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Socio-Economic Development in Africa: Tax Reform as a Tool for Fostering the Objectives of the AFCFTA

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Socio-Economic Development in Africa: Tax Reform as a Tool for Fostering the Objectives of the AFCFTA

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The African Continental Free Trade Area Agreement is aimed at transforming the economic landscape of the African continent. The agreement contains lofty objectives set up to enhance trade integration and promote the free flow of capital and investments. The agreement follows the EU model on market integration and signatories have committed to take measures to reduce the cost of doing business and create a conducive environment for private sector development in Africa. The agreement is not just aimed at eliminating barriers to trade, but is also focused on ensuring sustainable, inclusive social and economic development and structural transformation of the State Parties. The focus on the extensive benefits that trade integration might afford African countries presents an opportunity to review the underlying structural factors that erode the tax base of African countries and limit the potential of tax for socio-economic growth. This is important because trade liberalization stimulates trade and investment. Therefore, it is necessary to undertake effective structural reform to drive social and economic development in the continent.

This structural reform will involve the redesign of tax laws, renegotiation and/or cancellation of tax treaties, as well the implementation of institutional reforms to ensure efficient tax administration. Ultimately, the goal should be to maximize the benefits of trade integration to achieve social and economic development in the continent. The agenda for structural reform should focus on the significance of the VAT, which is a regressive tax and an important source of revenue for most African countries. With the removal of trade taxes, which is one of the key goals of the agreement, African countries will depend more on revenue from the VAT. Against this background, it is important for African countries to assess the equity and efficiency implications of the VAT in the economic paradigm. The goal should be to examine how African countries can use the VAT for socio-economic

development in the continent. This inquiry should consider base-broadening, to ensure that the tax base capture the provision of goods and services within the continent irrespective of the nature of the transaction.

It might also be appropriate to introduce VAT Credit to counter the regressive features of the VAT for low- and modest-income households. There is the need to also harmonize VAT legislations in the continent in order to eliminate the distortions and competitive practices that the different national VAT legislations might create. This harmonization will ensure that VAT rates and exemptions are uniform and there is clarity on which government is entitled to deduct VAT in specific instances. Tax harmonization is an integral aspect of market harmonization, as such it should form part of the infrastructure being created by African leaders. Tax harmonization will increase the competitiveness of the African continent and eliminate distortions in national tax systems that erode the tax bases of African countries. The reform should also ensure simplicity in the drafting of the VAT legislation to ensure ease of compliance.

Lastly, there is need to train tax administrators and provide them with modern resources to enhance optimal tax revenue collection and reduce the opportunities for tax evasion and avoidance. Substantial reduction of trade barriers in tariffs is expected to also increase FDI inflows in Africa. To that end, it is important that African governments consider changes to the current rules for attributing and calculating the taxable income of non-resident corporations in tax treaties. The changes should be aimed at ensuring that capital invested in the continent by non-residents are not eroded through treaty provisions. At the moment, tax treaties between developed and developing countries favour developed countries more than developing countries. The permanent establishment rule and limited source-taxing rights over passive income in tax treaties make source countries give up revenue. Studies have shown that developing countries negotiate away their corporate tax base through these source-restricting provisions in tax treaties. In addition to the reforms to source-restricting provisions in tax treaties, changes should also be made based on the arm's length principle. Transactions between associated enterprises occupy a large proportion of world trade.

The prescribed method for determining the taxable income of associated enterprises, the arm's length principle requires comparison between the transfer prices between related enterprises and unrelated parties dealing at arm's length. This principle, however, creates opportunities for aggressive tax avoidance by multinational corporations because tax authorities find it difficult to apply it correctly to transactions between associated enterprises because of the uniqueness of such transactions. Due to the significance of multinational corporations to world trade, base erosion and profit shifting from transfer pricing manipulation is therefore a huge source of revenue loss for countries, especially for African countries where corporate income tax revenue occupies a large share of total revenue.

Against this background, African countries should consider alternatives to the arm's length principle. A viable alternative to the arm's length principle: the unitary taxation (formulary apportionment) approach should be considered. This approach looks in detail at the

economic activities resulting into the profits of MNCs for tax purposes. Under this approach, tax authorities in Africa will justifiably impose corporate income taxes on “actual” profits of MNCs accruing from economic activities carried out in their jurisdictions, thereby eliminating the opportunities for base erosion and profit shifting in Africa.

In conclusion, the AFCFTA agreement is certainly a laudable initiative to harness trade integration for socio-economic development in Africa. However, it is important for African leaders to also consider the reform of underlying structural factors that might limit the potential of the agreement.

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