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The Advantages and Disadvantage of Double Taxation Agreements for Developing Countries

Alma Boustati
16 September 2022

Question

What are the advantages and disadvantages of Double Taxation Agreements (DTAs) on trade, investment, and other economic indicators based on existing evidence of DTAs done globally, with a focus on those entered between developing/developed countries? What model of DTA (OECD or UN model) have widely been used while agreeing DTA between developing and developed countries?

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1. Summary

When a developing and a developed country sign Double Taxation Agreements (DTAs), its generally the case that the developing country is the one that forgoes some of its tax revenues (Braun & Fuentes, 2016). Nevertheless, developing countries enter these agreements on the assumption that this will have enough economic benefits to offset these losses (Neumayer, 2007). Besides alleviating the burden of double taxation, DTAs also have the added value of improving exchange of information, which helps combat tax evasion and avoidance (Barthel et al., 2009).

One of the incentives for signing DTAs for developing countries is the increase in Foreign Direct Investments (FDIs) (Neumayer, 2007). The evidence from the literature on the link between signing DTAs and increasing FDIs is very mixed, with some finding a positive impact and others finding no impact (Quak & Timmis, 2018). This is not surprising, as this relationship is particularly difficult to study due to several methodological issues, including selection and direction of causality.

However, the literature points to some clear factors that drive the relationship between FDIs and DTAs. Firstly, a country's initial conditions matter; for example, middle income countries are more likely to benefit from DTAs in term of increase in FDIs than lower income countries (Baker, 2014; Barthel et al., 2010; Neumayer, 2007). Additionally, the relevance of the treaty also matters. For example, many treaties do not have material impact on the ground as they are old or outdated (Dong et al., 2019; Ohno, 2010). Others do not create substantial change, either because relief of double taxation already exists or because they do not reduce the tax burden with respect to the already existing global network of tax treaties (Baker, 2014; Petkova et al., 2020).

There are also studies that attempt to quantify the tax revenue loss of developing countries when they enter DTAs. All the studies find substantial negative loss, although most do not account for the potential benefit of increased FDIs (ActionAid, 2016; IMF, 2014; Janský & Šedivý, 2018; McGauran, 2013; Van de Poel, 2016). A key issue that the literature discusses when it comes to forgone tax revenue is the phenomenon of treaty shopping (IMF, 2014; McGauran, 2013). This refers to a situation whereby a third country takes advantage of a treaty between two states by setting up a conduit company solely for the purpose of enjoying the benefits of the treaty. This harms both developing and developed economies through eroding the tax base (McGauran, 2013).

There are also other reasons for why developing countries may still commit to negotiate and enter DTAs even when the benefits are not guaranteed. This includes increasing diplomatic ties with the treaty partner and the incentive of receiving foreign aid (Braun and Zagler, 2017). The other is a prisoner's dilemma situation; collectively, developing countries would be better off refusing to sign DTAs, but each one has an incentive to sign DTAs to gain a competitive advantage (Barthel and Neumayer, 2012).

The two most prevalent DTA conventions are the OECD Model and the UN Model. The UN Model tends to be more advantageous for developing countries compared to the OECD Model (Eyitayo-Oyesode, 2020). However, this comes with several caveats. While developing country negotiators tend to refer to the UN Model, the actual treaties signed contain many more OECD provisions. There are many issues over which the UN Committee's expert members from developed and developing countries disagree but developed country member are better at

influencing decisions. Finally, the OECD Model is updated more frequently, resulting in the UN one being comparatively out of date (Hearson, 2015; Quak & Timmis, 2018).

Generally, the literature on the impact of DTAs on developing countries' economies is extensive. This is especially the case for the impact of DTAs on FDIs as well as on tax revenue loss. However, because of the complexity of these issues, many of the empirical studies inevitably suffer from methodological issues that make conclusive claims very difficult. Notably missing from the literature is the impact of DTAs on international trade. Only one study (Pham et al., 2019) identified in this rapid review looks at this relationship directly. Otherwise, the impact of DTAs on trade is only seen through the lens of its impact on FDIs.

2. Background

According to Neuyman (2007), double taxation generally occurs when a multinational company pays tax on the same income earned from economic activity in a foreign country twice: once to the tax authorities of the foreign country, which is host to the economic activity, and once to the tax authorities of the home country, in which the company is set up. This double burden has many repercussions, not least of which is discouraging investment in foreign countries (Neuyman, 2009). As such, DTAs are signed between two countries to alleviate this double burden and, as a result, encourage the flow of foreign investment. It also serves to facilitate the exchange of information between two countries to help combat tax evasion and avoidance (Barthel et al., 2009).

Generally, the literature agrees that when it comes to DTAs between two economies with equivalent FDI positions, the reallocation of taxing rights that happens is not an issue, as there are no clear winners or losers (Quak & Timmis, 2018; Braun & Fuentes, 2016). On the other hand, when DTAs are signed between two countries with an asymmetric FDI flow, the capital-importing country (typically a developing country) is likely to forgo tax revenues (Braun & Fuentes, 2016; Quak & Timmis, 2018). DTAs thereby shift taxing rights from the capital-importing country or source states to the capital-exporting country or the residence state. Therefore, developing countries who sign DTAs are likely have their tax revenues reduced (Quak & Timmis, 2018).

According to Braun and Zagler (2017), there were around 3,000 DTAs in force as of 2010. While this is a large number, it is only a fraction of the number of potential bilateral relationships (IMF, 2014; Quak & Timmis, 2018). About 500 DTAs covered relationships between OECD countries (17% of total DTAs), a third of the treaties were signed between two developing economies, and more than 50% were between a developing country on the one hand and an OECD country on the other hand.

3. Impact on investment

Developing countries invest time and other scarce resources to negotiate and conclude DTAs with developed countries. They also accept a loss of tax revenue as such treaties typically favour residence-based taxation, as mentioned before. The incurred costs can only pay off if developing countries can expect to receive more FDI in return (Neumayer, 2007).

Therefore, it is not surprising that one of the most studied aspects of DTAs is their impact on FDIs to developing countries. In theory, it is difficult to discern with certainty the direction of the impact. Quak and Timmis (2018) lay out the opposing forces in which DTAs affect FDIs. On the one hand, the relief from double taxation will stimulate FDI activity into developing countries (Blonigen, Oldenski, & Sly, 2011). Additionally, tax treaties provide certainty and predictability for foreign investors (Lang & Owns, 2014). On the other hand, there is the controversial assumption that information sharing between governments as a result of DTAs may reduce the ability of multinationals to engage in tax avoidance or evasion, which in turn discourages FDIs (Blonigen, Oldenski, & Sly, 2011).

There are many empirical studies that attempt to find the magnitude and direction of this impact. However, there are several factors that make this relationship particularly difficult to study. First, there is the question of the direction of causality; it is unclear whether DTAs are signed when there is an expectation of increase in FDIs or if DTAs do indeed encourage FDIs (Quak & Timmis, 2018). Relatedly, it is very difficult to isolate the influence of treaties from other variables such as the economic and political environment of the country (Lang & Owns, 2014). The results of these studies, therefore, tend to be mixed and nuanced, pointing to different reasons and conditions under which the relationship between FDIs and DTAs take different forms.

One of those factors is the initial conditions of the country. Baker (2014) finds that there is no evidence of increased FDI flows to least developed countries as a result of entering into DTAs. Barthel et al. (2010), on the other hand, analyses a dataset of 105 countries and finds a positive impact of treaties on FDI stocks for middle-income countries. Neumayer (2007) confirms both of these findings; looking at developing countries that signed DTAs with the US, the study finds that the positive impact on FDIs flows is present for middle income countries but not for lower income countries. Millimet and Kumas (2007) look at countries that signed a DTA with the US and find a positive impact of treaties for countries with low initial FDI levels but a negative impact for countries with high initial levels. Braun and Fuentes (2016) conduct a case study on the impact of DTAs that Austria has signed with developing countries. The results indicate that the number of Austrian investment projects in middle income countries increases when a DTA is in place.

Shah and Qayyum (2015) look at Latin America and find that tax treaties have no effect on FDIs, as other factors take precedence including size of the market, development level, trade openness, and use of natural resources. Murthy and Bahsin (2014) conduct a case study on India to discern the impact of DTAs on FDI. Their results indicate that tax treaties do have a small, positive, impact on FDIs. They conclude that FDIs are mainly driven by supply and demand factors, but tax treaties, along with other trade policies, create the right environment to facilitate investments.

Another important factor considered in the literature is the extent to which DTAs are practically relevant. Baker (2014), for example, argues that most developed countries unilaterally provide for the relief of double taxation regardless of the treaty status with the host country, hence the lack of impact on FDIs. As such, least developed countries need to carefully consider what benefits (if any) comes about from such an agreement and whether it is worth the forgone tax revenue and negotiation costs. Ohno (2010) looks at the effect of DTAs on Japanese FDI in 13 Asian countries and finds that only new treaties have significant positive impact on FDI. He argues that as time passes and the treaties become old or are revised, they lose their significance. Dong et

al. (2019) also look at the impact of DTAs on FDIs for ASEAN countries. They find a negative association which they argue is not attributable to the exchange of information provision. Instead, they argue that some of the old DTAs tend to be ineffective in facilitating FDIs due to outdated clauses.

Similarly, Petkova et al. (2020) argue that many tax treaties are surprisingly irrelevant, hence the lack of impact on FDIs. They differentiate DTAs with respect to their relevance in terms of reduction of the overall tax burden to or below the one under domestic law and to and below the minimum one in the network. Their main result is that only relevant DTAs will lead to an increase in FDIs. Treaties that are irrelevant with respect to domestic law and treaties that are irrelevant with respect to an alternative indirect route that involves only one conduit do not alter direct bilateral FDI due to treaty shopping (which will be discussed in the next section). They demonstrate that tax treaties can only impact foreign investment if they reduce the tax burden with respect to the existing global network of double tax treaties, i.e., when they are relevant.

4. Impact on tax revenue

As mentioned, most DTAs shift taxing rights from the capital-importing country to the capital-exporting country. There are a few studies that attempt to quantify the loss in tax revenues. However, most of them do not take into account potential increase in FDI that signing tax treaties may cause. While some studies acknowledge this as a limitation, others justify it by the fact that literature findings on the impact of DTAs on FDIs is inconclusive.

Janský & Šedivý (2018) estimate the cost of the reduction in the tax rates on outgoing dividend and interest payments for 14 developing countries. The study finds that the highest potential tax revenue losses are within hundreds of millions USD and around 0.1% of GDP, with Philippines incurring the highest losses both in USD and relative to GDP. The study also finds that around 95% of the losses is due to dividends and that only four investor countries – Japan, Netherlands, Switzerland, and Singapore – are together responsible for more than half of the losses.

The IMF (2014) places tax revenue losses at 1.6 billion US dollars in 2010 for non-OECD countries that had tax treaties with the US. ActionAid (2016) estimates that Bangladesh might have lost up to 85 million US dollars in 2013 due to dividend tax breaks in its treaties with thirty other countries.

Van de Poel (2016) looks at the impact of the reduction of tax rates in Belgian tax treaties on the tax revenues for dividends and interest earnings. The findings indicate that the total loss for developing countries in 2012 was around 35 million euros. Van de Poel (2016) also notes that only 3% of Belgium’s overall FDIs are located in a developing country with which it signed a tax treaty. The author also argues that these losses are very conservative estimates because they only consider one developed country and only two provisions in tax treaties.

Balabushko et al. (2017) quantify the loss in tax revenue due to tax treaties for Ukraine. They exploit administrative data to estimate the tax sensitivity of dividend, interest, and royalty payments. Their results suggest that there are important revenue losses linked to reduced withholding tax rates. They also find that income flows to a specific country tend to decrease following an increase in the relevant withholding tax rate with the country. This effect reduces the simple mechanical revenue gain one can expect from renegotiating a withholding rate at a higher

level. They also investigate the indirect costs of reduced withholding rates and find that reported profits of Ukrainian multinationals are sensitive to withholding taxation, indirectly adding to total revenue losses.

McGauran (2013) estimates dividend- and interest-related tax revenue losses of 770 million euros in 2011 for developing countries because of lower tax rates in the developing countries' tax treaties with the Netherlands. The author also discusses the issue of treaty shopping, whereby a third country takes advantage of a treaty between two states by setting up a conduit company solely for the purpose of enjoying the benefits of the treaty. This harms both developing and developed economies through eroding the tax base. Hong (2017) looks into the direct and indirect routes that multinationals take to minimise taxation by using DTAs. The study shows that tax treaty shopping has a substantial effect on tax reductions on dividends incurred by multinational investors and as such face significant tax revenue losses.

5. Impact on other economic indicators

Impact on trade

The literature views the relationship between trade and DTAs as an extension between the relationship between FDI and DTAs. If DTAs impact FDI flows, then they will also indirectly impact international trade. According to Pham et al. (2019), it is possible that substitution and complementary effects exist between international trade and foreign investment of a multinational enterprise. Accordingly, a surge in demand for intermediate goods in the vertical chain integration could create substitution and complementary effects through the trade-in final goods

The only paper identified in the literature search that empirically looks at the relationship between DTAs and international trade is Pham et al. (2019). The study looks at the impact of DTAs on the bilateral trade of Vietnam with ASEAN member states. They find that double taxation treaties do indeed increase two-way trade. However, the trade flows generated by the tax treaties' effect are primarily one-way, through imports from developed countries into Vietnam. Therefore, they have little to no impact on Vietnam's exporting capacity nor on relieving the trade deficit. Pham et al. (2019) recommends that prior to entrance to a negotiation, developing countries should first strengthen their tax environment and economic development policies.

Other considerations

The IMF (2014) argues that the reason that most developing countries are still committed to negotiating DTAs, despite uncertain benefits, could be due to political and economic objectives beyond just attracting FDIs. These include the desire to heighten tax enforcement cooperation with the treaty partner, the need to satisfy the interests of particular domestic constituencies who will benefit from the treaty or for the aim of strengthening diplomatic ties with another country (Quak & Timmis, 2018).

DTAs may also have a direct positive effect on developing countries' economies through increase in foreign aid from treaty partners. According to Braun and Zagler (2017), asymmetric DTAs become mutually beneficial when the capital exporting countries compensate the capital importing countries through foreign aid. They argue that foreign aid is used strategically to put pressure on or reward recipient countries when it comes to negotiating bilateral treaties. By

examining DTAs signed between donor and recipient countries, they find that donor countries aid commitments to the other signature state increases significantly in the year of the signature.

Barthel and Neumayer (2012) argue that one of the reasons that net-capital importing countries sign DTAs is because they are caught in a prisoners' dilemma: collectively, they would be better off refusing to sign DTAs, but each one has an incentive to sign DTAs to gain a competitive advantage. Countries will be influenced by the policy choices of other focal countries and will follow their DTA activity. They find empirical evidence for this in their analysis; treaty conclusion between two countries is positively influenced by existing tax treaties of focal countries.

6. OECD vs UN model

According to Quak and Timmis (2018), nearly all DTAs are in line with the OECD Model Tax Convention on Income and on Capital and the UN Model Double Taxation Convention between Developed and Developing Countries. As discussed in Eyitayo-Oyesode (2020), these two conventions serve as model treaties containing common terms, including the rules of governing allocation and exercise of taxing rights by the states. The purpose of the rules is to split up taxing rights that arise from profits accrued by multinational corporations from their cross-border activities between states as source and residence state (Eyitayo-Oyesode, 2020). The OECD Model was published in 1963 and was most recently revised in 2017 (OECD, 2017; Quak & Timmis, 2018) and the UN Model was published in 1980 and was most recently revised in 2021 (UN, 2021; Quak & Timmis, 2018).

The current rules in the OECD Model originally come from the report by the Fiscal Committee of the League in the 1920s (Eyitayo-Oyesode, 2020). The purpose of these rules was to balance the taxation of the profits of multinational corporations by developed states for the prevention of double taxation. The UN published its model in 1980 when it observed that past model tax conventions, including the OECD one, failed to facilitate bilateral treaties between developed and developing countries. Specifically, the UN noted that allocation rules in these past models favoured residence countries more than source countries (Eyitayo-Oyesode, 2020).

As discussed in Eyitayo-Oyesode (2020), the UN Model only varies slightly from the OECD model. It follows the same form as the OECD Model and has some identical provision (Quak & Timmis, 2018). The main difference is that, compared to the OECD model, the UN Model favours retention of greater taxing rights under a tax treaty for the host country of investment as opposed to those of the investor (Hearson, 2015). For example, the UN Model does not prevent the source country from imposing tax on royalties paid by a resident of the source country to a resident of the other country, unlike the OECD Model (Arnold, 2013; Quak & Timmis, 2018). Eyitayo-Oyesode (2020) argues that, despite these differences, both models contain restrictive source-based taxing rights that facilitate capital flight from developing to developed countries.

Another key dissimilarity between the UN Model and the OECD Model is the way in which they are revised. The subcommittee that makes the decision on the OECD Model consists of tax officials from OECD countries (Arnold, 2013; Quak & Timmis, 2018). As such, non-member developing countries are unable to have any influence (Hearson, 2015; Quak & Timmis, 2018). On the other hand, the UN Model is revised and maintained by the UN's Committee of Experts on International Cooperation in Tax Matters (Arnold, 2013; Quak & Timmis, 2018). In contrast to

the OECD sub-committee, the majority of the tax officials in the Committee of Experts are from developing and emerging economies (Arnold, 2013; Quak & Timmis, 2018).

As mentioned, the UN Model tends to be more advantageous for developing countries compared to the OECD Model. However, according to Hearson (2015) and Quak and Timmis (2018), there are a few caveats to this. Firstly, developing country negotiators tend to refer to the UN Model as their starting point in negotiations. Most treaties signed by developing countries, however, have more OECD provisions than UN provisions. This could be due to developing countries' tax laws being weaker than the UN Model or because of lower negotiation capacity compared to their developed counterparts (Hearson, 2015; Quak & Timmis, 2018).

Secondly, there are several issues over which the UN Committee's expert members from developed and developing countries disagree. Developed country members, however, have a more coordinated approach to influencing the UN decision than developing country members. This is exacerbated by the lower attendance among developing country members (Hearson, 2015; Quak & Timmis, 2018).

Finally, the OECD's Committee has more resources and technical capacity than the UN Committee. As a result, the OECD Model is updated more frequently than the UN Model. Thus, there is a view that the UN Model is out of date compared to the OECD one (Hearson, 2015; Quak & Timmis, 2018).

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Suggested citation

Boustati, A. (2022). *The Advantages and Disadvantage of Double Taxation Agreements for Developing Countries.* K4D Helpdesk Report. Institute of Development Studies. DOI: 10.19088/K4D.2022.143

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