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The Role of Double Taxation Treaties on Attracting Foreign Direct Investment: A Review of Literature

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Abstract

Double taxation treaties are enacted to abolish incidents of double taxation. Moreover, it helps less developed countries in attracting foreign direct investment, discourage, and eradicate double taxation. Several studies have revealed that there is a positive impact of implementing DTTs on attracting foreign direct investment to developing countries. Implementing a double taxation treaty is not something that happens overnight. In fact less developed countries spent years efforts and other very scarce resources to discuss, implement and finalize these treaties with developed nations. In addition, less developed nations also forgo potential tax revenues. Most often these treaties favour residence-based over source-based taxation. The forgone tax incomes and the money invested in negations with developed nations in addition to other implementation cost can only make sense if the expected benefits in terms of FDI out-weight such costs. This paper critically reviews the literature on the impact of implementing double taxation treaties on attracting FDI inflows to developing nations. This review is further augmented with a synopsis of economic models used by policy makers to analyse potential tax impact on FDI decisions.

Keywords: Emerging Economies, Double Taxation, Treaties, Foreign Direct Investment, Developing Nations

1. Introduction

Investment has a very important role in economic development for both developed nations and emerging economies. It helps in economic and financial stabilization of the economy, proper exploitation of natural and human resources. Leading to lower unemployment rates and potentially welfare and prosperity of nations (Neumayer and Spess, 2005; Alfaro *et al.,* 2010).

Recently, while globalization is gaining momentum, there is exponential increase in cross- border trade and interconnectedness of world economy (Sayyar *et al.,* 2014; Yazdani and Aris, 2015; Elhabib *et al.,* 2014). That has led to a never-ending need to the assessment of tax systems of various nations in order to ensure equitable tax treatment to citizens and corporations in a vibrant global economy. This trend has led to need to study how tax treatment effect on the movement of private citizens and from one country or another. Such movement is often triggers double taxation on income earned in one country by citizens of another country. Besides, There other dilemma is that some countries base tax on place of residence or country of citizenship of taxpayers, whereas, other countries base the tax on the origin of incomes or revenues (Doernberg, 2004). However, the problem becomes more complex since taxation systems of different countries define income source differently, leading to another complication to the already complex situation. This will becomes even worth if the tax rate for both countries is higher than 50%, leading to an anomaly situation where assessed taxpayer living in one state earned income in a foreign state. If this tax payer is been taxed by both countries he will be left with a negative income, so he need to use his prior good year savings or to sell the family jewelry (if any) to pay tax. Marus (2012) argues that this phenomenon occurs due to countless structures of the tax systems, diverse controls of the tax subjection, multiplicity of controls of the tax subjection and contradictory interpretation of technical terms.

Mike (2013) argues that international double taxation has undesirable consequences for both developed and developing nations. For developed nations, excessive financial savings in contrast to few available investment opportunities may lead to economic recession. In contrast, developing countries will be denied access to funds to materialize economic development in their respective countries. Therefore, that problem has affected the whole society by snowballing the tax liability on private citizens, reluctance of foreign capital from contributing to economic life cycle and obstructing the freedom of extensions of investments within the county. This may leads to a lack of production. Thus, causing a shortage of national income and reducing employment opportunities. Hence, tax legislators have tried to solve this problem by adjusting some tax legislation or resorting to international conventions whether through the signing of agreement between individual countries or by entering into a collective agreement. This highlights the need to identify the role treaties for double taxation in attracting foreign direct investment to developing nations.

Implementing a double taxation treaty is not something that happens overnight. In fact less developed countries spent years efforts and other very scarce resources to discuss, implement and finalize these treaties with developed nations. In addition, less developed nations also forgo potential tax revenues. Most often these treaties favor residence-based over source-based taxation. The forgone tax incomes and the money invested in negations with developed nations in addition to other implementation cost , can only make sense if the expected benefits in terms of FDI out-weight such costs. This paper critically reviews the literature on the impact of implementing double taxation treaties on attracting FDI inflows to developing nations. This review is further augmented with a synopsis of economic models used by policy makers to analyse potential tax impact on FDI decisions (Egger and Merlo, 2011).

The effect of double taxation treaties on foreign direct investment is inconclusive base on the review of the literature. Several researchers claim that there is an evidence of a positive relationship. However other researchers provide contradicting evidence. Developing countries entering into these agreements signal to the international community a spirit of openness and willingness to adopt internationally accepted tax standards. In addition, also the reduction of withholding tax rates and the relief from double taxation may encourage FDI. On the other hand, DTTs may hamper FDI, as they also allow the exchange of information between the tax authorities. Hence, it is an empirical question as of whether or not DTTs help to attract FDI. So far, the empirical evidence on this issue is inconclusive. Consequently, from the above, this study a review of literature to what extent double taxation treaties attracting foreign direct investment.

2. Double Tax Treaties (DTTs)

A properly designed tax system is a corner stone of every country's sovereignty. Therefore, no two or more countries may tax the identical income arising from a cross-border transaction (Lang, 2013), this called double taxation. To preclude double taxation, countries enter into treaties known as double taxation treaties DTTs. DTTs preclude double taxation in one of two ways (i) allocating taxation rights exclusively to one signatory country or (ii) providing mechanisms where both signatory countries are granted taxation rights. In case where both signatory countries are granted taxation rights, DTTs provide some exemptions and credits as a mechanism to sidestep double taxation**.**

3. The benefits of Double Taxation Treaties

Customarily, DTTs are signed to avoid double taxation that results when two or more countries intend to tax the same income (Daurer, 2013). Moreover, it is often claimed that DTTs, which also provide mechanisms to exchange information between the tax authorities of the signatory countries, can help prevent tax avoidance and evasion. Besides avoiding double taxation, DTTs also serve other purposes. These include (i) allocating taxation rights between signatory countries, (ii) providing legal certainty, (iii) preventing tax avoidance, (iv) combating tax evasion and, (v) attracting foreign direct investment.

To avoid such adversity to individuals and also with a view to seeing that national economic growth does not suffer, a DTT is entered into with other countries. The following point summarizes the aims of DTTs as published by OECD and the United Nations Model Tax Convention.as follows:

1- to avoid and alleviate the negative impact of these treaties

a) Specifying r rules for splitting up of revenues between two countries.

b) Availing exemption from tax for specific revenues

c) Decreasing the tax rates for specific revenue types

2- Tax treaties inform taxpayers the expected ceiling of their tax liabilities in foreign countries. It also provides protection against tax treatment discrimination on foreign firms of citizens. Furthermore, it helps in lifting the burden of double taxation.

There are also other issues that DTTS should clarify so as help in achieving its intended objective such as a) ensuring that countries adopt similar tax terminologies, b) a clause should mention about how to resolve disputes, c) prevention of tax abuse and, d) means for exchanges tax information between the parties to the treaty. Special request is provided for in most treaties to assist countries counter tax evasion (Peter, 2013).

4. The significance of analyzing the DTTs

Signing DTTs with developed nation may cause some threats since these treaties are normally established base on the place of residence principle (Giraldo, 2008). Less developed countries are already at disadvantage since they are burdened with high indebtness, deficient in balance of trade and probably very poor infrastructure. Therefore, even if tax treaties are implemented they might not be able to attract FDI (Fitz Gerald, 2010). Therefore, these treaties might be to the disadvantage of less developed countries. Because of losing both potential tax income and inflow of FDI. According to Somo (2008) argue that some tax treaties are somewhat linked to creating tax heavens which is illegal because it promote tax evasion. Such nexus bring about some cloudiness and more criticisms to cross country capital movement and accumulation.

4.1 Implication of double taxation:
Several economists argue that double taxation has some advantages as well as disadvantages. However, the advantages of implementing a double taxation treaty are expected to outweigh the disadvantages (Abu al-Qasim Tabola and Salem Farhat, 2003). 1.1 below summarizes both the advantages and the disadvantages of implementing double taxation treaties.

Table (1.1) advantages and disadvantages of double taxation.

Advantages of double taxation	Disadvantages of double taxation
1- Increase in tax revenues.	1- Increasing tax burden on individuals, which encourages people to evade tax.
2- Keep national capital to within the borders of the country	2- It leads to capital flight to another country.
3- It may lead to reduce some harmful activities.	3- It hurts Developed countries to find investment opportunities for their surplus funds.
4- Reallocation of income within countries.	4- Reducing the ability of Developing countries to attract foreign investment.

4.2 Double Taxation Treaties and Foreign Direct Investment
Foreign Direct Investment has intensely improved in the past several decades to turn into a key force in the global allocation of capitals and technology. Prior to 1970, international trade generally grew more than speed than that of FDI, but in the decades since then the inflow of FDI has grown-up at more than twofold the rate of the growth of global exports. Early 1990s, the sales of global exports would be obscured by the sales of foreign

associates of MNCs (Dunning, 1998). Not only has the flow of FDI increased global but also the prominence of FDI as a source of capitals, to less developed countries specifically, increased. Private transnational movement of capital becomes gradually central to less developed countries. In the 1980s constricted budgets, the debt crisis and a largely declined concern to provide development assistance has caused a decrease in formal development aid from the developed nations. When funds movements to less developed nations started to increase, the flows would more and more be comprised of FDI (Zebregs, 1998). Nevertheless, in 2003, FDI was the prime constituent of the net funds flows to less developed countries and this is destined to continue for the foreseeable future (UNCTAD, 2003).

Initiatives intended to avoid double taxation date back to the eighteenth century. As stated by Easson (2000), the treaty between Austria-Hungary and Prussia from 1899 is the first modern DTT. However, the first Bilateral Investment Treaty BIT was signed between Germany and Pakistan in 1959. International Organizations such as the United Nations and the Organization for Economic Co-operation and Development also sponsored DTTs from embryonic stages. Up to the late 1960s, DTTs were mainly established among developed nations but, from the time, a growing number of treaties have been implemented between developed and less developed nations (Easson, 2000).

Subsequently to World War II, worldwide-accepted standards have arisen, leading to standardization of the majority of DTTs. Those standards have been predisposed by the national tax regulations of specific developed nations and multilateral organizations such as the OECD and the United Nations, that established their own models to assist as a basis for DTT negotiations (Lang, 2013).

4.3 Models for Double Taxation Treaties

As can be seen from Figure 1 there are two main models for DTTs, The OECD model and the UN model. Opponents of the UN model argue that the UN model is not adequately different from the OECD model and is still prejudiced against less developed nations interests (Figueroa, 1992). Besides, Pistone (2010), argue that the UN Model is no more than an updated version of the OECD model that included some updates.

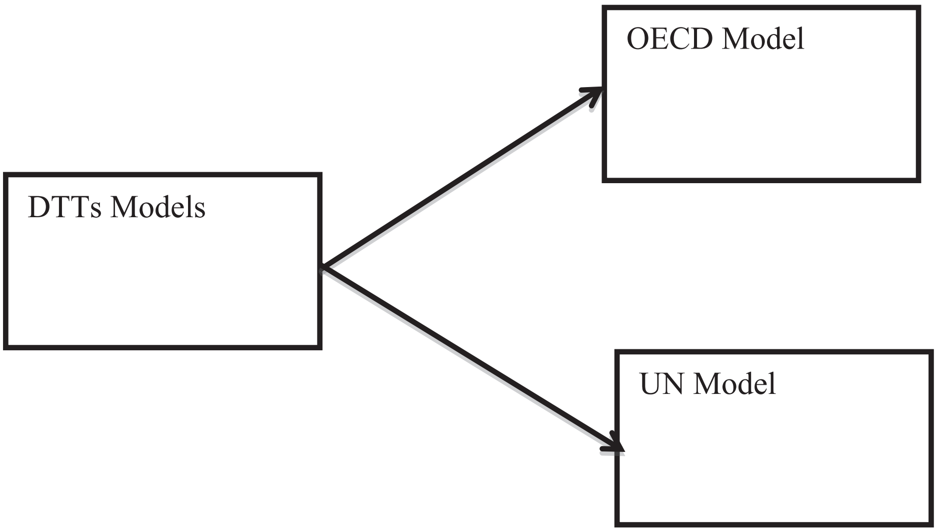

Figure 1: Double Taxation Treaties Models

The OECD's "Model Tax Convention on Income and on Capital" (OECD .2010), was originally developed between 1956 and 1961(Castelo Branco, 2011), publicly issued in 1963 and updated for the first time in 1977. Since then, both the OECD model and its commentaries, which serve as an official interpretation of its provisions, have been continuously revised. The OECD model is, needless to say, designed by its members, which are primarily high-income countries. Although the positions of non-OECD countries are considered to be an integral part of the OECD model, Pistone, 2012), non-member countries usually do not participate in shaping and updating the model. Hence, the OECD model reflects the international tax policy interests of its members. Since its origins, the OECD model has gradually gained in importance. The fact that this model has been used as a starting point for most DTT negotiations (Pistone, 2012), makes it easier for OECD-countries to implement their policies into DTTs. Moreover, tax authorities and courts around the world frequently use the OECD model provisions and its commentaries to interpret DTT provisions (Pistone, 2012).

The United Nations model (UN, 2011) as well as the OECD model are based on the principle of residence. However, the UN model factors for differences between countries and balances taxation rights in favor of source countries. Vogel (1997) offered a comprehensive analysis of the German-American DTT. Furthermore, he compared the treaty to both the OECD and UN models. Some my argue that double taxation exemplifies a major obstacle to attracting foreign direct investment to less developed nations. Ceteris paribus, double tax avoidance can brand a country as more attractive to foreign investors. According to Egger et al. (2004) Double taxation is a major impediment to FDI flow to a country. Similarly, BITs are considered as positive signals to (Dagan, 1999).

5. Reasons for developing countries to enter into Double Taxation Treaties with Developed Countries

There is a different discussion coming from the perspective of developing countries, calling for rethinking the international tax system. How do the international tax system in general and double tax agreements in particular impact developing countries? It is also being discussed whether developing countries at all benefit from the signature of Double Tax Treaties (DTTs) under the current internationally accepted standards (Neumayer, 2007).

The main objective is the eradication of double taxation, as identified by the OECD as a major challenge to FDI inflow (OECD, 2013). Treaties may also help in mitigating ambiguity for the foreign investor on their tax burden on profits and incomes earned in a foreign country. Moreover, DTTs may reveal the commitment to a attracting foreign capital (Christians, 2005). However, there are substantial costs to the less developed nations in implementing DTTs. The costs that are common the DTTs can take years to negotiate, and once it is signed it still needs to be endorsed in the corresponding countries before it is actually effective, a process that can take another two to three years, or even longer. Developing countries also have to relinquish some tax returns to execute a DTT with a developed nation to get capital foreign investment (Fabian et al., 2005).

6. Review of Studies on the Effect of DTTS on FDI

Although there are relatively few empirical evidence on the impact of double taxation treaties DTTs on foreign direct investment FDI movement, these few studies shows conflicting findings ranging from an evidence of a positive impact, no statistically significant impact, to an evidence of an inverse impact (Baker, 2014). Besides, Blonigen and Davies (2002), in a study conducted to analyze impact of DDTS on bilateral FDI outflows within OECD countries. Using data for the period 1982–92 found that the existence of DTTs is associated with larger bilateral FDI flows.

In contrast, Blonigen and Davies (2004) in study conducted using data for the period 1980 to 1999 to examine the impact of US double taxation treaties on inbound and outbound FDI, found that the relationship between DTTS and both outbound and inbound FDI flows to be statistically insignificant. Contrary to the above finding Egger et al. (2004) found a negative impact of newly implemented DTTs on FDI using data for the years 1985 to 2000. In spite of, a abundant literature on the factors for attracting FDI into developed countries such as Blonigen (2005), Carr *et al.* (2001), Schneider and Frey (1985), the empirical specifications used in studies on the impact of DTTs on FDI have several deficiencies, including, data availability and limited time horizons of studies.

7. Conclusion

Double taxation treaties are of paramount importance to abolishing the negative impact of double taxation and to attracting foreign direct investments (FDI) to developing countries. However, implementing a double taxation treaty is not something that happen overnight. In fact Developing countries spent time, efforts and other scarce resources to discuss, implement and finalize double taxation treaties (DTTs) with developed nations. In addition, they forgo potential tax revenues, as such treaties typically favor residence-based over source-based. The forgone tax incomes and the money invested in negations with developed nations in addition to other implementation cost can only make sense if the expected benefits in terms of FDI out-weight such costs. Several studies have revealed that there is a positive impact of implementing double taxation treaties and attracting foreign direct investment to developing countries.

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