratio =f (YPC, XM, A, P, Ag, Mf, D, U,) and further details concerning this equation are in *table 4.1* below. The use of this model is not meant to constitute 'hard' results but to determine potential determinants of tax revenue and to inform our understanding of the evolution of fiscal capacity at the Cape.

*Table 4.1 Determinants of tax revenues*

| **Variable** | **Description** | **Expectations signs** |
|---|---|---|
| YPC | GDP per capita | + (Higher per capita push demand for public goods and hence tax revenues) |
| XM | Share of exports plus imports to GDP | + (Trade taxes are easier to raise and more trade entails more tax revenue) |
| A | Share of Aid to GDP | - (Aid discourages self-sufficiency and causes moral hazard) |

| | | |
|---|---|---|
| P | Population density | + (The higher the density the easier it becomes to raise tax) |
| Ag | Share of agriculture to GDP | - (Agriculture shows early stages of development and is difficult to tax) |
| Mf | Share of Manufacturing to GDP | + (With more manufacturing more taxes can be raised) |
| D | Share of external Debt to GDP | - (High debt may create macroeconomic imbalances that reduce tax revenue) |
| U | Urbanisation | + (Taxes are easy to raise in urbanised countries) |

Sources: (Mkandawire 2010; Davoodi & Grigorian 2007; Teera & Hudson 2004; Stotsky & WoldeMariam 1997).

The above regression is used to estimate the tax ratio of a country and then this will be used to calculate the tax effort which is the index of expected level of tax revenue given the country's taxable capacity or 'tax handles' (Good 1976; Teera & Hudson 2004). The tax effort is therefore a ratio of the actual to potential tax level and when it is below one it reflects that the economy has more taxable capacity unexploited but above one shows that the economy is exploiting all taxable capacity. This is quite a crude measure which has to be carefully considered and applied differently given the circumstances of each country –rather a guiding metric that should not be mechanistically applied. According to Teera and Hudson (2004, p.797),

> It is however important to emphasize that a low index of tax effort does not necessarily indicate that the country should raise taxes or does a high index indicate that taxes should be lowered. Such a decision should emerge from a careful consideration of expenditure needs, alternative sources of finance, the effects of the particular taxes that would be changed, administrative capability, and the political acceptability of the program.

It is clear that this approach, although a good guideline of what could be expected in taxes given the existing tax handles, does make researchers to require intimate knowledge of each country before any advice can be given. This also beckons us to the importance of country studies and case studies which investigate the socio-political factors (Musgrave 1992). The above approach is even difficult to extend to the colonial period in which data is unreliable or simply unavailable and as a result tax effort and fiscal performance in general tend to be restricted to blunt measures. As a result, it is needless to say that in colonial period additional qualitative evidence is needed not only for complementing the quantitative measures but to unpack the influence of the imperial exogenous factors affecting the levels of tax revenue in a colonial setup. According to Good (1979, 610) the difficult feature known by the colonists continuously was the "inelastic and slow administration from Downing Street" – making any fiscal reform difficult.

The previous equation and the explanatory variables are also important as a guideline to understand the Cape Colony's fiscal evolution and indeed a selected number of variables are possible to quantify with the available data. These include per capita GDP from Magee *et al*.(2016), imports and exports from Schumann (1938), tax revenue (direct and indirect) and external debt from the compiled public finance data from the bluebooks. From a very parsimonious regression these have been found to be consistent with literature with expected coefficient signs and were all statistically significant (see *table 4.2*-to be refined). The only surprising variable is the per capita GDP (LPCGDP), a proxy for personal income which should positively affect shares of tax in GDP because as per capita income grows taxable capacity grows. For this study the Cape Colony has many 'unknowables' preventing a fully comprehensive model to be run but the available data allow for some measures which, when combined with qualitative evidence, allow a reasonably convincing picture about the fiscal evolution of the Cape Colony. Economic factors were very important because the GDP growth, growth of exports and imports, external debt, agriculture, mining, transportation and communication industries had huge implication on the taxable capacity of the Cape. Unlike during the VOC administration, when the Cape did not constitute a huge settler economy, the forgoing factors became more important as the Cape economy expanded. The liberalisation of local trade and international trade by the British administration strengthened the taxable capacity of the Cape over time.

### 4.3 The imperial effect on the Cape Colony's revenue strategy

The general narratives of the permanent occupation of the Cape by the British Empire from 1806 need not receive emphasis in this chapter because they have received enough attention in chapter 3 and more than adequate attention by other historians (De Kiewiet 1957; De Kock 1924; Davenport & Saunders 2000; Pretorius 2014; Schumann 1938; Greyling & Verhoef 2015). Here the emphasis is given to those aspects of empire-colony relationship which had a strong bearing upon the fiscal capacity development of the Cape Colony. These factors were important, besides the usual economic tax handles, in shaping a unique social and political order within which taxation took place. The empire effect was strong in the Cape, as the first major imperial project on the African continent, through avenues of the evolving colonial status and state capacity, the primacy of British capital and the native issues. These were quite interwoven issues which plagued the British Empire administrators not only at the Cape but in almost every British colony and it is important to see how these affected the Cape's fiscal trajectory.

*4.3.1 The colonial status and state capacity.*

The Cape Colony's status in the early decades was, in the British Empire's perspective, a crown colony that served to secure the route to East Indies. In the words of Kilpin (1930:37) it also served as "a convenient asylum to Britain's surplus population which was in the poverty and depression of the aftermath of the war with France and industrial revolution". The behaviour of governors who had been told that colonial revenue was a private property of King George IV was unquestioned by local colonists as long as the governors had been trusted with the colony by Downing Street in the first place (Kilpin 1930, p.50; Grundlingh 1937, p.11). India and other colonies had charters, even the VOC as the predecessor of British rule at the Cape had one, which had full guidelines as to how these colonies were to be run but the Cape relied on one autocratic governor up to 1833 when the legislative council was put in place (Grundlingh 1937). In the first half of the 19th century:

> New governors could bring new constitutions in much the same way as one might bring out a new suit of clothes for a distant relative, trusting to luck and the tailor that the suit would be a good fit (Kilpin 1930, p.50).

As a result of the above 'trial and error' approach there were many constitutional vicissitudes from the British imperial authorities as they tried many approaches of handling the Cape's affairs. Outright authoritarianism and disregard for popular opinion from settlers had failed given the immigration of the 1820 pro-democratic settlers – the success of the anti-convict protest in the 1840s testified to this relevance of public opinion.

With regards to the colonial status and state capacity a crucial event for the Cape's colonial status was the introduction of settlers in 1820 who had been used to British freedom and were free spirited. These settlers awakened Downing Street into worrying about the Cape affairs and forced them to send a commission of enquiry that put the Cape on the path towards the representative institutions in 1853 and responsible government in 1872 (McCracken 1967). The Cape Colony thus went through three phases constitutionally – the chaotic first half until representative government in 1853; consolidation period 1854-1873 and the self-governing period 1872-1909. These phases were gradually altering the status of the colony and had a bearing on the public revenues. During the early decades the public revenue was mainly obtained from transfer duties on immovable property, duties on wine and brandy imports, stamp duties, customs duties and auction duties (De Kock 1924, p.83). To a large extent these sources were bequeathed to the British system by the VOC which had long relied on these taxes (Fourie et al. 2013). What the British Cape government did was to elaborate these taxes, abolish some and gradually introduced new ones. The commission of inquiry in 1826 shows this removal, by the British colonial government at the Cape, of impolitic trade restrictions of the VOC dispensation. The commission pushed for the:

> …removal of various taxes such as tithes on the produce of the country brought to Cape town and Simon's town by land; trade in bread and corn be declared free; import and export of corn to be permanently free of duty; reduction of taxes levied on sheep and oxen slaughtered in Cape Town; an entire reduction of market duties. Privileged and licenced butchers were to be stripped of many privileges which inhibited the remote areas of a fair trading practice (Commission of inquiry on public revenue, 1826, p.36).

In light of the above development, state capacity and therefore legitimacy, took different shapes starting from an autocratic kind in the early decades towards a representative and responsible government which could not ignore the popular desires of the electorate. Responsible governance in 1872 meant a creation of a veto player and the end of absolutist spending patterns, to use the language of Dinnceco (2015). The franchise, despite being pegged high to exclude the indigenous people, entailed that the state could induce a 'quasi voluntary compliance to the tax payers (Levi 1988). It is worth noting that the state's coercive capacity at the Cape Colony (discussed in chapter 2) was buttressed by the British Empire's financial support to the garrison at the Cape – a feature of the Cape's public expenditure to be covered in chapter five. Because of this military 'backup' the Cape was artificially transformed into a powerful 'state' which eventually defeated the South African Republic and the Orange Free State in the South African war leading to the formation of the union in 1910.

Mkandawire (2010, p.1651) argued that colonists in settler colonies dominated by the indigenous majority were preoccupied with the need for security. He argued that the feeling of insecurity "produced in the minds of the denizens of the enclave a 'laager mentality', and the need for the construction of strong state apparatus for both administration and security." This means that the setters were ready to tolerate high taxation levels in exchange for a strong state that could protect them (Mkandawire 2010, p.1651). This argument seems to fit well the 20$^{th}$

century Union of South Africa but the Cape, in the 19th century, did not fit into such description due to the imperial role on its security against the indigenous people – the victory in the last few frontier wars is testimonial to this readiness to help by the British Empire. Data on taxes, especially direct taxes, shows that the colonists did not bear any strong burden for their security and defence –a usual defining feature of strong states (Besley & Person 2010, p.528).

*4.3.2 The primacy of British capital*

If the British Empire's success story is told, capital ought to be recognised as the leading tool of imperialism without-which only few imperial project would have been achieved. This was true especially in the 19th century when mercantilism giving way to *cosmopolitan* capital and this implies that any study on state formation or colonial fiscal history should not imply that the state formation process was taking place in a "closed laboratory for the formation of fiscal systems" (Yun-Casalilla 2012, p.19). The role of British capital in the Cape Colony, be it in terms of private investors or huge sums obtained through government bonds, was very influential to the nature of the economy and the development of taxable capacity in the Cape Colony's economy. This capital was crucial in railway construction, harbour developments, telegraphic systems and most importantly in mining. The argument of this chapter hinges on mineral discovery as an external shock that set the Cape's fiscal regime on an extractive and unsustainable path. The pre-eminence of capital is strongly revealed by the Diamond commission's representation to the Cape government in1881:

> It is a notorious fact that the amount of money invested in Mining Companies is far beyond the resources of the community; and that, as a remedy for this, it is absolutely necessary that European and foreign capital should be introduced. This can be done only by the re-floating of Companies in the European market. If, however, a heavy tax, namely 4%, is put upon transfer, it will most seriously hamper such undertakings, and such a tax is absurdly disproportionate to the just dues of Government" (Diamond commission[2], 1881:144).

Once such advice was given to the state by trusted commissioners, some of which had mining interest, there is ample evidence that the tax regime around mineral activities took a very extractive nature due to the liberal tax legislation which favoured capital. The counter argument for capital, as always the case throughout history, was that the Cape Colony, being poor had to create a conducive environment for 'business to thrive' This could be more meaningful if

[2] The point to note is that the Diamond Commission comprised of people with vested interests in the mining industry as well as the state, Cecil John Rhodes John X. Merriman, J.H Lange, L. Hoskyns etc.

diamond mining during this time had many forward linkages such as those found in manufacturing. The government had to rely on direct revenue from its railway lines and customs revenue as the major two sources of revenue. Due to fear of being 'punished' by capital diamond mining had few benefits to the economy, not through government revenue, but spill overs through financial developments, and a nascent manufacturing sector alongside the wool based agricultural sectors (Schumann 1938; Verhoef 2014). This means that the Cape remained mainly a primary exporter of raw commodities up to the formation of the Union in 1910. This evokes the resource curse debate but this has been linked to countries which have 20% or more of their public revenue from non-renewable mineral resources. The Cape's case seems to be worse than a resource curse because government actually made things easier by providing transport infrastructure for the looting to take place. This evokes the argument by O'Brien and De la Escousura (1998, p.98) who argued that the colonies provided high "...prospects for looting and plunder." The railways primarily linked the mining fields and before the Union they had not brought much return to the Cape Colony's remote interior places (Van Der Poel 1933, p.11; Goodfellow 1931). The railways could be seen as, from the fiscal perspective, simply assisting the looting of the Cape's, and thus South Africa's, minerals.

Capital, however, could not do it alone without cheap, and in some instances unfree labour of the indigenous people who had been from 1800s put on a path of becoming proletarianized underclass. Overtime the natives were compelled into a form of life in which their sustenance was derived from land and assets owned legally by the settlers (Austin 2008a, p.613; Plaatje 1915, p.23; Good 1976, p.606). Samir Amin (1972, p.519) argued:

> We must remember that their (*colonisers in the scramble for Africa*) target was the same everywhere: to obtain cheap exports. But to achieve this, capital at the centre – which had now reached the monopoly stage – could organise production on the spot, and there exploit the cheap labour and the natural resources, by wasting or stealing them, i.e. by paying a price which did not enable alternative activities to replace them when they were exhausted. Moreover, through direct domination and brutal political coercion, incidental expenses could be limited by maintaining the local social classes as 'conveyor belts'.

While Amin's argument spoke to the inherent nature of capital to seek increasing returns, it exposed the other dark side of the colonial systems which was the devastation of the indigenous people's lives (Good 1976, p.601). These arrangements make the GDP calculations quite difficult, and at best an overestimate of the actual, because cheap labour and other artificial nature of some of the forced economic activities, under condescension, are not taken into account – at best all the colonial measures of economic activities need to be approached with caution (Smith 1777, p.490). The primacy of capital posed a fundamental dilemma for the Cape government of striking a balance between creating a conducive business environment versus a mere 'conducive looting environment'. With limited forward and backward linkages in primary extractive industry such as the mining sector, diamonds were essentially a non-renewable resource (Blattman et al. 2007), conducive business environment easily becomes 'conducive looting environment'. It is one thing to impose a non-punitive level of direct taxes on few big mining companies – the Laffer curve argument, an amenable thing to do for any government, and another thing to simply do nothing and allow capital, through legislation, to have its way. Mauritius's latter success in its education and health care was attributed to a successful fiscal regime that relied on direct tax on income, businesses and property (Brautigam et al. 2008; Frankema 2011). The payment of fees and licences for mining claims were not based on the profit or output and as a result they were puny compared to the value of exported diamond. The diamond mining externalities were also meagre, unlike manufacturing would have been, and this left the Cape Colony in financial problems when gold mining traffic was directed via Lorenzo Marques – causing the Cape to lose both railway revenue and customs revenue.

#### *4.3.3 The native issues*

Among the chief concerns of the imperial government in South African territories was the native affairs and the proof is in volumes and volumes of archived correspondences titled 'native affairs' or broadly about the 'native question'. In the Cape Colony this was complicated by the presence of the British colonists, Dutch colonists, former slaves and indentured labour and therefore, unlike places like New Zealand, the Cape government had to come up with a *modus vivendi* to deal with this complexity at every turn (McCracken 1967, p.135). The granting of a responsible government in the Cape delayed because the British Empire worried about how the natives were going to be treated. The desire for a union or federation in 1870s, in British empire's perspective, was a move to provide a uniform policy towards the natives so that the European states in South Africa would not appear as divided on the native question. The last few of the series of the frontier wars had been costly to the British Empire and having an agitated native majority lingering around, rightly referred in archival dispatches as 'threatening conditions of the native affairs', was seen as a huge risk.

From the British Empire, however, the concern for natives was not out of a 'good heart' but the creation of uncertainty and instability together with the pecuniary implications were dreaded. Being seen by other powers as presiding over chaotic colonies would create a bad image and probably conjure other nations into thinking that the empire was insolvent and could not defend its territories. For this reason, the imperial authorities maintained that "the subject of defence and native police should on no account be delegated to any subordinate authority" despite calls by colonists to be allowed to have their way with the natives. In a letter to the governor P. Wodehouse, Granville was clear:

> I cannot satisfy myself of the justice or humanity of handing over this large native population to the uncontrolled management of a legislature composed of those whose habits, interests and prejudices are so entirely different (Morrell 1966, p.174).

This shows that while calls for independence were growing over time the uniqueness of the Cape Colony in terms of population diversity meant that even the self-governing Cape was going to be remotely controlled from Downing street. At the face of it, the imperial government seemed to be more sympathetic, for instance with their proposed constitution with a low franchise, but their remoteness meant the default position was indifference as long as peace prevailed in the colonies. This indifference allowed the colonists to practically shape how the colonial government was going to relate with the native population. This allowed a paternalistic relationship, along race and class, to develop at the Cape Colony overtime with the natives reduced to an underclass only good to serve their European 'masters'. Davernport (1978, p.76) argued that the relationship between the settlers and the natives was moulded by British colonists' "…paternalistic and circumscribed liberalism."

With confinements such as proposed in the Glen Grey Act and loss their prime land by hook or by crook, a huge labour reserve was formed – a proletariat migrant labour whose traditional way had been fundamentally changed into non-existent (Amin 1972). The implication for the fiscal regime was important. Of all the direct taxes in the Cape a major form of direct revenue was the hut tax which directly affected the way of life of the natives. According to Act 3 of 1869, the hut tax consolidation act, heavy penalties were imposed on a non-payment of hut tax, through cattle seizure and burning of any hut for which no owner could be ascertained. There was no sign of such draconian measures taken against non-payment among settlers. Of all the direct tax revenue sources, (income tax, tithes on wine and grain, land taxes and hut tax), the hut tax and land tax are the only two direct sources constituting the direct tax category for a long period in the Cape history. The income tax only came to be implemented in 1904 meaning that on the direct tax category, the indigenous people bore the heavier burden if ability to pay principle is considered.

This tax structure of the Cape left the tax burden on colonists very minimal, at least when direct taxes are concerned, and consequential on the natives and their livelihood. Within the native population the taxable capacity was very low and hut taxes could push them to supply their labour to farms and mines in order to raise not only hut tax but livelihood after their means of life had been discontinued by the colonial system. In both Natal and the Cape Colony, chiefs were used as a way, although their powers were reduced gradually, of indirectly controlling the natives (Davenport 1978). In other words, the British Empire's proclivity for peace and stability meant that revenue for the administration of native affairs had to be sourced from the natives themselves while the imperial authorities heavily protected the settlers through payment for defence and security.

## 4.4 The descriptive revenue statistics.

### *4.4.1 Total revenue, tax revenue and non-tax revenue*

The amount any government can raise in taxes, no matter how innovative the fiscal system is, will always depend on the economic prosperity of its people. This is what has been referred in literature as the tax base, and tax-handles by Musgrave (1969) and the Cape Colony was no different. The positive correlation between total government revenue (LTREV) and GDP (LGDP) in *figure 4.1a* (All figures in the Appendix) is full evidence that the Cape's central government revenue grew as the economy grew. The government's responsibilities for providing public goods such as magistracy, courts, hospitals and public roads among others called for increased tax revenues.

The GDP from figure 4.1b decidedly grew from the 1870s period which was the year in which diamond mining got more traction at Kimberly as well as the wool boom in the same period. Before 1870, the total revenue reflects very low levels of public revenues and therefore limitations of what could be done by the colonial state on the fiscal front. Tellingly, in the fifth session of the third parliament of 1868, the governor reflected on the limited revenues of the Cape and the resilience of the government in holding on to fiscal prudence:

> While pressure lasts, the government must, I think, continue to be conducted on the most economical principles. It is easy to find in every direction objects on which money should be spent to the satisfaction of those in the vicinity. But it will be the duty of the government in the interest of all, to deny itself the pleasure of yielding to local

> solicitations, and to trust to the general support of the whole community in the exercise of a wise parsimony (Governor P. Wodehouse, 1868 p.2).

Yet few years later the outlook had changed in the Cape and economic prospects were promising and government revenue expected to increase drastically. Governor Henry Barkly commented on the public accounts in 1872:

> I congratulate you on the continued financial prosperity which public accounts exhibit. Under the combined effects of the high prices of wool in Europe and the development of trade of the Diamond-fields out here, the customs Duties alone in 1871 exceeded those of the preceding year by 42000 and a total improvement of 50000 has been realised. (Governor Barkly, 1972 p. 5).

In 1873, a year later, certainty of the prosperous times was more evident through continuous increase of pubic revenues

> The statement of the public accounts for the past year exhibit a condition of unprecedented prosperity; the total revenue of 1872 amounting to a million and close upon forty thousand pounds sterling, an increase of more than 300000 pounds over that of 1871 (Governor Barkly, 1973 p. 2).

The ‘unpresented prosperity’ was based on wool farming and diamond mining. These two commodities depended on the foreign markets and the Cape was a price taker without any control to what happens in the commodity markets. This made the customs duties a relatively unstable source of revenue, especially without any form of sovereign wealth funds, (see Cavalcanti et al. 2012) depending on which commodity were booming at the market (Spatafora & Tytell 2009, p.27). Blattman et al. (2007, p.176) emphasized that volatilities of commodities, such as gold and diamond, adversely affected not only the growth of these economies but directly affected the customs revenues. The non-tax revenue, mainly railway receipts, was also to a large extent dependent on the volumes of imports to be transported to the diamond fields through the Cape’s railway lines. The government’s non-tax revenue, railway being major receipts overtime, came to constitute 50% of total revenue by the end of the 1900 (figure 4.2).

### *4.4.2 Direct vs indirect revenue*

The difference between direct tax and indirect tax reveal important facts about the nature of the fiscal system. According to Levi (1988) a quasi-voluntary behaviour of tax payers comes from their perception of the legitimacy of the state. The 1840s in the Cape Colony was the period of dissent, aggravated by the anti-convict protests, and in such environment, where the composition of the legislature itself was questioned, it was difficult to impose any form of direct taxes. For the rest of the period direct revenues remained very low and there is no enough evidence showing any significant effort being invested in trying to bring new sources into existence.

The *figure 4.2* shows that direct revenue, for the entire period never exceeded 2.4% of GDP while the indirect taxes were substantial stretching towards 20% of GDP over this period. The dire financial situation in the second half of the 1860s led to proposition of direct taxes in the form of income tax and property taxes with incomes of less than 50 pound being exempted (source). This was rejected, as anticipated, and over the years non contentious indirect taxes were adjusted frequently as it did not alter the prevailing social contract of no payment of burdensome direct taxes. With more economic prosperity in the Cape other indirect taxes such as excise taxes from 1879, were introduced together with revision of the existing rates of these indirect taxes. One difficulty of this period is that often the popular merchants and farmers, and indeed others with mining interests, often made it into the legislative council and the house of assembly bringing a conflict of interest when it came to voting for various bills and Acts in relation to taxation. Foreign capital, in mining and other sectors, was also not easy to tax directly and with company regulatory framework not yet fully developed the onus was simply on the company to argue why they could not pay a certain tax. One example of such petition was from Standard bank in 1964 against the government's proposed stamps and licence bill:

> That your petitioners beg to submit to your honourable house that the proposed mode of raising a duty upon the subscribed capital of joint stock companies, as set forth in the schedule annexed to the bill, is one which is wrong in principle and inequitable in its nature. This will stop shareholders from being interested in this colony from the mother country and other parts. Your petitioners submit that an impost upon the subscribed capital of the Standard Bank would bear with quadruple weight upon its working capital and would be therefore be unjust and unfair (J.S Kirkwood and three others, 1864).

The only remaining means of government to raise revenue from companies was mainly through the imposition of licences and stamps for companies wishing to conduct business in the Cape. This made the prospect of owning public utilities an attractive role for the government because it could easily guarantee the sufficiency of the government revenue – making railways a 'tool' of taxation. This extended to other public utilities such as telegraphic systems which in many ways were already, even under private ownership, subsidised by the state (Governor H. Barkly 1872).

Although these are crude measures, the elasticities in *figure 4.3* are simple yearly elasticities of various revenue categories with respect to changes in GDP. The responsiveness of tax revenues to changes in GDP (tax elasticity) shows that throughout the period tax revenue was very responsive to changes in GDP. Breaking down the tax revenue into direct and indirect tax revenue shows that it was only indirect taxes which were very responsive but direct taxes were not very responsive –especially from the mineral discovery period. This reinforces the argument about the lack of effort by the Cape government to impose direct taxes to its society.

### 4.5 Diamond discovery and its effects on the Cape's tax regime

*4.5.1 Structural changes to the economy*

The diamond discovery brought structural changes to the Cape economy. Subjecting the non-tax revenue series to the breakpoint test reveals 1876 as the break date (*figure 4.5*). This was the year in which mining got more traction and this was manifesting in the revenue of the Cape. The annexation of the diamond field, a contested territory between Transvaal, Orange Free State and the chief of Griqualand, was seen to be economically beneficial to the colony which solely relied on wool farming during this period.

The graph only depicts the non-tax revenue category because it directly made the difference in the public revenues through public utilities. Tax revenue took time to reflect the changes because the government did not respond with new taxes while the change of railways from private companies into becoming government owned meant a sudden leap in revenue captured by the break in *figure 4.5*. It is clear that the major response of the Cape government to the newfound mineral 'jackpot' was the acquisition of public utilities mainly railways and telegraphic systems which then became instruments of taxation.

*4.5.2 Responsible government and financial overhaul*

The early 1870s coincided with a lot of things in the Cape Colony and these include the granting of responsible government, mineral discovery and the formation of state utilities. The new responsible government could not operate on non-transparent basis because they now had to be accountable not only to the imperial authority, about their ability to run the colony transparently, but to the electorate as well. Earlier, during the early council years, the financial discussions were "very circumscribed and the council was left in an awkward position of not being able to repeal taxes which by common consent were no longer required" (Kilpin 1930, p.63). With the responsible government public accounts were to be laid before parliamentary scrutiny every year and this entailed a system overhaul in the manner in which records were kept. From 1872 onwards the Receiver general was replaced by a full-fledged treasury department "which was no longer a mere depository of revenues and moneys, charged only with the custody and issue, but all the duties and responsibility, such as the Chancellor of the Exchequer in England had." The select committee on the state of public finances in 1860 reported to the house:

> The committee has experienced much difficulty, in consequences of no fixed, definite, clear and easily understood plan being adhered to, in making out of the public accounts, and the fact that loans and advances being mixed up with revenue (Select committee on finance, 1860, 4).

This was not only an obscure accounting system at central level, inherited from early decades of British Cape Colony years, but the divisional districts revenues were also problematic. The governor, P.E Wodehouse, transmitting a letter from the auditor general reported:

> With a cursory examination the accounts of the divisional councils are very unsatisfactory and indeed worthless. Transactions of every description are blended together, legitimate revenue is mixed up with sums borrowed without authority of law and in many cases accounts are not signed by auditors nor is it known if any have been elected. The accounts submitted are deficient, evincing great carelessness on the part of the officers charged with the accounts (Governor P. Wodehouse, 1867, p.3)

With the advent of the responsible government, a commission was set up in 1874 to investigate the system of audit and public accounts of the Cape Colony and they recommended the treasury department to be led by a "Controller and editor general of public accounts". This was enacted into legislation in the Audit Act of 1875. The commissioners also recommended that:

> The revenue of certain heads such as customs, stamps, licences be stated in greater detail and the same should be done for expenditure in order for a clear comparison of votes and actual expenditure. (The public accounts audit commission, 1875, p.181).

Within the captured data, the public records overhaul is evident in that instead of the revenue sources being classified vaguely as was the case before 1870, more details were provided. Before the Audit act the regulatory framework was inadequate and could not provide checks on unauthorised expenditures. The customs revenues from 1876, for instance, was divided into import duties, export duties and wharfage duties. The same applies to the expenditure side where clear categories had to be established for each department, in terms of how much went to salaries, transport and contingencies among others. Transparency was brought into the system and each year the various departments were supposed to make estimates of expected revenues to allow expenditure estimates to be done. In most years from the 1870s the estimates were quite conservative and they were in many cases exceed by the actual revenue eventually received.

Another important aspect of the public accounts overhaul was the public debt consolidation Act 30 of 1870 which removed obscurity from public revenues. Before this Act, the ordinary revenues were mixed with short term loans and this rendered it difficulty for the Cape government to accurately assess its financial position. The Act enabled the ordinary revenue accounts to be separated from the loan accounts and these two were managed separately henceforth. The public finance overhaul was imperfect in the sense that it did not separate public utilities such as the post office, railways and telegraphic systems out of the ordinary revenues. This provided a false sense of health public accounts because these public utilities were run as tools of taxation without a clear fiscal strategy being pursued. This weakness in the financial accounts overhaul was invisible as long as the economy was performing well and the state received direct earnings from its utilities.

#### *4.5.3 Legislative and state capture*

The discovery of diamond, I propose, gave the colonial state an opportunity to determine the legislative framework to maximise the public revenue but this failed because of vested interests. A clear contrast is observed in Transvaal where Gold Tax was introduced, going as high as 30 percent on output or profit, and the government also invested directly in gold mining. The Cape government, soon after annexing the diamond territory, moved in with a heavy handedness and relegated the established Diamond Committee into the background and appointed an inspector and a mining board. On this path the Cape was heavily involved in the activities of the mining fields and the miners disliked it since they were inclined towards self-governances through their self-appointed committees. The miners wanted the government to only intervene in protecting lives, through safety engineers, and property rights. According to the diamond commission report, De Beers was involved in pressuring the government into making a new legislation which was brought in in 1880. The new legislation gave power to the mining companies to govern themselves without government intervention.

The mining legislation was thus heavily influenced by the mining companies whose owners were also influential in the Cape parliament. This brings the state capture argument because the minimalistic legislative framework was meant to allow the mining interests to have their way at the mining fields while the government could only regulate the licencing process. A closer look at the requirements for one to own a mining licence also reveals the fact that the legislation was meant to protect the few big companies. For instance, for one to get a certificate for a claim, a certificate of good character was to be obtained from local resident magistrates. This effectively excluded most natives from owning mining claims since they were easily legislated out of the mining activities. The diamond mining commissioners' recommendation was clear in terms of wanting to limit government revenue to licence fees only:

> We consider that, as far as applicable, a proper survey should be made of all alluvial diggings, and that claims should be numbered in the same way as is now practice in the dry diggings. This, we believe, would increase the revenue, and prevent what we consider the objectionable practice of holding several claims under one licences (Diamond commission, 1881, p 15).

With the revenue from utilities such as railways, post office and the telegraphic system the licences from the mining firms were puny and the government simply gave in to the extractive tax regime. Other sectors, as a result, could not yield to direct taxation when the mining industry had set the standard for the rest of the economy. The agricultural and manufacturing sectors were not yet thriving and they actually received subsidies in the form of cheaper access to the state owned transport system. The exit threats were quite strong from capital that the government was left with no option but to leave capital to have its way. These exit threats seem to be less real considering later developments in the Transvaal, which had no option but to tax gold mining heavily since it had no railways nor ports of entry to get government revenue through customs. Gold mining activities did not dwindle because of these high tax levels on output but instead the government managed to embark on many developmental projects based on the receipts from mining activities. This could not have been the case had the Transvaal relied on licence fees only as the Cape did.

Considering the liberal legislative environment, which could be seen as 'conducive business environment', the Cape lost a lot of potential revenue which could have easily accrued to the government. The railway construction by the state was a developmental endeavour but this mostly did not help to drastically transform societies. Goodfellow (1931) argued that due to the manner in which South African railways were built Australia and north America were closer to the gold fields than some remote areas in South Africa. This entails that, besides direct revenues for the government, railways were more beneficial in the period post 1910 when branches were developed – otherwise the railway system provided mere convenience for rentier capital to flourish.

### 4.6 Municipal revenues and fiscal decentralisation

The Cape Colony's capital city had been Cape Town, even during the VOC rule since 1652, and as a result of this, the commercial, judiciary and other public services were easily accessible to those in the vicinity of Cape Town. While there was no problem during the VOC period, in which the population had not penetrated further into the interior and frontier regions, the British period had to expand its administrative reach – especially with the British policy of encouraging immigration into the colony. In 1873, a Bill was passed, for the introduction of provincial governments in the colony, and the Bill acknowledged that the remote regions suffered many difficulties and disabilities because they were "far removed from the Seat of Government in Cape Town". The colony was then divided into three provincial governments namely Western, Midlands and Eastern provinces – each with its own provincial legislature. The railway system was also divided according to these provinces headed by a provincial board but accountable to the central board of railways.

Even before the provincial governments were introduced municipalities and divisional councils were an earlier phenomenon in the Cape Colony. The first one was the Municipal Ordinance (No 9 of 1836) for the creation of municipal boards in towns and villages of the Colony. The government's reach to all remote towns and villages was limited and as a result complaints were incessant at the doors of the colonial administrators at Cape Town regarding many challenges faced by colonists in the remote districts. There was no need for the parliament in Cape Town to continue to receive parochial requests, such as "lack of shelter at train stations in Utenhage" (McCracken 1967, p.137), which could be dealt with by municipal or divisional boards. With municipal boards and provincial legislatures, the separatists were to some extent appeased as they could now have a degree of autonomy in their local affairs.

The municipal and divisional boards were given, through various ordinances and Acts, permission to raise local revenues to defray local expenses such as police, street lights, roads and bridges. In the event of loans being raised, the central government had to assent to this because central revenues in most cases were used to guarantee these loans. The Cape's decentralisation was, when carefully considered, not a 'luxury' creation but a necessity in a diversified society in which regional and racial 'fault lines' could easily destabilise the colony.

The revenue of the municipalities, just like what the central government could raise, depended on the broader economic performance of the colony. The correlation between the central government revenue and municipal revenue is very strong (*figure 4.5)* because in most cases the government had to consent to municipal revenue strategies. There was a general positive spill over effect in terms of capacity to raise revenue, if local factors are held constant, from central government to the municipal levels. The aggregate municipal revenue trend shows a similar trend to that of the central government. From a simple log-log of municipal revenue on central government revenue, a percentage increase in central government revenue was matched by more than a one percent increase in municipal revenue – many factors held constant (figure 4.5). In other words, the economic growth mattered, for increasing public revenues, but municipal revenues were influenced by other factors such as regional economic dynamics, population, structure of economic activities and many other local factors.

The municipal revenues, total aggregate revenues from each municipality's sources, grew between 1881 and 1907 and the shifts in the top five municipalities highlights important dynamics of the economic progress of the Cape Colony. Cape town municipality as the hub of the cape's political and commercial activities remained in the top five municipalities between 1881 and 1907. It is however important to emphasise the fact that in 1881 it was behind Uitenhage in terms of financial performance (*figure 4.6*). The 1870s and early 1880s were the period of wool boom and the economic activities were more focused on the eastern region hence making Cape Town to come second in terms of revenues. Once wool farming had subsided, Uitenhage's revenues declined and in 1907 it was relegated to number eighteen in the list.

Economic geography has also explained such regional and geographical dynamics that affect economic performance of countries in general. These factors include, among others, distance to the coastlines, population, railways, major economic activity and climate. The municipalities which dominated in terms of revenue were the coastal municipalities. Kimberly municipality, and to some extent Uitenhage with its wool washing industry in late 1870s and early 1880s, was the inland municipality to rival the coastal municipalities because of diamond mining activities which attracted many people and businesses. This means that the municipality could easily raise revenue through rates and other forms of local taxes which other inland municipalities with no economic activities could raise. De Kiewiet, the South African historian observed:

> In a year after the rush, Kimberly was the most populous place in south Africa outside Cape town with two churches , hospital, theatre and probably as many grogshops as the rest of south Africa put together (De Kiewiet 1957, p.89).

The concentration of people around such a major economic activity made Kimberly a testing ground for the Cape's social welfare policy (more on this in chapter 5). Archival evidence also shows that Kimberly was difficult to handle legislatively hence it was also testing ground for the legislative capacity due to the volumes of mining disputes solved each year. The diamond commission recommended a mining tribunal to be formed, after the manner of the Australian Courts of Mines, to specifically handle mining disputes but this was rejected on grounds of costs. In such a difficult legislative environment, for instance underground mining claims disputes where interwoven with surface land ownership disputes – the main issue was the land owner and the digger's rights on the land, water, business stands, buildings to be erected and diamond itself. On the surface the proprietary rights were to be observed while beneath the soil diamonds meant a different legislative framework.

### 4.7 Conclusion

This main conclusion from this chapter is that diamond discovery was a decisive factor in the evolution of the Cape Colony's fiscal capacity building. It shifted the attention of the government into railway projects whose earnings were substantial to the point of relegating the need to creatively improve the tax regime. Settlers did not, throughout the period, pay high level of direct taxes to the government as argued for settler-labour reserve colonies by Mkandiwre (2010). This was because the British Empire viewed the Cape as a key colony and was ready to defend it from external threats as well as securing its colonists from the indigenous population. With no need for a huge defence and security budget, the Cape Colony's fiscal inertia was set very low and even later when they were called to pay for part of the troops they resisted with a plea of poverty as key tool in their armoury. The result was that state capacity was bolstered but in an artificial way through Downing Street's troops and financial expenditure on defence and security. Shirking has been the often term used by the imperial authorities to describe the Cape's stance on its defence and therefore they had to be coerced to take full responsibility of their defence, especially after Gladstone was appointed in 1868 (Morrel, 1969, 174).

On one hand, indirect taxes were a major feature of tax revenue, the bulk of this being customs revenue and on the other hand non-tax revenue was important from 1870s, the bulk of this being direct railway earnings. Considering both tax and non-tax revenue sides, two major sources of the Cape's public revenue were therefore customs revenue and railway receipts. This meant that the Cape's fiscal regime was on an unsustainable path because the railway traffic was mainly for the mining fields, be it equipment or supplies of food items, and by no means permanent. Customs revenue itself was a matter of revenue collection than an organised policy with developmental goals such as the mid-1900s'import substitution policy (Goodfellow 1931, p.25). The status of having developed railway lines meant that the Cape's ports became the preferred and easy ports of entry into the interior mining fields in South Africa. As long as the Cape had no competition, because it was the first colony to complete the railways, customs duties were guaranteed and overall government revenue was in good shape.

The Cape's agriculture and manufacturing business enjoyed reduced rates on the Cape's railway lines and were not significant sources of government revenue. After the opening of the Transvaal line via Lorenzo Marquees the Cape lost the gold mining traffic, and therefore customs revenue because traffic on the Cape lines declined from 80% to a 12% of gold mining traffic. The loss of the control of bulk part of diamond traffic and customs meant that revenue loss was catastrophic. This exposed the fact that the Cape had not strategically thought about their fiscal regime, having used railway system as an instrument of taxation, and was thrown into a sort of querulous despondency was eagerly waiting to throw its burden onto the unionized South Africa (Goodfellow 1931; Van Der Poel 1933).

This chapter has also shown that literature that focusses on colonial fiscal capacity/ fiscal states, assuming no empire effect, can be deceptive and misleading. This is because the colonial *fiscality*, though depending on economic factors as in sovereign countries, was not independent from the imperial authority's direct or indirect influence. This has not been fully explored by the cross-colony studies which remained mostly at abstract level with hypotheses that are tailored to suit data than true historical processes shaped by imperial institutions, colonists' wishes and existing pre-colonial institutions. Mining has been used as the shock that set in motion various interlinked developments which led to the undiversified and therefore unsustainable path of the fiscal regime of the Cape Colony.

# Appendix

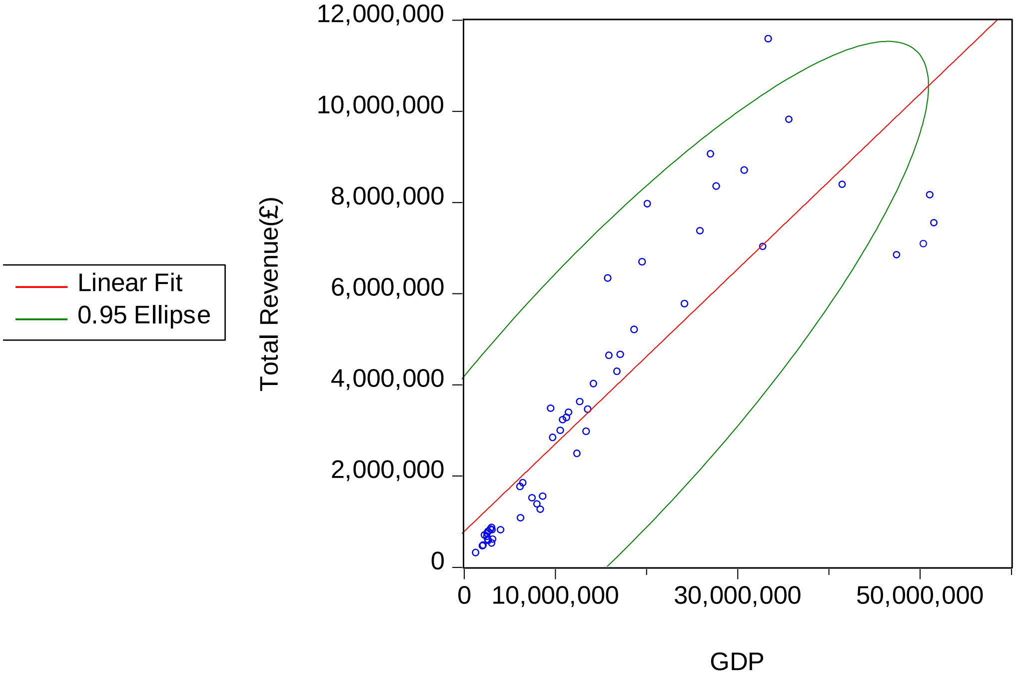
*4.2 Tax shares in GDP (few quantifiable variables-this is to be refined)*

Dependent Variable: LT_Y
Method: Least Squares
Date: 09/21/16 Time: 16:44
Sample (adjusted): 1857 1909
Included observations: 53 after adjustments

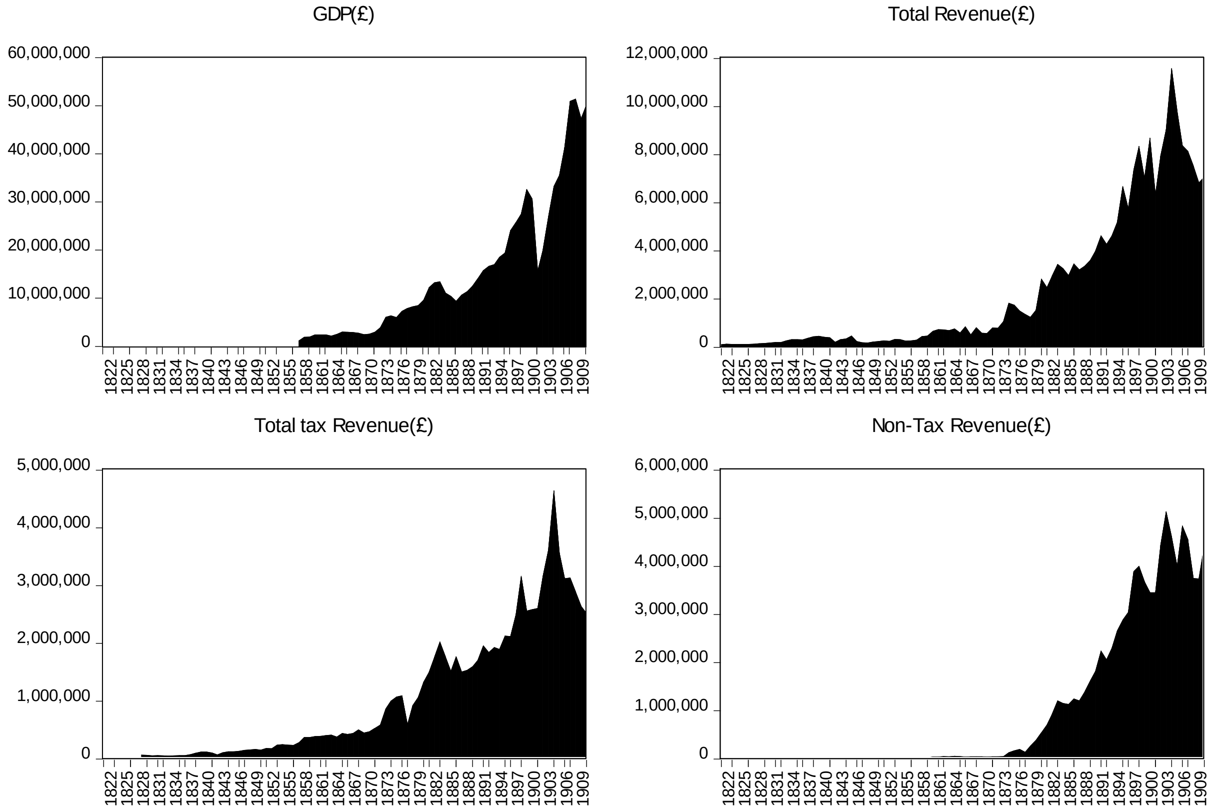
| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -0.701671 | 0.233446 | -3.005706 | 0.0042 |
| LGVTD | 0.072413 | 0.039801 | 1.819382 | 0.0751 |
| LMX | 0.878680 | 0.318091 | 2.762357 | 0.0081 |
| LNTXREV | 0.094659 | 0.045199 | 2.094243 | 0.0415 |
| LPCGDP | -0.521143 | 0.057062 | -9.133003 | 0.0000 |

| | | | |
|---|---|---|---|
| R-squared | 0.697615 | Mean dependent var | -2.067826 |
| Adjusted R-squared | 0.672416 | S.D. dependent var | 0.305771 |
| S.E. of regression | 0.175008 | Akaike info criterion | -0.558383 |
| Sum squared resid | 1.470133 | Schwarz criterion | -0.372506 |
| Log likelihood | 19.79714 | Hannan-Quinn criter. | -0.486903 |
| F-statistic | 27.68448 | Durbin-Watson stat | 0.904218 |
| Prob(F-statistic) | 0.000000 | | |

4. 1a) *GDP growth and central government revenue growth*




*4.1b) Total revenue, total tax revenue and total non-tax revenue*




*4.1c) Tax and non-tax revenue to GDP*

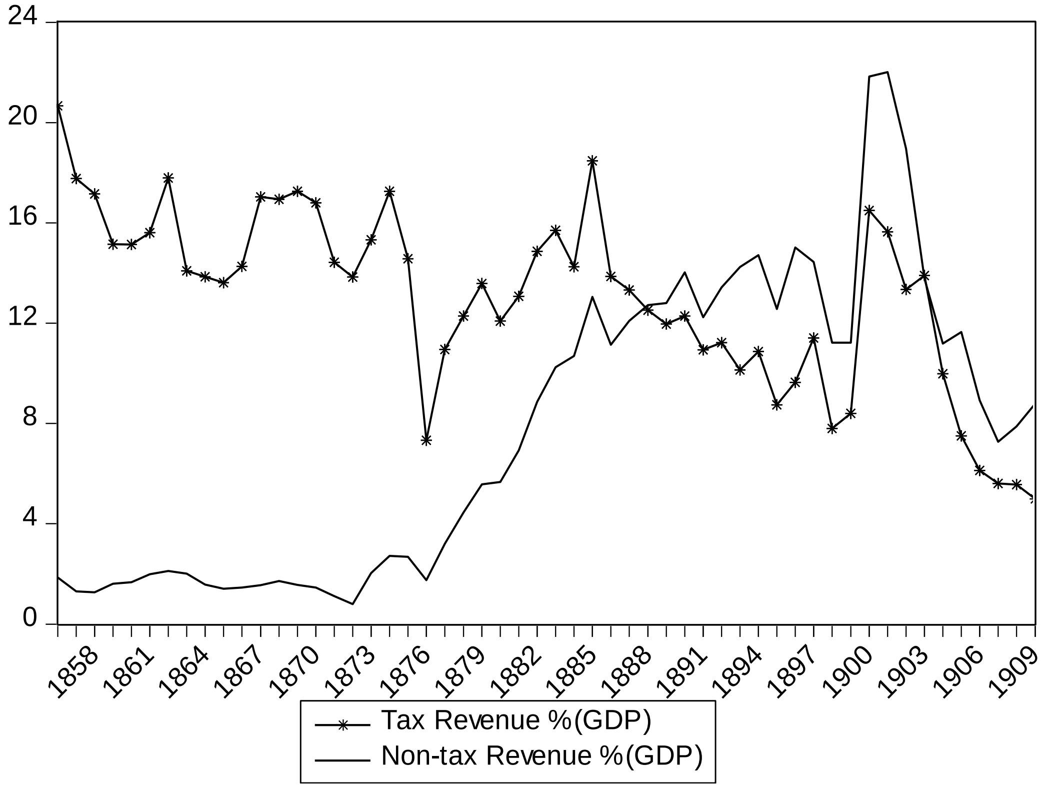


*Figure 4.2. Direct tax vs indirect tax*

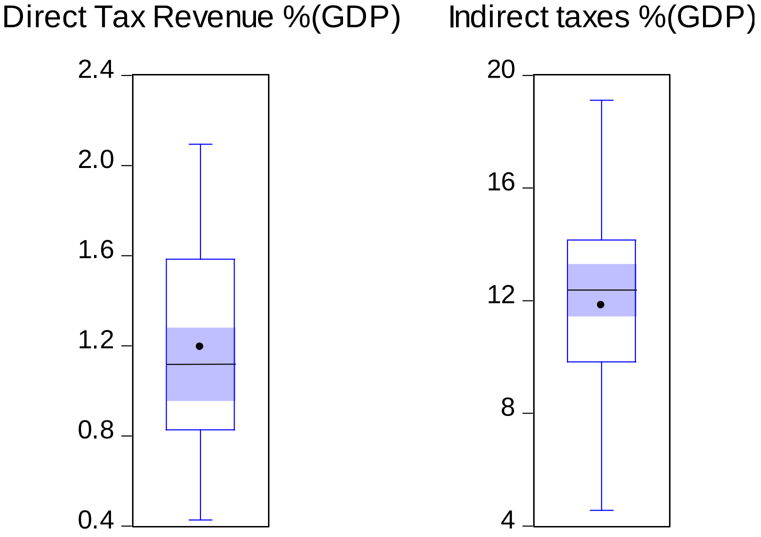
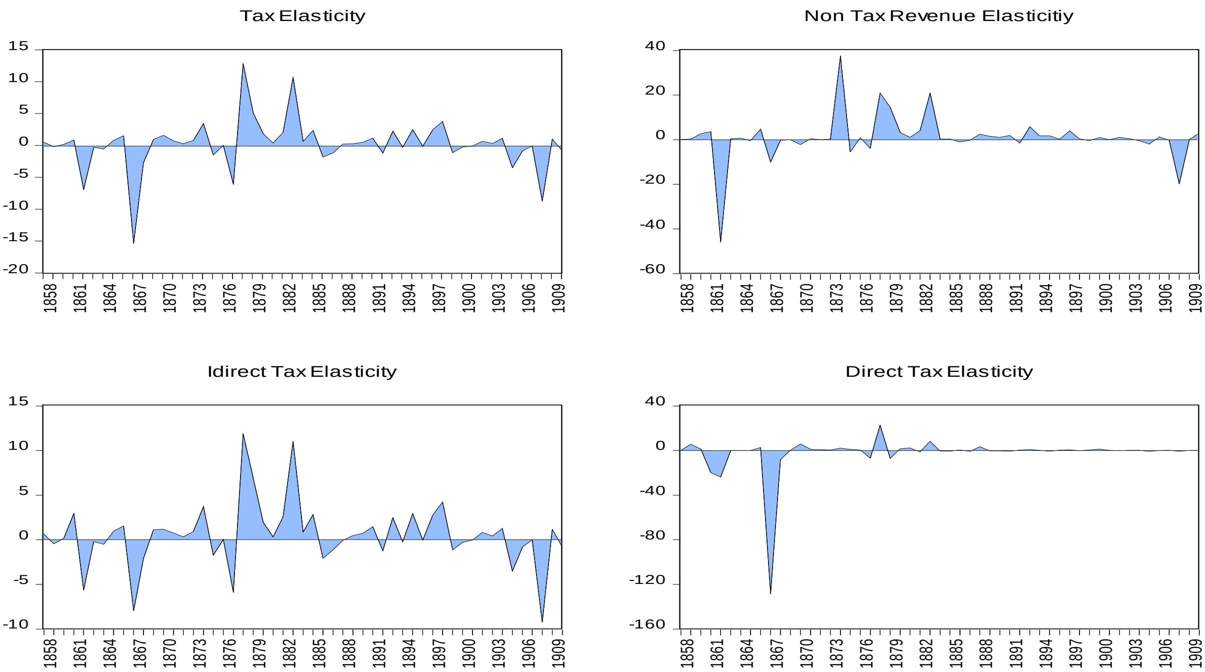



*Figure of 4.3 Tax elasticities*



*Fingure 4.4. Structural break in the non-tax revenues*

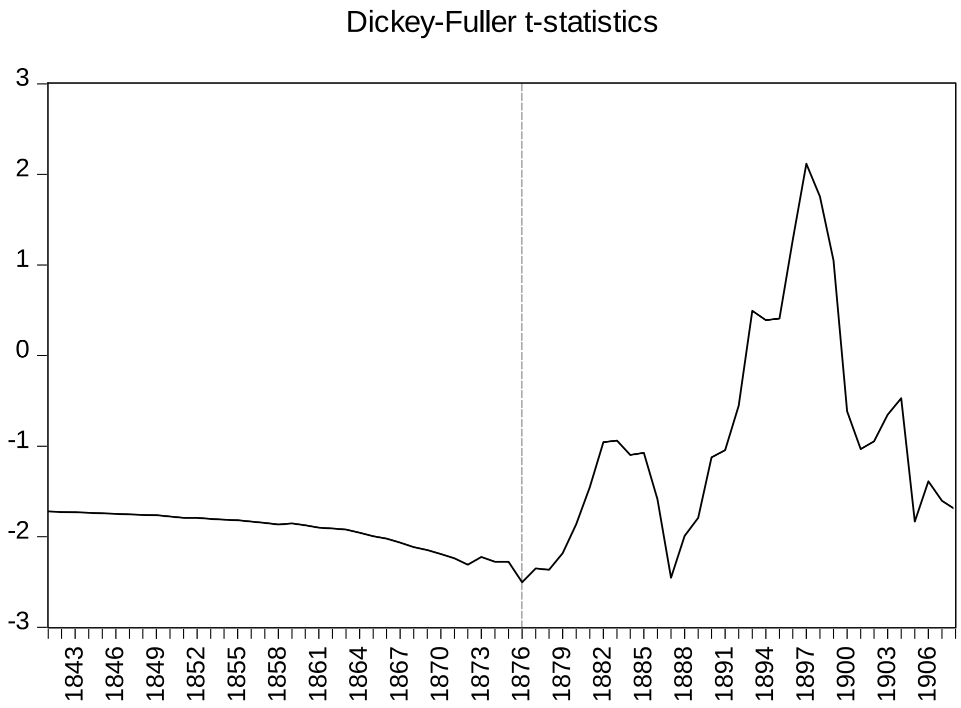
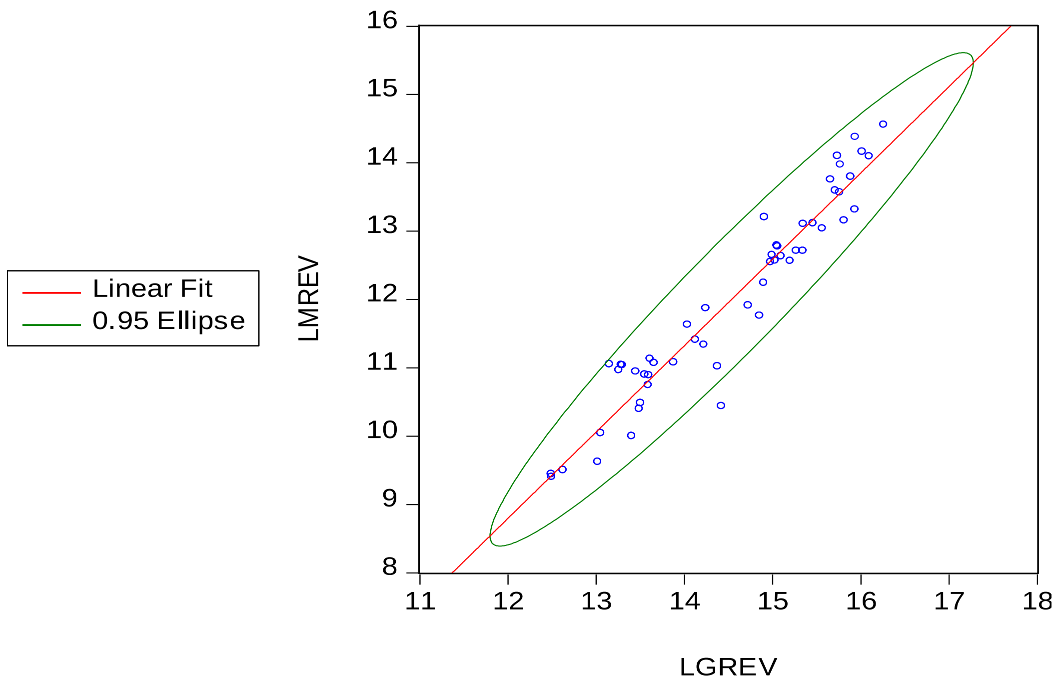
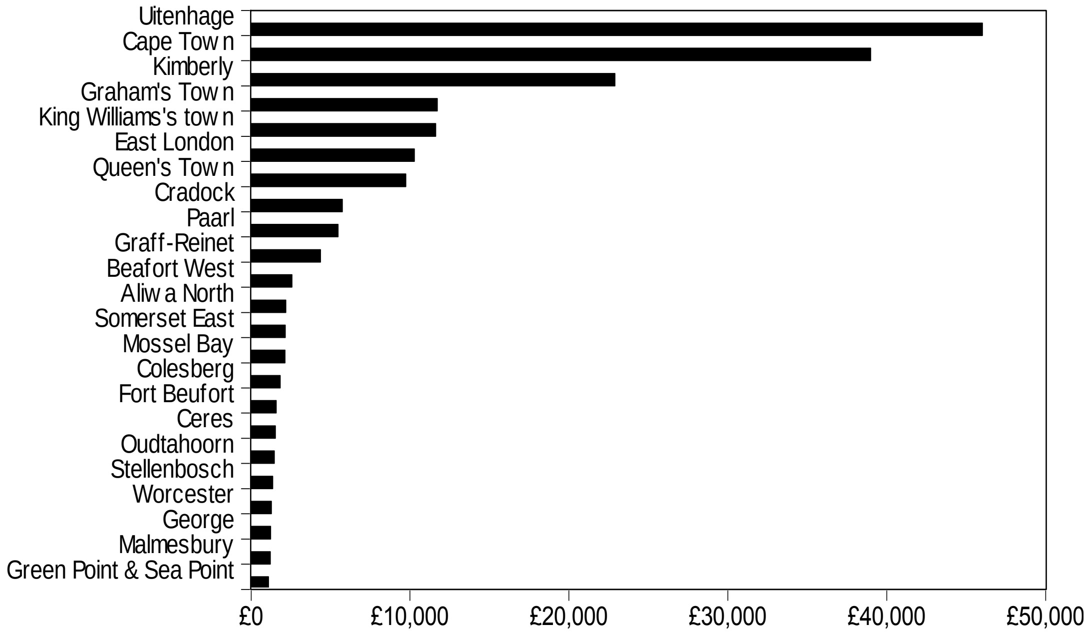



*Figure 4.5 Municipal revenue (LMREV) and central government Revenue(LGREV)*

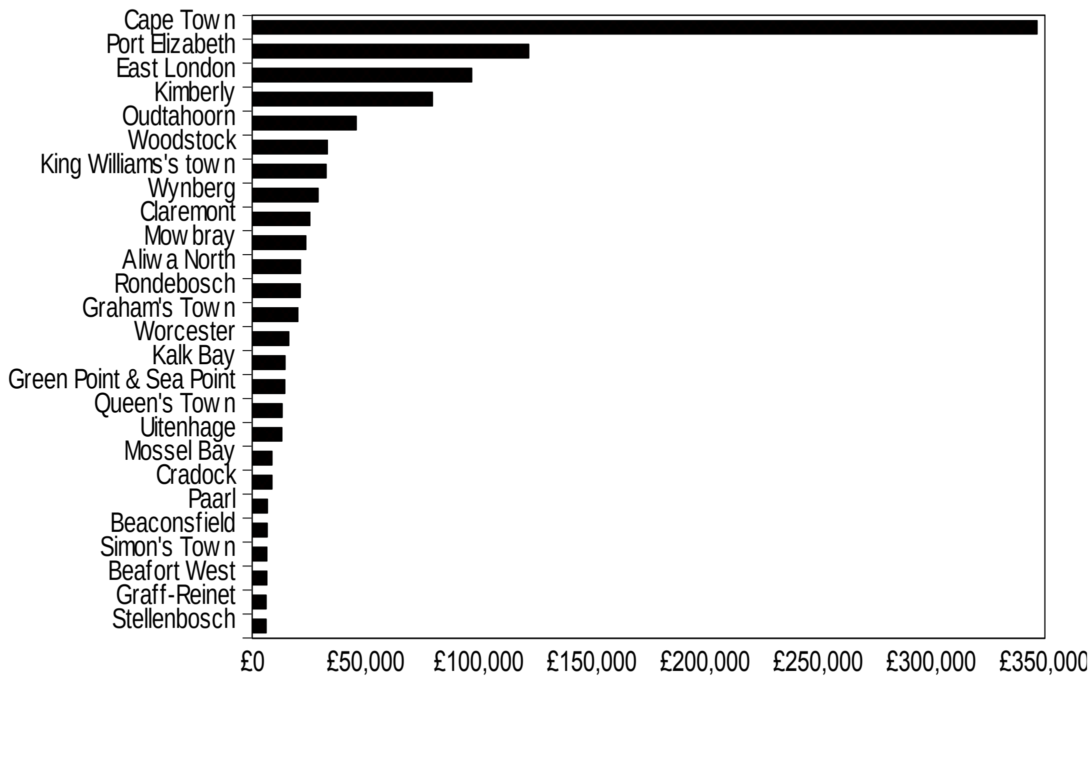



*4.6 Municipal revenues (top performing 1881 and 1907)*

**Municipal Revenue (1881)**




Municipal Revenue (1907)



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