

Double Taxation Agreements and Developing Countries

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Question

Query: What are the key issues surrounding double taxation agreements (DTAs) and developing countries? An overview should include:

- *An overview as to the extent of the international tax treaty regime (i.e. how many, between which states);*
- *Existing commentary of the international standards (i.e. OECD and UN Tax Treaty Models);*
- *Critical and supportive voices on the role of DTAs in supporting development outcomes (i.e. loss of tax revenue versus tax certainty to attract FDI).*

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1. Overview

The literature estimates that approximately 3,000 Double Taxation Agreements (DTAs) are in force, which could be a fraction of the number of potential bilateral tax relationships, as there is no centralised, complete and public database.

- Between 1,000 and 2,000 of these agreements involve at least one developing country.
- Most of these were concluded within the last 20 years, while DTAs between advanced economies mostly date from before 1990.
- Countries in Eastern and Southern Asia have concluded more DTAs than countries in sub-Saharan Africa.
- Asian countries' treaties grant the source country greater taxing rights than African countries' treaties.
- Developing countries' DTAs contain lower withholding tax rates on passive income than in the past, but less stringent permanent establishment provisions.

The overwhelming majority of bilateral DTAs are based, in large part, on the OECD Model Tax Convention on Income and on Capital (OECD Model) and the UN Model Double Taxation Convention between Developed and Developing Countries (UN Model). The key difference between the Models is that the UN Model preserves a greater share of taxing rights for the source country (i.e. the country where investment takes place). Although the UN Model is more advantageous for developing countries than the OECD Model, negotiations to date using the UN Model have not been too successful. Furthermore, despite being in a majority, developing countries lack influence in the UN's Committee of Experts, while the OECD's Committee of Fiscal Affairs has considerably more resources and technical capacity than the UN Committee.

The literature shows that between two economies with largely reciprocal Foreign Direct Investment (FDI) positions, the reallocation of taxing rights towards the residence country after signing a DTA is not that problematic. When, however, such a treaty is signed between two countries with an asymmetric investment position, the capital-importing country risks forfeiting tax revenues. Although not conclusive, literature shows that source countries could benefit from a FDI inflow, however, positive effects on FDI is most likely for middle-income countries and less likely for low-income countries. Other studies find a significant impact on firms' entry into a particular country, though not on the level of their investment once they are present.

Whether a capital importing country benefits from signing a DTA depends also on the effects on its tax base.

- Like corporate income tax rates treaty withholding tax rates have trended downward over the past decades, suggesting that they have been subject to a similar process of tax competition.
- Treaty shopping by international operating corporations in which they search for tax minimisation through the network of tax treaties, is a real concern according to the literature.
- Studies show that treaties with the Netherlands led to foregone revenue for developing countries of at least EUR 770 million in 2011. Similar, calculations suggest that US tax treaties cost their non-OECD country counterparts perhaps \$1.6 billion in 2010.

That developing countries are still attractive to negotiate such deals means that source countries' governments have political and economic objectives beyond the immediate attraction of investment that may be served by a treaty, such as 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 the aim of strengthening diplomatic ties with another country.

According to the literature, there is significant FDI asymmetry and capacity asymmetry in negotiations between high income countries and low-income countries, impacting the outcome of DTAs.

- Research shows that developing countries that depend more on corporate income tax are more likely to sign tax treaties with wealthier countries and more likely to negotiate higher WITHHOLDING TAX rates in those treaties, but no more likely to obtain better results overall.
- The more complex clauses are less likely to be favourable to developing countries when the FDI relationship between the two countries is more one-sided, with the developing country more of a net importer of capital from the treaty partner.
- Developing countries also become better negotiators as they gain experience.

The literature mentions several ways to improve the position of source (developing) countries. One is the inclusion of "limitation of benefit" provisions that can provide important protection as it limits reduced withholding rates and other treaty provisions to apply only to companies that meet specific tests of having some genuine presence in the treaty country. Another way is to increase knowledge and awareness on spill-over effects of tax treaties on developing countries. The IMF states that "considerable caution" is needed when entering any DTA where one party is primarily a capital-importing country.

2. The international DTA network

Analysing the extent of the international Double Taxation Agreements (DTA) network is difficult due to the absence of a centralised, complete, public database (Hearson, 2016a, p.13). Hearson (2016a, p.7) notes that information on DTAs is "scattered in PDF files on websites or in proprietary databases", which makes measuring and comparing countries' treaty networks challenging. Nevertheless, both he and the IMF (2014, p.25) estimate that approximately 3,000 DTAs are in force. While this is a large number, it is only a fraction of the number of potential bilateral relationships (IMF, 2014, p.25). Depending on how "developing country" is defined, between 1,000 and 2,000 of these agreements involve at least one developing country (Hearson, 2016a, p.10). Most of these were concluded within the last 20 years, while DTAs between advanced economies mostly date from before 1990 (IMF, 2014, p.25).

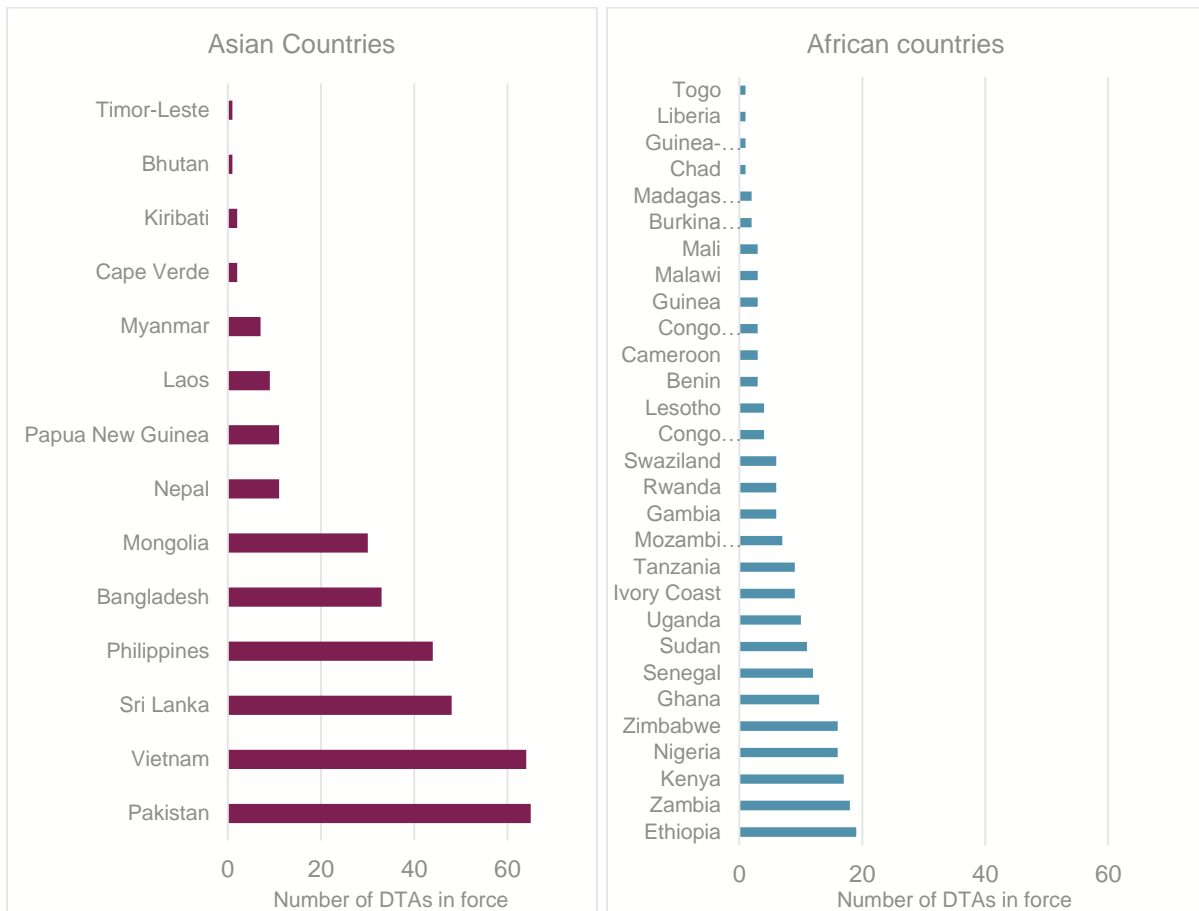
To address the gap in comparative DTA data, Hearson developed the publicly available *ActionAid Treaties Dataset* (Hearson, 2016a, p.7). The dataset presents information on DTAs for low- and lower-middle-income countries in sub-Saharan Africa and Eastern and Southern Asia, excluding India and Indonesia.¹ All DTAs concluded by these countries since 1970 are included,

¹ India and Indonesia are excluded due to their roles as capital exporters to the other sample countries (Hearson, 2016a: 13)

except those which depart significantly from the conventional content of modern treaties and/or are unavailable in English. The resulting sample includes 519 DTAs, approximately one sixth of the total number in force. The following bullets provide descriptive statistics on this portion of the international DTA network:

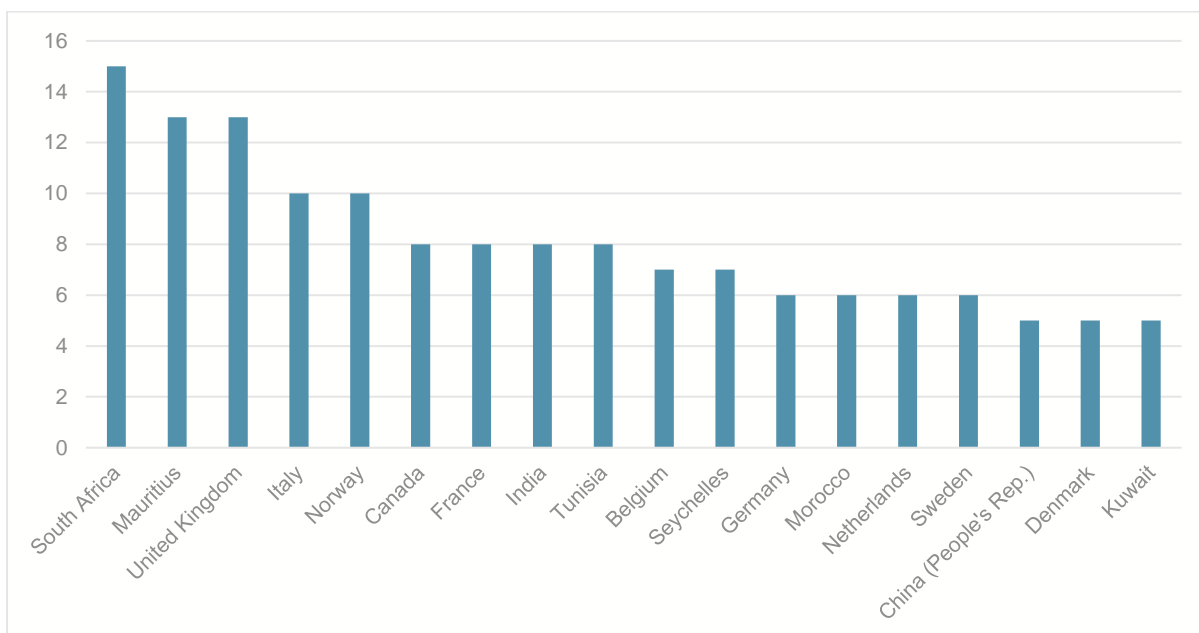
- **Countries in Eastern and Southern Asia have concluded more DTAs than countries in Sub-Saharan Africa.** There are 314 tax treaties in force in Asia, compared to 205 in Africa (Hearson 2016b). Six Asian countries (Pakistan, Vietnam, Sri Lanka, Philippines, Bangladesh and Mongolia) have concluded 30 or more DTAs, while no African country has concluded more than 19 (Figure 1). However, there are stark differences between Asian countries, with nearly half of those sampled having fewer than ten agreements in force.
- **Over half of the agreements are with non-OECD countries.** 51% of the treaties in Africa and 55% of the treaties in Asia are with non-OECD countries (Hearson, 2016b). Most of these were signed after 2000; before the millennium, the majority of developing countries' DTAs were with advanced economies (Hearson, 2016b; Hearson 2015, p.8). Among African countries, the largest number of treaties are with South Africa, Mauritius, United Kingdom, Italy and Norway (Figure 2). India, Republic of Korea, Malaysia, Singapore and Thailand have signed the most treaties in Asia (Figure 3).
- **Asian countries' treaties grant the source country greater taxing rights than African countries' treaties.** The dataset scores each DTA against a "Source" index, which measures the number of pro-source provisions it contains (Hearson 2016a, p.17). Pro-source provisions entitle a country to tax foreign income earned within its borders. Asian countries' DTAs score consistently higher against index than African countries' DTAs on average, indicating that Asian countries retain greater taxing rights on inward foreign investment than African countries (Hearson, 2016a, p.19-20). Moreover, the gap has widened over time (Hearson, 2016a, p.20). This trend is partly explained by the fact that Asian countries have concluded a greater proportion of their agreements with non-OECD countries (see previous bullet). The dataset finds that non-OECD countries impose fewer restrictions on developing countries' source taxing rights than OECD countries when concluding DTAs (Hearson, 2016a, p.20). In fact, OECD countries' DTAs with developing countries are increasingly curbing the latter's ability to tax foreign income, indicating "a growing division between approaches to tax treaty negotiation in the OECD and the rest of the world" (Hearson, 2016a, p.36).
- **Developing countries' DTAs contain lower withholding tax rates than in the past, but less stringent permanent establishment provisions.** There are two key ways that DTAs can restrict a country's ability to tax foreign investors. First, by lowering the rate of withholding tax levied on foreign income earned at source. Second, by imposing a high threshold for permanent establishment, that is, the minimum level of activity that must take place before taxes can be levied (Hearson, 2016a, p.9). The dataset constructs a 'WHT' index and a 'PE' index in order to measure the restrictiveness of DTAs' withholding tax and permanent establishment provisions across countries and over time (Hearson, 2016a, p.17). For both African and Asian countries, there is a trend towards lower withholding tax rates. In Africa, this trend is more pronounced in DTAs with OECD countries (Hearson, 2016a, p.22). However, PE provisions are becoming less restrictive over time, which means that recent DTAs expand the circumstances in which countries can tax foreign companies' income within their borders (Hearson, 2016a, p.22).

Figure 1: Number of DTAs concluded by Asian and African countries since 1970



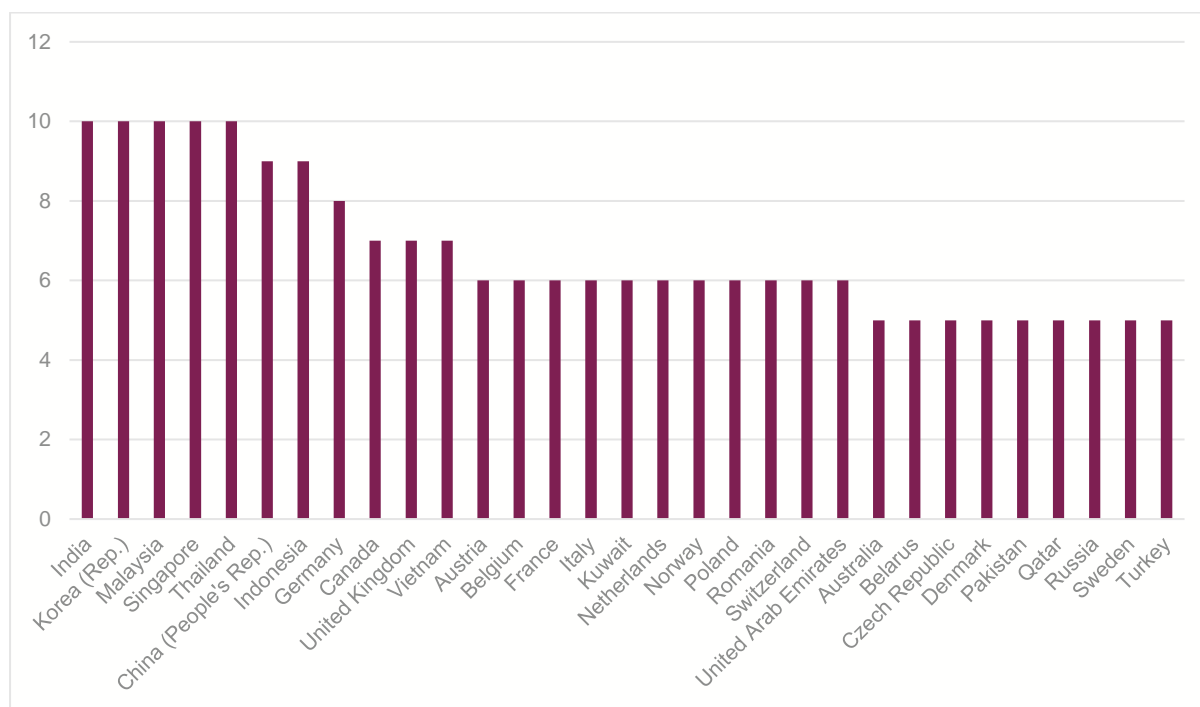
Source: Hearson, 2016b; analysed by the author

Figure 2: Countries having signed five or more treaties with African countries



Source: Hearson, 2016b; analysed by the author

Figure 3: Countries having signed five or more treaties with Asian countries



Source: Hearson, 2016b; analysed by the author

3. International DTA models

The OECD & UN Models

The overwhelming majority of bilateral DTAs are based, in large part, on the OECD Model Tax Convention on Income and on Capital (OECD Model) and the UN Model Double Taxation Convention between Developed and Developing Countries (UN Model) (Arnold, 2015, p.1). The OECD Model was first published in 1963 and has since been revised multiple times, most recently in 2017 (EY, 2017). The UN Model was published in 1980 and was revised in 2001 and in 2011 (Arnold, 2015, p.5). Both Models are accompanied by a detailed Commentary to facilitate interpretation and application of their provisions (Arnold, 2015, p.4-5).

The UN Model follows the pattern set by the OECD Model and many of its provisions are identical, or nearly so. Therefore, “it makes sense not to view the United Nations Model Convention as entirely separate [from the OECD Model] but rather as making important, but limited, modifications” (Arnold, 2015, p.5). The key difference between the Models is that the UN Model was produced “with regard to the special needs of developing countries” and therefore preserves a greater share of taxing rights for the source country (i.e. the country where investment takes place) (Hearson, 2016, p.31; UN, 2012, p.1). Relative to the OECD Model, it permits taxation of more types of cross-border income and lowers the threshold for permanent establishment. For example, unlike Article 12 (Royalties) of the OECD Model, Article 12 of 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 (Arnold, 2015, p.5). The UN Model also considers a construction site to have permanent establishment after 6 months, compared to 12 months under the OECD Model (Arnold, 2015, p.5).

Another important difference between the Models is the process by which they are revised. Decisions about the OECD Model and its Commentary are taken by a sub-committee of the OECD's Committee on Fiscal Affairs called Working Party 1 (Hearson, 2015, p.32). This consists of senior tax officials from OECD member countries (Arnold, 2015, p.4). Non-member developing countries are able to enter formal "observations" on the OECD Model and its Commentary, but have no other means of influence (Hearson, 2015, p.32). The UN Model and its Commentaries are revised and maintained by the UN's Committee of Experts on International Cooperation in Tax Matters (Arnold, 2015, p.5). In contrast to the Working Party 1, a small majority of the tax officials in the Committee of Experts are from developing and emerging economies (Arnold, 2015, p.5).

On paper, the UN Model is more advantageous for developing countries than the OECD Model. As net capital-importers, developing countries stand to benefit from the UN Model's pro-source provisions, which allow increased taxation of inward foreign investment (Hearson, 2016a, p.8). They also have greater opportunity to influence revisions to the UN Model, as they are well-represented on the relevant decision-making body. However, in practice, there are a number of caveats to this assessment, as identified by Hearson (2015, p.32).

- **Negotiations to date using the UN Model have not been too successful.** Although developing country negotiators frequently refer to the UN Model as their starting point in negotiations, the actual treaties signed by developing countries contain on average many more OECD provisions than UN provisions. This may be because developing countries' tax laws are weaker than the UN Model or because their negotiating capacity is low.
- **Despite being in a majority, developing countries lack influence in the UN's Committee of Experts.** There are many issues over which Committee members from developed and developing countries disagree, a notable example being a proposed revision to allow source countries to tax technical service fees. However, developed country members, particularly from the European Union, exhibit a better coordinated approach to influencing the UN instruments than developing country members. Moreover, attendance among developing country members at Committee sessions is often low.
- **The OECD's Committee of Fiscal Affairs has considerably more resources and technical capacity than the UN Committee.** As a result, the OECD Model is updated more frequently than the UN Model, often with revisions that benefit both developed and developing countries. For example, the 2017 update of the OECD Model mainly comprised changes recommended by the Base Erosion and Profit Shifting project in order to reduce opportunities for tax planning (EY, 2017). Thus, there is a view that the UN Model is out of date (Hearson, 2015, p.32).

Other Models

In addition to the OECD and the UN Models, some regional economic organisations have also formulated model DTAs. Two examples are examined below.

The East Africa Community (EAC) Model

The EAC has formulated a model DTA for negotiations by its members with third parties. This has some strengths relative to the UN Model. For example, it includes a general "limitation of benefits" clause, which prevents application of the treaty where the company concerned has

been using it for treaty shopping. It also permits a withholding tax to be levied on management fees, unlike both the UN and OECD Models. However, Hearson (2015, p.28-9) identifies a number of shortcomings in the EAC's model. First, it specifies low withholding tax rates on FDI shares, interest and royalty payments and management fees. Second, it draws tighter restrictions on the circumstances in which African countries can tax inward investment as "permanent establishment" than the UN Model. Third, the EAC model omits the UN paragraph allowing source country taxation on capital gains from the sale of general shares. Hearson (2015, p.30) argues that some of these provisions "could have been kept in reserve, rather than included in the model, to be given up in return for something else during negotiations".

The Common Market for Eastern and Southern Africa (COMESA) Model

The COMESA model DTA was developed by European consultants in 2010-12 (Hearson, 2015, p.30). Its main advantages are the inclusion of specific anti-avoidance provisions and its revision process whereby member states can enter "reservations" on the existing model. However, the COMESA model's protection of source taxing rights is weaker than both the EAC and UN models. For example, its permanent establishment clauses are particularly restrictive and it employs a less-expansive definition of royalties. It also fails to specify withholding tax rates, which may be preferable to the low rates set out in the EAC model, but is less beneficial than higher rates would be.

4. The impact of DTAs

Both the OECD and (to a lesser extent) the UN Models favour the residence principle; where tax residents of a country are subject to taxation on their worldwide income, a greater portion of taxation rights are allocated to a residence country (Dauer & Krever, 2012). DTAs thereby shift taxing rights from the source state (capital-importing country) to the residence state (capital-exporting country). Research shows that between two economies with largely reciprocal Foreign Direct Investment (FDI) positions, this reallocation of taxing rights is not problematic. When, however, such a treaty is signed between two countries with an asymmetric investment position, the capital-importing country risks forfeiting tax revenues (Braun & Fuentes, 2016, p.384). This is the case for developing countries, who have to balance the costs (e.g. revenue losses) with the benefits (e.g. increase of FDI) of a DTA.

Impact on FDI

The primary benefit that developing countries seek from signing a DTA is increased inward investment. Yet the evidence for such an effect is inconclusive. One of the problems that the literature highlights is that identifying causality is inherently problematic, since tax treaties may precede investment not because they spur the latter, but because they may be concluded only when there is an expectation of such investment (IMF, 2014, p.26). Hence, studies that measure the impact of DTAs on FDI flows to countries are "susceptible" to the concern that what they are measuring is actually tax treaties' responding to, rather than causing, changing patterns of inward investment (Hearson, 2018, p.236).

The literature distinguishes the following assumptions regarding FDI flows:

- Signing a tax treaty relieves international investors from double taxation, the reduction of withholding tax rates on passive income provides incentives for FDI, and by signing

DTAs governments show to investors the willingness to adopt internationally accepted tax standards (e.g. Blonigen et al, 2014; Lang & Owens, 2013).

- Comprehensive domestic legislation that provides an overall transparent, non-discriminatory and predictable tax environment is more important for foreign investors than a DTA alone. This means that a clear relationship between domestic law and DTAs is important for an easier application of DTA provisions (e.g. Pickering, 2013).
- Although controversial, some literature also assumes that DTAs could hamper FDI flows through their prevention of tax avoidance (e.g. through profit shifting), tax evasion, and treaty shopping, for example through information exchange clauses in DTAs (e.g. Barthel et al., 2010; Blonigen et al., 2014).

Several empirical studies in economic literature have investigated how far DTAs have an impact on FDI, however, with very mixed results. Although inconclusive, more recent literature seems to show that there is to some extent a positive impact of DTAs on FDI flows (Hearson, 2018, p.236). Some of the most important findings on the impact of DTAs on FDI are:

- **Studies using macro-level data find a wide range of effects, however, positive effects on FDI is most likely for middle-income countries and less likely for low-income countries.** Millimet and Kumas (2007) find a positive impact of treaties for countries with low initial FDI levels (but a negative impact for countries with high initial levels), and Neumayer (2007) finds a positive impact on US outbound FDI only for middle-income countries. Barthel and others (2010), analysing a dataset of 105 countries, find a positive impact of treaties on FDI stocks, particularly for middle-income countries. For a broad dataset of 155 countries, Di Giovanni (2005) finds a positive impact on mergers and acquisitions.
- **Studies using firm-level data find a significant impact on firms' entry into a particular country, though not on the level of their investment once they are present.** Davies and others (2009), using firm-level data on Swedish corporations, find that treaties raise the probability of entry into a country by 17 percent relative to the sample average, but, conditional on presence, have little impact on investment. Egger and Merlo (2011) find similar results from firm-level data from Germany: controlling for the host country tax rate, the presence of treaty increases the probability of entry by 58 percent relative to the sample mean.
- **There is evidence that "tax sparing" provisions (through credits and exemptions) of DTAs have encouraged FDI.** Such provisions grant to multinational enterprises that benefit from source country (developing countries) tax incentives a credit against residence country (developed countries) tax, equal to the source country tax saved as a result of those incentives (Hearson, 2018).
- **Studies of the impact of withholding tax rates on FDI find mixed results.** Egger et al (2006) find that the outbound FDI of OECD countries is negatively related to source country dividend withholding taxes, controlling separately for corporate income tax rates and depreciation allowances. Arena and Roper (2010), examining marginal debt issuance decisions for internationally operating companies based in 29 countries, find that a low ratio of interest to dividend withholding tax results in a higher leverage ratio for foreign subsidiaries.
- **Studies that aim to capture the impact of DTAs solely through a dummy variable also find mixed results.** A reason could be that most DTAs contain both elements that may encourage FDI (such as reduced withholding tax rates and clarity of liability) and

elements that could discourage it (such as commitment to information exchange). The outcome is that they may balance each other out. A study by Blonigen et al (2011) analysing US firm-level data found that the presence of a tax treaty increases average foreign affiliate sales by 45%, while the exchange of information reduces them by 28%. The authors also find that presence of a DTA roughly doubles the entry rate of new foreign affiliates.

A case study on India (Murthy & Bhasin, 2014) shows the importance of including variables as GDP and per capita income in FDI analysis for a better understanding of the demand driven and supply driven forces of investment. Overall the study shows that the introduction of tax treaties had a positive impact on FDI inflows into India. As this study shows, this was further stimulated by growth in India's GDP and as well as growth of per capita income in residence countries (high-income countries). The former ensures the supply of capital abroad and the latter the demand in source countries (Murthy & Bhasin, 2014, p.761). This means that a low population growth of residence countries and a relatively high GDP growth of source countries are main drivers of supply and demand of capital flows.

A case study (Braun & Fuentes, 2016) on the impact of DTAs that Austria has signed with developing countries shows that the number of Austrian investment projects in middle income countries increases by 25.2% to 33.7% when a DTA is in place. However, the results may capture treaty shopping, which could lead to an overestimation of the effect of DTAs on FDI originating in Austria (Braun & Fuentes, 2016, p.412).

Impact on tax revenue

Whether a capital importing country benefits from signing a DTA depends not only on how much it gains from FDI, but also whether this gain offsets any tax revenue loss. By committing to reduced withholding tax rates on inactive income (e.g. dividend, interest, royalties etc.), countries that are primarily capital importers reduce their tax revenue at any given level of inward investment. The exchange of information aspects of DTAs, however, run in the other direction: they may increase source country revenue at unchanged behaviour and, by the same token, could discourage inward investment (IMF, 2014, p.26).

With a treaty in place, international business' incentive is to extract income in forms that attract a low or zero withholding tax rate, which may be ones that the host authorities find particularly difficult to value. As the IMF paper (2014) shows, the opportunities for this are amplified by the possibility of "treaty shopping": constructing advantageous routing by linking bilateral tax treaties, typically through low tax conduit countries. In effect, a treaty with one country can become a treaty with the rest of the world. Some literature make estimations of the loss, for instance, that treaties with the Netherlands led to foregone revenue for developing countries of at least EUR 770 million in 2011 (McGauran, 2013). Similar, calculations suggest that US tax treaties cost their non-OECD country counterparts perhaps \$1.6 billion in 2010 (IMF, 2014, p.68).

Like corporate income tax rates (see also the K4D HDR 324 on tax competition)², both domestic law and treaty withholding tax rates have trended downward over the past decades, suggesting that they have been subject to a similar process of tax competition (IMF, 2014, p.28). Since the early 1980s,

² See: Quak, E. (2018) The Impact of International Tax Competition on Low and Middle-Income Countries. K4D Helpdesk Report. Brighton, UK: Institute of Development Studies. <https://opendocs.ids.ac.uk/opendocs/handle/123456789/13784>

tax treaty withholding tax rates on portfolio dividends, interest and royalties have on average fallen by about 30%, while the average rate on participating dividends has fallen almost 50% (see table).

Table 1: The evolution of WHT rates

Time period	Dividend	Participating dividend	Interest	Royalty	
Year:	Average Domestic Law WHT Rates				No. countries
2000	15.2	14.1	15.1	17.2	107
2013	13.1	10.7	14.0	15.7	179
Treaty age:	Average Treaty WHT Rates				No. treaties
0-5	10.1	5.6	7.9	8.0	533
5-10	11.7	6.9	9.1	9.3	635
10-20	12.4	8.1	9.6	9.8	1554
20-30	14.2	11.2	10.8	11.5	529
>30	14.6	11.1	11.7	11.3	328

Source: International Bureau of Fiscal Documentation database, 2011 (from: IMF, 2014, p.69).

In practice, rather than relieving double taxation, the most significant effect of a DTA between a developed and a developing country is to shift the burden of tax alleviation from the former to the latter (Brooks & Krever, 2015; Paolini et al., 2016). As Hearson (2018, p.236) explains, this is because “most developed countries already take unilateral steps to relieve double taxation on their investors, either by giving them a credit for taxes paid abroad or increasingly by exempting foreign-source income from domestic tax altogether”. A developed country that uses the credit system may raise more tax revenue as a result of the treaty, because the tax liability in the developing country falls. If developed countries instead exempt their outward investors from tax on the profits they make in developing countries (whether through treaties or their tax laws), this may compromise developing countries’ ability to tax those investors. This is because, if investors face no further tax on their earnings beyond that incurred in the host state, they have a greater incentive to encourage tax competition between potential host states or to try to avoid paying tax in them (Hearson, 2018, p.236).

The findings from the literature shows that tax treaties, although initiated to avoid double taxation, could be used as an instrument for tax competition. Although the literature mentions tax treaty shopping as a mechanism that undermines a transparent international tax system this phenomenon is not part of the impact analysis of tax treaties. There is few literature available that takes into account treaty shopping as part of its analysis. Just one study (Hong, 2017) could be found;it looks into the direct and indirect routes that multinationals take to minimise taxation by using DTAs. It 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 (Hong, 2017, p.).

The IMF (2014) even discourages developing countries from signing treaties and advices their governments to renegotiate current tax treaties. Some countries like Mongolia, Argentina, Rwanda, Uganda and Zambia have done this. Why most developing countries are still attractive to negotiate

such deals could be explained that source countries' governments may also have political and economic objectives beyond the immediate attraction of investment that may be served by a treaty, such as 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 the aim of strengthening diplomatic ties with another country (Christians, 2005; Pickering, 2013).

5. The role of power asymmetry

The literature also shows that for developing countries the outcome of signing DTAs depends heavily on their negotiation skills to overcome power asymmetry. According to the literature, there is significant FDI asymmetry and capacity asymmetry in negotiations between high income countries and low-income countries (Hearson, 2018, p.239). Qualitative case studies of these negotiation outcomes emphasise power politics, knowledge asymmetries and negotiating capability in the eventual distribution of taxing rights between signatories, yet such insights are absent from cross-country quantitative work. Until now quantitative studies of tax treaty negotiation have generally assumed that negotiation decisions by developing countries reflect a rational assessment of the costs and benefits (Hearson, 2018, p.234). However, developing countries' approach to negotiating tax treaties under constraints of asymmetries has been "boundedly" rational at best (Hearson & Kangave, 2016). In a bounded rationality framework, negotiators and policy makers with limited capacity to assimilate information will resort to heuristics, for example, by according a greater weight to information that is 'more available' because it is easier to understand or obtain (Poulsen, 2014).

The study of Hearson (2018) is the only one that takes into account the power asymmetries for the outcome of tax treaties on the economy. The study shows that:

- **Developing countries that depend more on corporate income tax are more likely to sign tax treaties with wealthier countries and more likely to negotiate higher withholding tax rates in those treaties, but no more likely to obtain better results overall.** Because withholding tax rates are the most prominent parts of tax treaties to non-specialists, this supports a "saliency" argument derived from the bounded rationality literature: policy makers in countries that depend more on corporate tax are willing to support a policy of signing tax treaties, so long as higher withholding tax rates are negotiated, while ignoring other, less easily understood parts of the treaty. In contrast, developing countries that raise more tax revenue overall are more likely to negotiate better Permanent Establishment clauses, an area that is less easily understood by non-specialists, as well as a better overall balance across all provisions of the treaty. Greater tax revenue overall is thus associated with better negotiation, but it does not make a country more or less likely to sign tax treaties.
- **The more complex clauses are less likely to be favourable to developing countries when the FDI relationship between the two countries is more one-sided, with the developing country more of a net importer of capital from the treaty partner.** This could be because the higher tax/GDP and smaller FDI asymmetry translates into greater bargaining strength in negotiations. This findings could also indicate that power asymmetries play a role in negotiations between developed and developing countries, but not in negotiations between more developed countries.
- **Developing countries also become better negotiators as they gain experience.** This makes a strong case for developing countries to revisit their existing treaty networks as their understanding of their fiscal costs grows.

6. Alternatives for current DTAs

The literature mentions several ways to improve the position of source (developing) countries. One is the inclusion of “limitation of benefit’ provisions that can provide important protection as it limits reduced withholding rates and other treaty provisions to apply only to companies that meet specific tests of having some genuine presence in the treaty country (such as a minimum share of ownership by its residents or a minimum level of income from conducting an active trade or business there). Although the OECD recommends inclusion of limitation of benefit provisions, they are not common in treaties (IMF, 2014, p.27). Limitation of benefit provisions are often complex and are not self-executing: where capacity is weak and access to information limited, verifying that the pre-requisites for treaty benefits are met can be difficult. However, treaties sometimes include anti-abuse provisions in the form of more general ‘beneficial ownership’ rules, though these normally apply only to withholding provisions and not to entire treaties, and are subject to much more interpretation by the source country.

The European Commission’s Communication on the External Strategy for Fair Taxation (2016) states that Member States should apply a balanced approach to negotiating bilateral tax treaties with low-income countries. The Commission also announced that it would launch a debate with Member States, within the Platform on Tax Good Governance, on how to ensure fair treatment of developing countries in bilateral tax treaties. This initiative builds on the momentum created by the UN Addis Ababa Action Agenda and the 2030 Agenda for sustainable development to reconsider aspects of international tax treaties. The European Commission takes the issue seriously as it wants to ensure consistency between tax and development policies (EC COMM, 2015). In this context, Member States could take steps to reconsider their tax policies with developing countries, in order to reduce spill-overs and ensure consistency with development needs. Such possible revisions would be in line with the provisions concerning Policy Coherence for Development (TFEU, Article 208) as reiterated by the European Consensus on Development. It is part of the “Collect More-Spent Better” strategy that outlines how the EU intends to assist developing countries over the coming years in building fair and efficient tax systems, including by tackling corporate tax avoidance. As such the Platform on Tax Good Governance has developed a tool box for Member States to measure spill-over effects of EU tax policies on developing countries (EC, 2017).

Based on his research, Hearson also set out on his website ‘Tax, Development and International Relations’ some recommendations for developing countries:³

- Incorporate an assessment of tax foregone due to tax treaties into an annual breakdown of tax expenditures.
- Ensure that all tax treaties are subject to parliamentary approval as part of the ratification process.
- Ensure that future updates to provisions of the UN and OECD model treaties, or to their commentaries and reservations/observations, reflect the positions set out in their national models.

³ Retrieved from the website of Martin Hearson: “Tax treaties in sub-Saharan Africa: a critical review” (23 November 2015) <https://martinhearsen.wordpress.com/2015/11/23/tax-treaties-in-sub-saharan-africa-a-critical-review/>

- Strengthen the African model treaties (EAC, COMESA, SADC) so that they act as opposite poles to the OECD model, rather than compromises between the UN and OECD models.

The IMF goes even further, stating that “considerable caution” is needed when entering any DTA where one party is primarily a capital-importing country (IMF, 2014, p.26). Except from the exchange of information aspects, the reciprocal benefits of a treaty may be of relatively little value. The exchange of information can also be provided by signing a Tax Information Exchange Agreement or by signing the Convention on Mutual Administrative Assistance, while any withholding tax rates and the permanent establishment definition can be provided in domestic law. If a DTA has been (re)negotiated it should include a limitation for benefit clause also in domestic law (IMF, 2014, p.28).

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