

# Effects of double taxation agreements on developing countries

Committee on Economic Cooperation and Development

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**There is no strong evidence base that double taxation agreements (hereafter “tax treaties”) have a positive impact on investment into developing countries.** Policymaking and political debate on tax treaties and developing countries continue to be constrained by the inconsistent evidence around the impacts of tax treaties. Academic literature on the benefits for developing countries still struggles to tell a consistent story, despite increasingly sophisticated methods such as network analysis, and data such as firm-level microdata.<sup>1</sup> Null and negative results are still as common as positive ones. Recent studies have moved towards a more nuanced account that asks what elements of tax treaties stimulate investment, and in what circumstances. For example, several recent studies support the view that bilateral flows of foreign direct investment increase where a tax treaty lowers the effective tax rate on income repatriated as dividends; this finding relies on the presence of treaty shopping, and thus does not necessarily indicate an overall gain in investment into the host country.<sup>2</sup>

**We can be more confident that tax treaties have significant fiscal costs for developing countries.** There are several studies that estimate the tax costs for developing countries from just two of the clauses found consistently in tax treaties, those on the taxation of dividends and interest payments. In two of these studies, the estimated revenue foregone in one year through treaties with the Netherlands was €770m, and with the United States \$1.6bn.<sup>3</sup> Viewed from the developing country’s perspective, the annual costs estimated to Bangladesh and Zambia are \$85 million and Zambia \$42 million respectively.<sup>4</sup> Uganda’s tax treaty with the Netherlands may have cost it as much as \$85 million in one single capital gains tax case. While these are not transformative amounts, they are nonetheless significant, and they may only be the tip of the iceberg for tax treaties, the full costs of which cannot easily be estimated. Meanwhile, a recent IMF/World Bank working paper identified significant revenue costs to developing countries from the conclusion of tax treaties.<sup>5</sup>

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<sup>1</sup> The evidence for an investment impact of treaties between OECD member states is stronger.

<sup>2</sup> Sebastian Beer Jan Loeprick, *The Cost And Benefits of Tax Treaties With Investment Hubs: Findings From Sub-Saharan Africa*, Policy Research Working Papers (The World Bank, 2018); Kunka Petkova, Andrzej Stasio, and Martin Zagler, “On the Relevance of Double Tax Treaties,” SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, February 18, 2018); Arjan Lejour, “The Foreign Investment Effects of Tax Treaties,” CPB Discussion Paper, 2014.

<sup>3</sup> Katrin McGauran, *Should the Netherlands Sign Tax Treaties with Developing Countries?* (Amsterdam: SOMO, 2013); IMF, *Spillovers in International Corporate Taxation*.

<sup>4</sup> ActionAid, *Mistreated: The Tax Treaties That Are Depriving the World’s Poorest Countries of Vital Revenue* (London: ActionAid UK, 2016); Martin Hearson, *Tax Treaties in Sub-Saharan Africa: A Critical Review* (Nairobi: Tax Justice Network - Africa, 2015).

<sup>5</sup> Sebastian Beer Jan Loeprick, *The Cost And Benefits of Tax Treaties With Investment Hubs*.

**Tax treaty negotiations do not always take place on an equal footing.** With due respect to the often impressive technical competence of today's negotiators from developing countries, negotiating capacities have frequently been limited by an absence of training and experience, and an inability to retain experienced civil servants.<sup>6</sup> In quantitative analysis I have showed a systematic improvement in negotiating positions as countries sign more tax treaties, learning through their early experiences of negotiation and application.<sup>7</sup> On top of this, negotiations often take place in the context of political pressures that oblige negotiators to conclude agreements before they are ready, and prevent them from sticking to their red lines.<sup>8</sup>

**The consequence of these political economic dynamics is that many developing countries have networks of tax treaties, including some signed quite recently, which their current negotiators regard as bad settlements.** The cost of these tax treaties extends beyond their direct impacts because of the precedent they set for future negotiations. The UK's renegotiation with Zambia in 2014 is a good example. The UK sought reduced withholding tax rates to match Zambia's agreement with China, which contained unprecedentedly low rates. It also pursued a 'balanced renegotiation' of the 1972 agreement, a policy that does not take into account the weak capacity of Zambia's negotiators in the early 1970s, nor the changes to both countries' tax systems that have made some parts of that treaty redundant.<sup>9</sup> In addition to their impact on domestic resource mobilisation, poorly negotiated tax treaties can create uncertainty for investors, as countries seek to renege on their commitments, either through cancellations and renegotiations, or through *de facto* treaty overrides.

**Germany's treaty network is among the least favourable to developing country signatories.** In a recent response to questions tabled by Eva-Maria Schreiber and other MPs, the government states that it is willing to integrate clauses from the UN model treaty into its tax treaties with developing countries. The UN model is developed by a committee of 25 technical experts, one of whom is from the German Ministry of Finance. It is intended as a compromise between the preferences of developing (capital-importing) countries and developed (capital-exporting) countries because it allows the capital importer to tax a greater proportion of the income generated from inward investment. I have developed a database that allows comparative analysis of the content of 500 tax treaties signed by developing countries. The database allows me to assign a value between 0 and 1 to each treaty, where a 1 indicates the inclusion of more provisions, including UN model provisions, that give a greater share of taxing rights over inward investment to developing countries. As figures 1 and 2 overleaf show, Germany's treaties with developing countries have low scores, indicating that they place comparatively more restrictions on developing countries' ability to tax inward investment. Figure 3 compares Germany's most recent treaty from the dataset, with the Philippines (2013), with the latter's other treaties with OECD member states. As can be seen, the this treaty imposes greater restrictions on the Philippines' ability to tax inward investment than almost any other, including because it omits provisions of the UN model.

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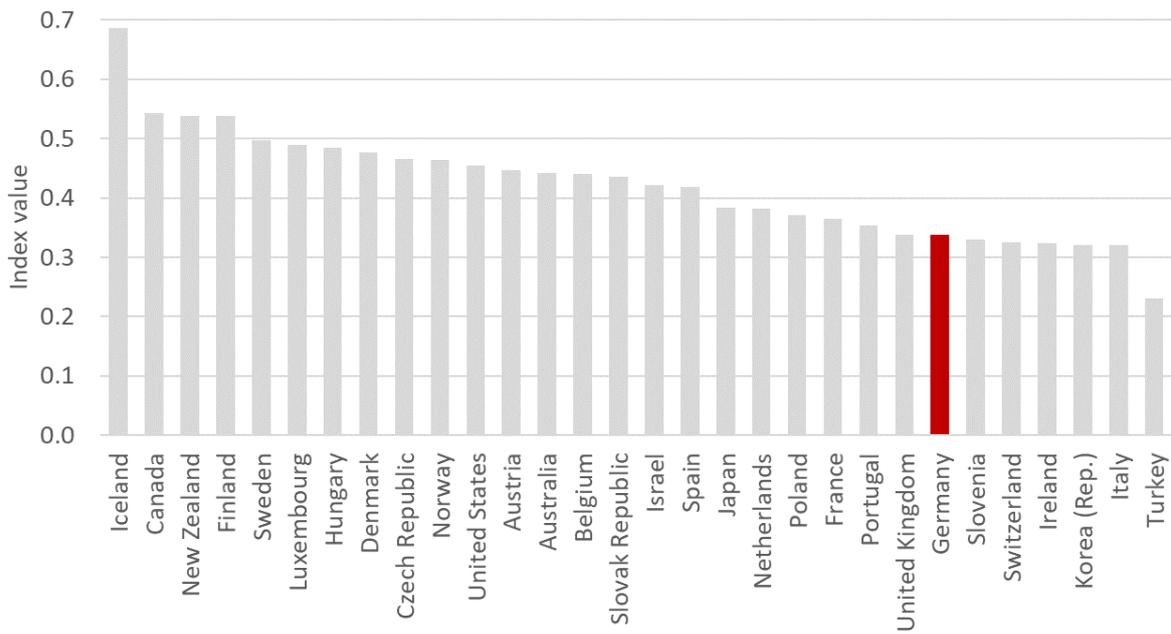
<sup>6</sup> For historical examples based on HMRC negotiators' own experience, see Martin Hearson, "The UK's Tax Treaties with Developing Countries during the 1970s," in *Studies in the History of Tax Law, Volume*, ed. Peter Harris and Dominic De Cogan (Oxford: Hart Publishing, 2017), 363–381.

<sup>7</sup> M. Hearson, "When Do Developing Countries Negotiate Away Their Corporate Tax Base?" *Journal of International Development* 30, no. 2 (2018)

<sup>8</sup> See, for example, Ariane Pickering, *Why Negotiate Tax Treaties?* (New York: United Nations, 2013).

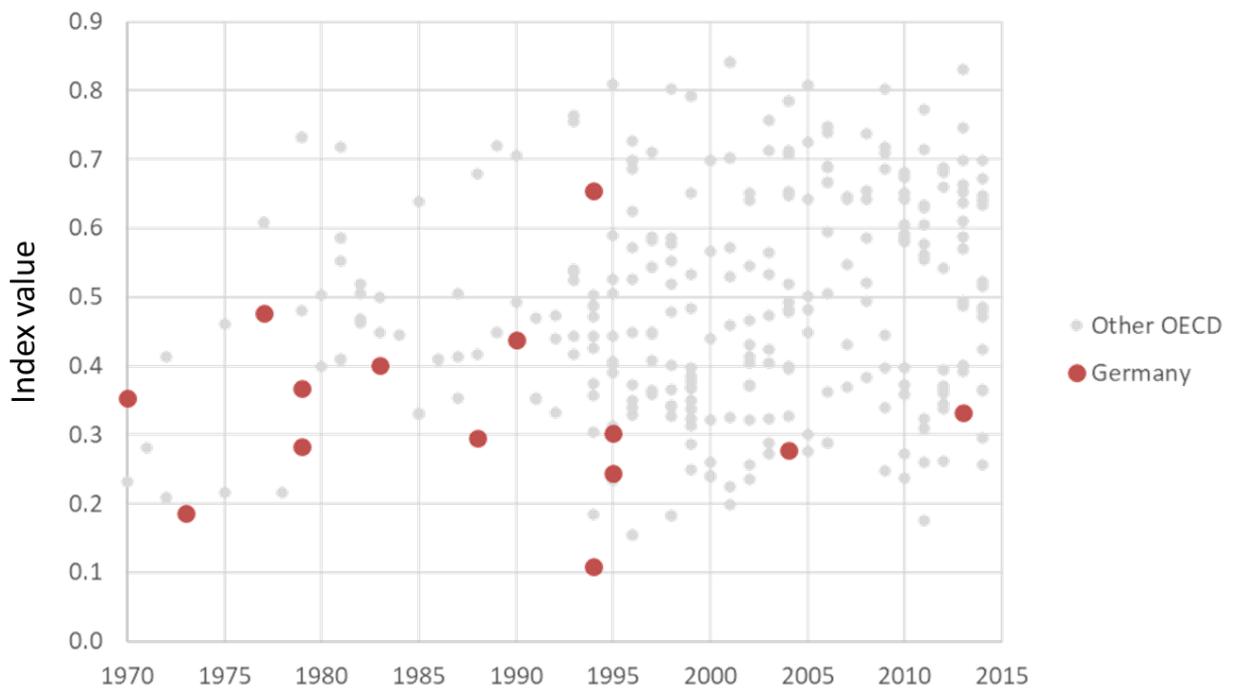
<sup>9</sup> On Zambia, see Hearson, *Tax Treaties in Sub-Saharan Africa: A Critical Review*.

Figure 1: average content of tax treaties with developing countries, OECD member states



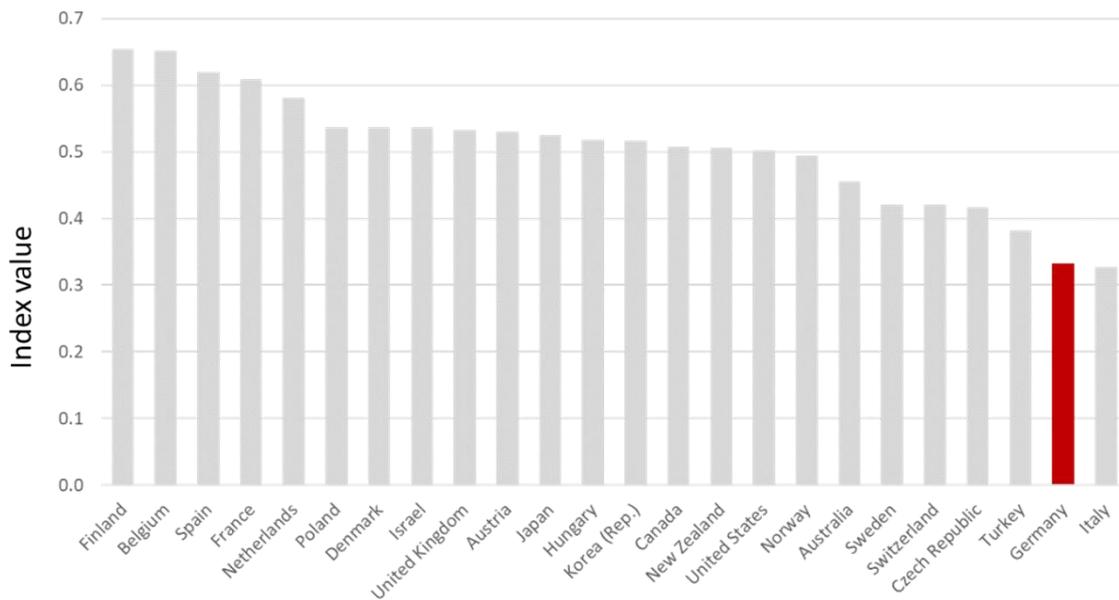
Source: M. Hearson, *The ActionAid Tax Treaties Dataset*, 2016

Figure 2: content of individual tax treaties between developing countries and OECD member states



Source: M. Hearson, *The ActionAid Tax Treaties Dataset*, 2016

Figure 3: content of the Philippines' tax treaties, OECD member states



Source: M. Hearson, *The ActionAid Tax Treaties Dataset*, 2016

**Policy coherence for development requires the assessment and renegotiation of existing tax treaties with developing countries, as well as a fresh approach to new negotiations.**

The European Parliament has resolved that “when negotiating tax treaties, the European Union and its Member States should comply with the principle of policy coherence for development established in Article 208 TFEU.”<sup>10</sup> I agree with Eurodad, a European coalition of civil society organisations, that to do this European Union member states should “ensure that harmful treaties are not signed with developing countries in the first place, and that harmful treaties that already exist are renegotiated or revoked.”<sup>11</sup> Organisations including the IMF and European Commission, as well as NGOs such as ActionAid and Christian Aid, have advocated identifying priorities for renegotiation through ‘spillover analyses’ of tax treaties with developing countries, as Ireland and the Netherlands have already undertaken.<sup>12</sup> Though there are limits to what such analyses can determine, and debates over how to undertake them, they are useful policy tools. The Commission has compiled a toolkit for its Platform for Tax Good Governance, incorporating recommendations and examples from various organisations.<sup>13</sup> In negotiations, the government should recognise historical and present constraints on developing countries’ negotiating capability, as well as their revenue needs. In practice, this means offering developing countries a more favourable settlement, within a policy framework that has been subject to political debate, and that recognises policy coherence for development considerations.

<sup>10</sup> European Parliament, resolution of 8 July 2015 on tax avoidance and tax evasion as challenges for governance, social protection and development in developing countries

<sup>11</sup> Eurodad, *Tax Games: the Race to the Bottom - Europe's role in supporting an unjust global tax system*, 2017.

<sup>12</sup> ActionAid, *Stemming the Spills: Guiding framework for undertaking national tax spillover analyses*, (Johannesburg, 2018); Christian Aid Ireland, *Global Linkages: re-examining the empirical basis of the 2015 tax spillover analysis* (Dublin, 2018); IMF, *Spillovers in International Corporate Taxation* (Washington, DC: International Monetary Fund, 2014).

<sup>13</sup> European Commission, *Toolbox spill-over effects of EU tax policies on developing countries* (Platform for Tax Good Governance, Platform/32/2017/EN, 2017);