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Towards the elimination of direct tax barriers to regional economic integration in southern Africa

Jude Amos

1. Introduction

Regional integration in southern Africa is being pursued mainly through the institutional mechanisms of the Southern African Development Community (SADC), comprising the 14 member states of Angola, Botswana, the Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.¹ Although the integration of the region is intended to cover a wide range of sectors, the economic sector remains the focus of much of the effort to deepen the level of integration, which is intended to reach various stages by certain deadlines, including a free trade area (2008), customs union (2010), common market (2015) and monetary union (2016).

The focus of this paper is the role of tax systems and the options that exist for removing the barriers they may create to deeper economic integration. The fact that national tax systems can create barriers to greater regional economic integration is widely recognised. However, the more challenging issue remains the means by which the barriers they create can be effectively reduced or eliminated altogether. SADC's Finance and Investment Protocol² sets out the framework of the Community's approach mainly in terms of the creation of a tax database, initiatives to build capacity in the tax administrations of the member states, plans to develop a common framework on the grant of tax incentives, the establishment of a comprehensive tax treaty network for the member states, and the coordination and harmonisation of indirect taxation within the member states.

¹ Treaty Establishing the Southern African Development Community (1992) 32 *International Legal Materials* 116-135. The Southern African region is also partly covered by the Common Market for Eastern and Southern Africa (COMESA): see Treaty Establishing the Common Market for Eastern and Southern Africa (1994) 33 *International Legal Materials* 1067-1124. For the purposes of this paper, southern Africa will be taken to cover the geographical region of the member states of the SADC.

² See Annex 3 of the SADC *Protocol on Finance and Investment* (2006) (on file with author).

Although these measures would significantly contribute to the elimination of direct tax barriers to regional integration, there is need for additional measures that will help advance the goal of investment facilitation. In this connection, the main argument of this paper is that the most effective approach for removing the direct tax barriers to greater economic integration of the southern African region is the harmonisation of key aspects of the member states' direct tax systems in accordance with established tax treaty standards.

The paper is structured as follows. Section 2 shows the role of investment attraction in regional economic integration in general. Section 3 addresses the role of direct tax systems and the nature of the barriers they raise in the context of SADC. In Section 4 the options for eliminating the direct tax barriers to greater regional integration in SADC are considered. The paper concludes in Section 5 by emphasising some of the key points made and lines for future research on this issue.

2. Regional Economic Integration and capital flows

The attraction of Foreign Direct Investment (FDI) flows into a region is a key objective of all regional economic integration efforts, including that of SADC.³ The wider market created by such integration is expected to achieve this result by creating an environment that enables firms to grow stronger and larger than is possible in individual national markets. This would occur especially if integration leads to the national treatment of foreign investors, effective dispute resolution mechanisms, the existence of strong investor property rights which reduce the risk of direct or indirect expropriation, and the creation of a predictable policy environment.⁴

The need to attract greater volumes of FDI into developing countries in general is necessitated by their generally low percentage share in total FDI flows worldwide, despite the phenomenal growth in such flows over the past two decades. This should, however, not obscure the relative significance of these flows for the host economies. Two of the indicators used to measure such significance are the share

³ SADC Treaty, art 5(2)(d); SADC *Protocol on Finance and Investment*, art. 2(2)(a); and SADC Secretariat, 2003: sections 3.2.5. and 5.2.5.

⁴ Blomström and Kokko, 1997: 3-7.

of such flows as a percentage of the host state's gross fixed capital formation (GFCF)⁵ and the share of FDI stock as a percentage of the state's gross domestic product (GDP). Table shows that when measured in such terms, the significance of FDI inflows into the southern African region compares favourably with other regions of the world.

Table 1: FDI flows as a percentage of gross fixed capital formation (GFCF), 2002-2004 and FDI stocks as a percentage of gross domestic product (GDP), 1990, 2000, 2004

		FDI flows as a percentage of GFCF			FDI stocks as a percentage of GDP		
		2002	2003	2004	1990	2000	2004
Developed economies	<i>inward</i>	10.9	7.9	6.1	8.2	16.3	20.5
	<i>outward</i>	12.0	10.3	10.3	9.6	21.5	27.3
Developing economies	<i>inward</i>	9.5	8.8	10.5	9.8	26.2	26.4
	<i>outward</i>	2.8	1.6	4.2	4.3	13.6	12.7
Africa	<i>inward</i>	13.0	15.0	12.5	12.7	26.5	27.8
	<i>outward</i>	-	1.1	2.4	4.8	8.5	6.2
SADC Member Countries							
Angola	<i>inward</i>	46.1	82.6	42.7	10.0	87.4	88.8
	<i>outward</i>	0.8	0.6	0.6	-	0.5	0.7
Botswana	<i>inward</i>	33.1	23.7	2.3	34.8	36.6	15.1
	<i>outward</i>	3.5	11.7	13.5	11.9	10.4	19.9
Congo (DR)	<i>inward</i>	29.0	20.4	75.8	5.8	12.4	28.7
	<i>outward</i>	-0.5	..	..	..	..	..
Lesotho	<i>inward</i>	8.8	9.6	14.6	13.5	38.2	31.6
	<i>outward</i>	-	-	-	-	0.2	0.1
Madagascar	<i>inward</i>	1.4	1.3	4.5	3.5	9.1	11.8
	<i>outward</i>	..	..	..	-	0.3	0.2
Malawi	<i>inward</i>	3.3	6.0	8.4	10.5	18.8	20.4
	<i>outward</i>	..	..	..	..	0.5	0.5
Mauritius	<i>inward</i>	3.1	5.5	4.6	6.4	15.1	15.0
	<i>outward</i>	0.9	3.2	2.3	-	2.9	3.7
Mozambique	<i>inward</i>	47.5	44.9	15.5	1.7	29.7	39.0
	<i>outward</i>	-	-	-	-	-	-
Namibia	<i>inward</i>	32.4	15.8	38.6	80.9	35.6	32.6
	<i>outward</i>	-0.9	-1.0	-2.8	3.1	1.3	0.2
South Africa	<i>inward</i>	4.5	2.7	1.7	8.2	33.9	21.7
	<i>outward</i>	-2.4	2.2	4.6	13.4	25.3	13.5
Swaziland	<i>inward</i>	42.7	-25.7	24.9	39.9	38.6	39.2
	<i>outward</i>	-0.3	4.1	1.3	4.5	6.8	4.9
Tanzania	<i>inward</i>	23.2	27.7	21.9	9.1	33.4	48.0
	<i>outward</i>	..	..	..	..	..	..
Zambia	<i>inward</i>	10.3	16.0	27.7	31.1	72.9	55.8
	<i>outward</i>	..	..	..	..	..	..
Zimbabwe	<i>inward</i>	1.6	1.7	3.0	1.4	15.1	20.7
	<i>outward</i>	0.2	..	..	1.0	3.3	4.3

Source: UNCTAD, *World Investment Report 2005* (New York and Geneva: UN, 2005) Annex Table B.3 at 313-324.⁶

⁵ Gross Fixed Capital Formation refers to investments made in fixed assets, for example, expenditure on buildings, vehicles, plant and machinery for replacing or adding to the stock of existing fixed assets (Gilpin, 1977:100).

⁶ FDI flows with a negative sign (e.g. in the data for Botswana, Namibia and Swaziland) indicate that at least one of the three components of FDI (equity capital, reinvested earnings or intra-company loans) is negative and not offset by positive amounts of the remaining components. These are normally instances of reverse investment or disinvestment. See UNCTAD, 2005: 298.

However, the mere attraction of FDI capital into the region and its relative significance to national economies is not enough for realising effective regional economic integration. If larger investment flows are to be attracted into the region through the creation of a larger market, investment into a particular country in the region must also be seen as a springboard for investment into the rest of the region. Ultimately, therefore, greater economic integration would depend upon strong investment-based linkages that are facilitated by a environment conducive to significant cross-border capital flows within the region. Table 1 shows that the aggregate FDI outflows from the countries in the region, based on the available data, is generally low or nonexistent, with the exception of Botswana and South Africa (and to a limited extent Mauritius, Swaziland and Zimbabwe). The absence of data prevents a more reliable assessment of the extent of such outflows for all the countries. Consequently, the current scope of intra-regional investment flows is difficult to determine, although the existing data suggests that in any case it is likely to be very limited.

Creating an appropriate environment for achieving greater economic integration through more significant cross-border investment flows would require the removal of barriers that limit such flows. The next section of the paper considers how direct taxation measures can create such barriers

3. Direct taxation and regional economic integration

3.1 Taxation and capital flows within regional markets

There is no unanimity of views regarding the impact of taxation on the attraction of FDI-related capital. It appears to be generally accepted that tax factors are often not the most influential consideration in an investor's decision to invest in another country and that other factors may be more important, including the political and macroeconomic stability of the host economy, the availability of raw materials, the development of the infrastructure (e.g. transportation and telecommunications network), and the level and cost of human and technical skills. Thus, if there are

serious deficiencies in the general investment environment, tax factors are not likely to create any incentive for increased investment.⁷

However, it is also widely acknowledged that once the decision to invest has been made, tax considerations play an important role in the choice of the investment location; a role which has been enhanced over time by the progressive liberalisation of trade and investment regimes worldwide.⁸ In sub-Saharan Africa, for example, a significant number of market-seeking, resource-based and export-oriented investors consider duty exemptions and tax reductions as being desirable in their operations.⁹ It can therefore be expected that where two countries offer similar factor endowments from the perspective of an intending foreign investor, tax considerations could have an impact in tilting the balance in one country's favour.

The above observations apply equally in the context of regional economic integration. In this connection, two main challenges arise for policymakers of the participating countries. The first is whether, and if so, how far a state is entitled to use its tax measures to enhance its attraction relative to the other countries within the group in obtaining a greater share of the capital resources within the region. This raises the prospect of 'tax competition' which, if left unchecked, will distort the efficient allocation of such resources or even result in the significant erosion of the entire capital income base of the countries involved. The other related challenge, which this paper addresses, is what measures the participating states should adopt to remove the direct tax barriers arising from their national tax systems to the efficient allocation of capital resources within the integrated regional economy.

To illustrate the types of tax barriers that may exist for greater regional integration in the southern African region, this paper focuses on two common features of the direct tax systems in the region that operate to such an effect: the tax burden on capital flows and the vagueness in domestic tax laws with regard to the tax treatment of transactions between affiliated enterprises.

⁷ Wells, 2001: 97.

⁸ Easson, 1999: 17-19.

⁹ UNIDO, 2003: 57.

3.2 Direct tax barriers to regional economic integration

3.2.1 Tax burden on capital flows

One of the potential barriers to greater economic integration of the Southern African region is the tax burden on cross-border capital flows, particularly those in the form of equity investments. This arises as a result of the double taxation of such investments – first in the form of profits and secondly in the form of distributed dividends. To illustrate this, the tax burden on equity investments is compared to that on the other main form of investment capital (i.e. loans).

shows the tax rates applicable to such flows when paid from SADC member states to non-resident companies in general. It reveals varying aggregate tax rates on equity investments (i.e. domestic corporate income tax on profits plus withholding tax on dividends) ranging from a high of 52% in the Democratic Republic of Congo to a low of 25% in Mauritius.¹⁰

Table 2 –Tax Rates on FDI-Related Outbound Capital

Country	Equity			Debt
	Profits (%)	Dividends (%)	Profits & Dividends (%)	Interest (%)
Angola	35	10*	41.5	10*
Botswana	25	15*	26.25	15*
Congo(D.R.)	40	20*	52	0
Lesotho	25	25*	43.75	25/15 ⁴
Madagascar	30	30*	51	30*
Malawi	30	10*	37	15*
Mauritius	22.5	0	22.5	22.5
Mozambique	32	20*	47.6	20*
Namibia	35	10*	41.5	35
South Africa	29	0 ¹	29	0
Swaziland	30	15*/12.5* ²	40.5/38.75	10*
Tanzania	30	10*	37	10*
Zambia	35	15*	44.75	15*
Zimbabwe	30	20*/15* ³	44/40.5	10

* - final tax

1. Resident companies are also subject to a secondary tax on companies (STC), which is imposed at the rate of 12.5% on the net amount of dividends declared out of after-tax profits. However,

¹⁰ It should be noted that a fuller picture regarding the tax burden in all of these countries can be gained by examining the tax treatment of the income flows in the home state of the investor. For reasons of space, this issue is not developed in this paper.

- exemptions from the STC generally apply in respect of dividends declared by a company to its holding company that forms part of the same group of companies (i.e. with at least 70% equity shareholding).
2. The 12.5% rate applies if the dividends are paid to companies in Botswana, Lesotho, Namibia or South Africa unless such companies are subsidiaries of companies outside Botswana, Lesotho, Namibia or South Africa.
 3. The 15% rate applies to dividends paid by a company listed on the Zimbabwe Stock Exchange.
 4. The 15% rate applies to Lesotho-source interest payments on loans used solely in the production of manufacturing income subject to the concessionary tax rate (i.e. 15%).

The higher burden on capital flows in the form of equity investments has implications for the goal of enhancing capital flows within the region: the significantly higher tax on dividends in most of the countries encourages the retention of profits, thereby reducing the amount of capital that is available for investment elsewhere. Although investment may still increase in such cases in that the profits retained could be used to invest in the host economy, the fact that such a result will be dictated more by tax considerations could undermine a more efficient allocation of FDI capital within the region on the basis of non-tax considerations. If increased FDI-related capital flows are essential for deeper economic integration within the region, there is a case for lowering the tax burden on intraregional investments, particularly in the countries with much higher rates.

Another impact of the significant difference in the tax burden on equity compared to debt is that it increases the attraction for cross-border investments to be financed through debt rather than equity and may therefore provide fertile grounds for tax avoidance in the form of 'thin capitalisation'. The relative attraction of investing in debt rather than equity is based on the fact that as a general rule, interest on a loan is treated as a cost of carrying on a business and is thus allowed as a deductible expense from gross income for purposes of determining taxable net income, while dividends from shareholding typically are not considered as a return to investment and therefore part of such taxable net income. Thus, while an investment in the form of debt would usually bear only one level of tax in the country of source, namely the tax on the interest, this is not the case for equity. This has implications for the preservation of the tax base of the participating countries, since they will thereby be left with less taxable income from the investment.

The problem of thin capitalisation is especially relevant considering that of the countries in the region, only Lesotho, Mozambique, Namibia, South Africa, Zambia

and Zimbabwe have rules specifically designed to deal with such a tax minimisation strategy. While such rules may be necessary to safeguard the tax base of the countries concerned if applied reasonably and on a non-discriminatory basis, narrowing the gap in tax burdens in order to minimise the incentive to engage in such tax avoidance practices could prove to be a more effective approach. One of the options for achieving this result will be considered in Section 4.

3.2.2 Tax treatment of inter-affiliate transactions

Direct tax obstacles to greater regional economic integration in southern Africa may also arise as a result of defects in the tax systems themselves. One of these is the uncertainty in key areas of tax laws affecting cross-border investments, in this case the tax treatment of inter-affiliate transactions (e.g. between a parent and subsidiary company or between subsidiaries of the same parent company).

The importance of having clear rules with regard to inter-affiliate transactions (commonly identified in the tax literature under the subject 'transfer pricing') is made evident by the growing significance of such transactions in international business. The data so far suggests limited intraregional investment in the Southern African region, but the drive towards deepening the level of the region's economic integration to make the region attractive for both extra- and intraregional investments means that this issue will become more relevant as the pace of integration progresses.

While transfer-pricing practice constitutes a necessary and integral part of corporate strategy, it may also result in the erosion of the tax base of the countries involved. In a simple case scenario, goods may be sold by a company to its affiliate located in a relatively low tax jurisdiction at a price well below the market price so that the substantial portion of the profit arises when the goods are sold by that affiliate in the low tax jurisdiction or to another affiliate in another country at the market price. Conversely, commodities being sold to an affiliate in a high tax jurisdiction may be priced above the market price so that little profit accrues for taxation in that jurisdiction. By structuring its transactions in this manner, the multinational group would have ensured that the greatest possible portion of its income is subject to the least possible amount of tax. In any case, at least one tax jurisdiction is deprived of

tax revenue that would have been payable had the transaction taken place between independent parties dealing with each other at arm's length.

Thus transfer-pricing rules are needed not only to provide certainty for the investor, but also as a means of protecting the tax base of the participating countries. Most modern domestic tax laws therefore incorporate provisions that are designed to fulfil such an objective. The main goal behind such rules is therefore to ensure that values attached to the transfer of goods and services or any other business arrangements between affiliated parties reflect, for tax purposes, those that would obtain in the context of transactions between unconnected parties dealing with each other at arm's length. Thus, where such values deviate from the arm's length price, transfer-pricing rules would typically operate to permit a readjustment of these values to reflect an arm's length value.

With the exception of Malawi and Swaziland, the countries in the region do include transfer-pricing provisions in their tax laws, which spell out the basic principle stated above. However, in order to provide an investor with clear guidance as to how the law would operate, it is usually necessary for the law to indicate how the broad principle will apply in practice. Specifically, it is necessary for the law to be clear about how the arm's length standard will be determined in particular business circumstances. It is therefore common for transfer-pricing provisions in many domestic laws to be accompanied by detailed guidelines showing how the broad principle will apply in these circumstances. In their approach on this matter, domestic tax laws in several countries have been significantly influenced by the Organization for Economic and Cooperation Development (OECD) Guidelines,¹¹ which are viewed as establishing the global standard in the area.

Of the countries in the region, only South Africa has issued such guidelines¹² which are based in substantial part on the OECD Guidelines. The absence of such guidelines in the other countries in the region is the main source of uncertainty in this area that needs to be addressed. A possible approach in this direction will be considered in the next section of this paper.

¹¹ OECD, 1995.

¹² South African Revenue Service (1999).

4. Eliminating direct tax barriers to regional economic integration

4.1 The International Experience

The need to eliminate the barriers posed by direct taxation to regional economic integration is not unique to the Southern African region, but is also faced by other regional economic integration groupings. In considering the options for Southern Africa, it is therefore helpful to review briefly the experience of these other regional groupings in order to ascertain what main lessons can be drawn. The focus in this section will be on the experience in Europe, the Asia-Pacific region and sub-Saharan Africa.

The review will reveal that the most favoured approach in this area has been limited to three main options: the conclusion of bilateral treaties, the conclusion of a multilateral tax treaty, or the harmonisation of direct tax systems. Of these, the most common option has been the conclusion of bilateral tax treaties, while the conclusion of a multilateral treaty has been rare. Notably, the tax harmonisation option has been difficult to achieve and its realisation has so far been confined to indirect taxation.

4.1.1 Europe

The European Union (EU) is the most widely known example of regional economic integration. The EU's ultimate objective is to achieve an economic and political union, including the establishment of a truly single market. To that end, the member states are pursuing common policies in a wide range of fields, including taxation.

One of the key means for eliminating direct tax barriers within the EU is through the coordination of tax policies within the framework of the bilateral tax treaty network of the member states. This, however, represents a 'second best' option, which does not completely resolve all the issues raised by different direct tax systems within the single market. Some of the problems that arise with such an approach include the lack of complete uniformity in the bilateral treaties themselves and lack of

consistency in how they interact with domestic laws and differences in the interpretation of tax treaties from country to country.¹³

The favoured method for eliminating the barriers posed by direct taxation to the effective functioning of the single market is through harmonisation of member states' policies in this area. Although there is no explicit provision in the EC treaty for the harmonisation of direct taxes, EU actions in this field of tax have generally been based on Article 94 of the EC Treaty, which authorises 'directives for the approximation of such laws, regulations or administrative provisions of Member States as directly affect the establishment or functioning of the common market'.

Nevertheless, some degree of harmonisation of direct tax measures has been achieved, mainly through the implementation in member countries of EU legislation, in particular various directives issued by the European Council. The areas covered so far include mergers, divisions, transfers of assets and exchange of shares of companies of different member states, and the transfer of a company's registered office from one member state to another. Furthermore, a common system of taxation has been developed for the tax treatment of profit distributions between parent companies and subsidiaries or permanent establishments situated in different member states. Also of significance is the common tax system that applies to interest and royalty payments between associated companies of different member states.¹⁴

In addition to the policy and legislative developments, the expansion of European tax law has a very important judicial component, with the European Court of Justice (ECJ) achieving harmonisation over the past two decades through the application of nondiscriminatory principles based on the fundamental market freedoms, namely free movement of goods, services, people and capital.

¹³ Jimenez, 1999: 173 – 196.

¹⁴ Gormley, 2005: 307 – 340.

4.1.2 Asia-Pacific Region

Regional economic integration groupings active in the Asia-Pacific region include the Association of South-East Asian Nations (ASEAN), the Asia-Pacific Economic Cooperation (APEC) and the South Asian Association for Regional Cooperation (SAARC).

Regarding the removal of barriers posed by direct taxation to greater economic integration, the approach favoured by these groupings is the strengthening of the bilateral tax treaty network among the member states. Thus, APEC, for example, recommends the conclusion, where appropriate, of bilateral double taxation agreements that are in conformity with international norms, and the expansion of the coverage of such agreements. The ASEAN approach is similar, except that it has prepared a model treaty for this purpose for use in tax treaty negotiations between member states, as well as negotiations between member and non-member states.¹⁵ The model treaty's provisions are designed to cater for the special interests of the member states and therefore include various novel provisions such as a broader concept of the definition of a 'permanent establishment' and a wider scope of the concept of professional services.¹⁶ The notable exception to the above approach is that of SAARC, which has taken a multilateral approach to the issue by concluding a multilateral tax agreement to which all the member states are party.¹⁷

None of the above groupings has as yet pursued concrete measures for tax harmonisation as a means of eliminating the potential direct tax barriers to regional economic integration, although it has been argued by some writers that there is a case for such an approach.¹⁸

¹⁵ Intra-ASEAN Model Double Taxation Convention on Income (1987), *IBFD Tax Treaties Database*.

¹⁶ Yoingco, 1996: 253. It appears the model has so far not had much impact in influencing the contents of tax treaties concluded with non-member states.

¹⁷ See SAARC, 2005 (in *IBFD Tax Treaties Database*).

¹⁸ See Richardson, 1996: 430 – 439.

4.1.3 Sub-Saharan Africa

Sub-Saharan Africa has had a long experience with regional economic integration groupings, going back to the immediate post-independence era. Thus, apart from SADC, economic integration in the subregion is also being pursued through a number of other groupings, notably the Economic Community of West African States (ECOWAS),¹⁹ the Common Market of Eastern and Southern Africa (COMESA), the East African Community (EAC), the Economic Community of the Central African States (ECCAS)²⁰ and the *Communauté Économique et Monétaire de l'Afrique Centrale* (CEMAC).²¹ The type of integration schemes sought to be established by these groupings range from an economic and monetary union (ECOWAS) to the creation of a common market (e.g. COMESA) or the establishment of an economic and political union (e.g. EAC).

Although the harmonisation of fiscal policies or systems is the chosen means in all of these groups for removing the barriers posed by tax systems to the achievement of greater economic integration,²² the actual measures implemented in this direction have been restricted to indirect and not to direct taxation. In the latter area, the approach that has generally been opted for is that of expanding the bilateral tax treaty network of the member states. For example, ECOWAS member states have undertaken 'to avoid double taxation of Community citizens and grant assistance to one another in combating international tax evasion'.²³ A similar undertaking is made by COMESA member states 'to conclude between themselves agreements on the avoidance of double taxation'.²⁴ The only notable exception is the multilateral treaty concluded on 28 April 1997 by the member states of the EAC.²⁵

¹⁹ See Revised Treaty of the Economic Community Of West African States. 1996. 35 *International Legal Materials* 660-697).

²⁰ Treaty Establishing the Economic Community of Central African States. 1984.. 23:5 *International Legal Materials* 945-1008.

²¹ In 1999 CEMAC replaced the *Union Douanière et Économique de l'Afrique Centrale* (UDEAC) established in 1964.

²² Arts 55(1) of the revised ECOWAS treaty, above note 19; articles 76 and 159(1)(d) of the COMESA treaty; art 21 of SADC treaty, above note 1; and articles 4(e) and 7(a) of the ECCAS treaty, above note 20.

²³ Art. 40(5) of ECOWAS treaty, above note 19.

²⁴ Art 161 of COMESA treaty, above note 1.

²⁵ *Agreement Between the Governments of the Republic Of Kenya, the United Republic of Tanzania and the Republic of Uganda for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*. IBD Tax Treaties Database.

4.2 Options for southern Africa

4.2.1 Expanding the bilateral tax treaty network

As already noted above, bilateral tax treaties are a favourite means of reducing or eliminating the barriers posed by direct tax systems to regional economic integration. Indeed, bilateral tax treaties were a favoured tool for removing tax barriers to cross-border investments long before regional economic integration agreements, and the vast majority of existing tax treaties are between countries that are not necessarily party to the same regional economic integration agreement.

Tax treaties achieve the result of eliminating tax barriers, primarily by providing for shared tax jurisdiction between the state parties in respect of income flows between them. Through this mechanism, the incidence of double taxation of cross-border investment flows is effectively removed.

Table 1 shows the bilateral tax treaty network within SADC (i.e. treaties concluded by SADC member states with other member states). It is clear from the table that the existing network is very restricted, with Mauritius and South Africa having by far the most number of treaties.

Table 1. SADC Bilateral Tax Treaty Network

Country	Angola	Botswana	Congo (DR)	Lesotho	Madagascar	Malawi	Mauritius	Mozambique	Namibia	South Africa	Swaziland	Tanzania	Zambia	Zimbabwe
Angola	-	0	0	0	0	0	0	0	0	0	0	0	0	0
Botswana	0	-	0	0	0	0	√	0	0	√	0	0	0	√
Congo (DR)	0	0	-	0	0	0	0	0	0	√	0	0	0	√
Lesotho	0	0	0	-	0	0	√	0	0	√	0	0	0	0
Madagascar	0	0	0	0	-	0	√	0	0	0	0	0	0	0
Malawi	0	0	0	0	0	-	0	0	0	√	0	0	0	0
Mauritius	0	√	0	√	√	0	-	√	√	√	√	0	0	√
Mozambique	0	0	0	0	0	0	√	-	0	0	0	0	0	0
Namibia	0	0	0	0	0	0	√	0	-	√	0	0	0	0
South Africa	0	√	√	√	0	√	√	0	√	-	√	√	√	√
Swaziland	0	0	0	0	0	0	√	0	0	√	-	0	0	0
Tanzania	0	0	0	0	0	0	0	0	0	√	0	-	√	√
Zambia	0	0	0	0	0	0	0	0	0	√	0	√	-	0
Zimbabwe	0	√	√	0	0	0	√	0	0	√	0	√	0	-
Total	0	3	2	2	1	1	8	1	2	10	2	3	2	5

Source: Compiled by author from IBFD, Tax Treaty Database

The question that arises is whether, in view of the role such treaties can play in the context of regional economic groupings, there is the need for SADC countries to broaden their bilateral network. This issue must, however, be examined in the light of the structural limitations or weaknesses of bilateral tax treaties in general, and in the context of an economically integrated market in particular.

One of the weaknesses of bilateral tax treaties is their restrictiveness. This arises because by their very nature, any effect they have on the removal of direct tax barriers is confined to the tax systems of the two contracting states. This weakness is particularly relevant in view of the fact that for the creation of an integrated regional economy to be successful, a multilateral and not a bilateral approach to most issues, including taxation, is required. At the level of the economic agents whose operations are intended to be enhanced through the integration of the various economies, a

bilateral approach also falls far short of what is required because of the increasingly integrated nature of business operations by various firms.

No less important in the circumstances of the SADC member states is the fact that the creation of a comprehensive bilateral tax treaty network connecting all the member states would require the devotion of a great deal of time and resources, since at least 70 separate bilateral treaties would be needed. However, as can be seen from Table 1, only 21 bilateral treaties have so far been concluded between countries in the region.

4.2.2 Concluding a multilateral tax treaty

In view of the general shortcomings of bilateral tax treaties, an idea that is gaining increasing attention is the replacement of the bilateral treaty network with a multilateral treaty or framework for resolving international tax conflicts. The debate on this issue has occurred more with reference to the international tax system as a whole than to regional economic integration groupings in particular.²⁶ Nevertheless, it is relevant in the context of economic integration arrangements since the challenges that arise in this context are identical to those of the wider international tax system.

The advantages or strengths of a multilateral treaty or approach can be viewed as the converse of the weaknesses of the bilateral approach. Thus, a multilateral agreement provides a better means of facilitating reforms to tax systems in individual countries. Where contemplated reforms conflict with the multilateral treaty, a multilateral arrangement provides a forum for discussing and agreeing to amendments or internationally coordinated action. In this connection, its interpretation and application would be easier.²⁷

One of the attractive features of multilateral treaties is that it enables smaller countries without the resources for concluding numerous bilateral tax agreements to become part of a treaty network without incurring the costs that would otherwise arise

²⁶ See Thuronyi, 2001: 1675 – 1679; and Vann, 1991: 100.

²⁷ McIntyre, 2002: 253; and Loukota, 1997: 90.

were they to conclude separate bilateral treaties.²⁸ Viewed in the context of the Southern African region, this would mean that a single multilateral treaty for the region would make it unnecessary to conclude the over 70 bilateral treaties that are required to establish a comprehensive tax treaty network covering the entire region.

While the conclusion of a multilateral treaty may be difficult to achieve at the worldwide level, it does remain feasible in the context of a regional or subregional setting where a greater degree of identity may exist.²⁹ The SADC itself does not seem to aim for such a multilateral treaty, but rather for the establishment of a common policy on tax treaty negotiations leading to a model treaty for the region to be used in tax treaty negotiations with both member and non-member states.³⁰ If so, the approach may have to be reconsidered to entail the conclusion of a multilateral treaty for the member

4.2.3 Tax harmonisation

Another option for eliminating obstacles posed by direct tax systems to regional economic integration is through tax harmonisation. This may involve different degrees of standardisation, involving at one end a total harmonisation of taxes in the participating jurisdictions (e.g. with each jurisdiction having the same taxes, tax bases and rates) or on the other end the adoption of certain minimum requirements. In between, there could be an intermediate degree of harmonisation which involves giving each jurisdiction the ability to choose between various options.³¹

Although it appears to be virtually impossible to achieve worldwide tax harmonisation, a conclusion which is partly validated by the general failure to achieve such harmonisation even among regional economic groupings, there is an argument to be made for pursuing some degree of tax harmonisation in the field of direct taxation as a means of eliminating the barriers to deeper regional economic integration in Southern Africa. While complete harmonisation may be difficult to achieve given the differences in country size and the economic strengths of the

²⁸ McIntyre, 2002: 253; and Thuronyi, 2001:1656.

²⁹ Van Raad, 2002: 248.

³⁰ Article 5 of Annex 3 of the SADC *Finance and Investment Protocol*, above note 2.

³¹ IBFD, 2005: 204-205.

countries in the region, some degree of harmonisation is possible. In particular, such harmonisation would entail the standardisation of certain key aspects of domestic tax provisions affecting investments in accordance with tax treaty norms. Some ideas regarding how this may be approached, particularly with reference to the two main barriers raised in the previous section, are considered next.

4.2.3.1 Lessening the tax burden on intraregional capital flows

One area where a harmonised approach could be taken by southern African states is with regard to the reduction in the tax burden for intraregional capital flows. The basic framework of such an approach would require that substantial equity investments (defined with reference to a percentage of the share capital or voting shares) made by southern African resident companies in other companies in the region will be subject to a lower tax rate than the rate currently applicable under domestic law for nontreaty countries.

That brings us to the question of what an 'ideal' lower rate will be. This is where tax treaty norms could be used as a reference for adopting a harmonised approach. On the basis of a review of the rates on dividends and interest prescribed under both the domestic laws and tax treaties concluded by SADC Member States, it would seem reasonable to suggest a withholding rate of 5% for substantial equity investments and maximum of 10% for interest payments.

4.2.3.2 Clarifying the tax treatment of interaffiliate transactions

Following the argument that reference to tax treaty norms would provide an effective tool for a harmonised approach to the elimination of tax barriers to regional integration, and in view of the status of the OECD Guidelines in this area, one solution would be for the countries simply to adopt these Guidelines into their domestic laws, following the example of South Africa.

Indeed, for the resolution of transfer-pricing cases that arise in the context of the existing tax treaty network within the southern African region, the Guidelines remain the most authoritative source of reference. It would appear logical to extend this

recognition to all other transfer-pricing cases arising in the absence of specific tax treaties. Adopting the Guidelines into domestic law would have the advantage of providing both the tax administration and investors operating within their jurisdiction with a clear internationally established standard against which approaches to countering tax base erosion through transfer pricing can be measured. Moreover, construction or interpretation issues will be easier to resolve through the continuous interpretational activities undertaken by the OECD in updating its guidelines.

There may, however, be reasons why such an approach may not necessarily resolve the issue at stake. One of these is the soundness of the approaches endorsed in the Guidelines for resolving transfer-pricing issues, in particular the difficulty with applying transaction-based methods in an increasingly integrated world. Specifically, the difficulty or near-impossibility of obtaining approximate arm's length prices for an increasing number of interaffiliate transactions has led to increasing calls for the adoption of a different approach to resolving the transfer-pricing problem.

Of the alternatives to transaction-based approaches that have been proposed, the one that has received the greatest attention is the adoption of a formulary apportionment method in the taxation of affiliated businesses. This method involves 'the apportionment of income among related companies based on a formula turning on sales, labour costs, or assets, or some combination of those three plus perhaps a fourth factor relating to research and development expenditures'.³² Under such a system, the income of an integrated group of companies will be apportioned among the jurisdictions in which they operate on the basis of the actual economic activities that take place within these jurisdictions (e.g. payroll, profits and sales).³³

From the perspective of developing countries, such an approach has the appeal of administrative simplicity in view of the limitations they generally face in various areas, including the identification of taxpayers, the lack of adequate staff, communication problems, and accessibility of relevant information.³⁴

³² Graetz, 2001: 1420.

³³ McLure, 2003: 155.

³⁴ See Kopits and Mutén, 1984: 270.

Of the factors that militate against adopting such an approach, even in the context of an economic integration grouping consisting of developing countries, the most pertinent would seem to be lie in its general rejection by the OECD as well as international business firms.³⁵ Thus any attempt at introducing such a method unilaterally either by a particular country or group of countries is likely to be counter-productive to the effort to encourage FDI inflows.

5. Conclusion

The member states of SADC have embarked upon a laudable objective of integrating their economies, with the ultimate goal of creating a common market, for the purpose of realising enhanced economic growth and development for the peoples of the region. In this connection, their efforts are similar to initiatives being pursued in other geographical regions.

The push towards greater economic integration requires a great deal of cooperation to remove the barriers existing in a broad range of fields. This paper has highlighted some of the impediments that exist in the field of direct taxation. The focus on the range of direct tax barriers has been limited, but such impediments could arise with regard to the operation of all aspects of the direct tax systems of the countries in the region. These may include the rules governing the basis of tax jurisdiction, determining the scope of taxable income, deductibility of expenditure, and the procedures or processes involved in the administration of direct taxes. Thus, a comprehensive picture of the tax barriers to economic integration in the region will require a more extensive study of all of these aspects.

The paper also has considered feasible options for the elimination of direct tax barriers, including the strengths and limitations of existing approaches. In particular, it stresses the need for some degree of tax harmonisation in certain key areas of domestic laws affecting FDI-related capital flows. However, based on the experience of other regional economic groupings, the expansion of the existing tax treaty network would seem to be a necessary first step. In this connection, the conclusion

³⁵ 1995 Guidelines, above note 11, par. 3.64 - 3.73; Mutén, 1988: 471-472; and International Chamber of Commerce, 1981: 170-172.

of a multilateral treaty that is not necessarily comprehensive in its coverage, but incorporates only the key aspects directly affecting cross-border investments, might offer a more effective solution compared to the conclusion of separate comprehensive bilateral treaties between the member states.

The experience of the various regional economic groupings further shows that although it remains an attractive option for eliminating direct tax barriers, tax harmonisation has either not been seriously considered or it remains a difficult goal to achieve. At this stage for the southern African region, such an option may therefore seem to be too advanced, seeing that the economic realities that may justify its adoption may not have ripened as yet. However, if the region is to make any progress towards deepening the level of its economic integration in the light of its ultimate goal of creating a common market, such an approach would require some serious consideration in due course. In that connection, tax harmonisation must also lead to a simplification of and the introduction of clarity into the existing tax systems, particularly in areas directly relevant for cross-border investment flows.

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