

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

**أثر اتفاقيات تجنب الازدواج الضريبي على جذب الاستثمار الأجنبي  
المباشر: مراجعة أدبيات**

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**ملخص الدراسة:**

تهدف اتفاقيات تجنب الازدواج الضريبي إلى القضاء على تكرار فرض الضرائب على نفس الدخل، كما تُعتبر أداة فعالة تساعد الدول النامية في جذب الاستثمارات الأجنبية المباشرة، أظهرت العديد من الدراسات أن لهذه الاتفاقيات تأثيراً إيجابياً على تدفق الاستثمارات إلى البلدان النامية. إلا أن التوصل إلى هذه الاتفاقيات يتطلب سنوات من الجهود والموارد النادرة من جانب الدول النامية، التي غالباً ما تضحي بإيرادات ضريبية محتملة لصالح نموذج ضريبي يفضل دولة الإقامة على دولة المصدر، ومن هنا فإن تكاليف تنفيذ هذه الاتفاقيات لا تبرر إلا إذا كانت الفوائد المتوقعة من حيث تدفق الاستثمار تفوق تلك التكاليف. تستعرض هذه الورقة البحثية بشكل نقدي الأدبيات المتعلقة بتأثير تطبيق معاهدات الازدواج الضريبي على جذب الاستثمار الأجنبي المباشر إلى الدول النامية، ويُستكمل هذا الاستعراض بملخص للنماذج الاقتصادية التي يستخدمها صانعو السياسات لتحليل التأثير الضريبي المحتمل على قرارات الاستثمار الأجنبي المباشر.

**الكلمات المفتاحية:** الاتفاقيات الضريبية الدولية لمنع الازدواج الضريبي، الاستثمار الأجنبي المباشر.

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

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

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### **Abstract:**

Double taxation treaties are enacted with the aim of eliminating double taxation. Furthermore, these treaties help less developed countries attract foreign direct investment (FDI) and reduce and eliminate double taxation. Numerous studies have revealed the positive impact of implementing double taxation treaties on attracting FDI to developing countries. Implementing double taxation treaties does not happen overnight. In fact, LDCs have expended years of effort and scarce resources to negotiate, implement, and conclude these treaties with developed countries. Furthermore, LDCs lose out on potential tax revenues. These treaties often favor residence-based taxation over source-based taxation. The lost tax revenues and capital invested in negotiations with developed countries, in addition to other implementation costs, can only be justified if the expected benefits of foreign direct investment (FDI) outweigh these costs. This paper critically reviews the literature on the impact of implementing double taxation treaties on attracting FDI to developing countries. This review is supplemented by a summary of economic models used by policymakers to analyze the potential tax impact on FDI decisions.

**Keywords:** Emerging Economies, International Double Taxation Treaties, Foreign Direct Investment.

### **1.Introduction:**

Investment plays a crucial role in the economic development of both developed and emerging countries. It contributes to achieving economic, financial stability and the optimal utilization of natural and human

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resources, which in turn contributes to reducing unemployment rates and enhancing the well-being and prosperity of countries.

Recently, with increasing globalization, cross-border trade and the interconnectedness of the global economy are increasing dramatically. This has created an urgent need to evaluate the tax systems of various countries to ensure fair tax treatment for citizens and businesses in a vibrant global economy (Davies, 2024).

This trend highlights the need to study the impact of tax treatment on the movement of individual citizens from one country to another. This movement often results in double taxation of income earned in one country by citizens of another. In addition, another dilemma is that some countries determine tax based on the taxpayer's place of residence or country of citizenship, while others determine tax based on the source of income or revenue.

However, the problem is further complicated by the different definitions of income sources in different countries, which exacerbates an already complex situation. This value increases if the tax rate in both countries exceeds (50%), leading to an anomaly where a resident taxpayer in one country earns income in a foreign country. If they are taxed by both countries, their income will be negative, forcing them to tap into their previous savings or sell their family jewelry (if they have any) to pay the tax.

Baker (2014) 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) highlights 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 deprived of the financing necessary to achieve economic development in their countries. This problem has therefore impacted society as a whole, exacerbating tax burdens on citizens, deterring foreign capital from contributing to the economic cycle, and hindering the freedom to expand domestic investment.

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This could lead to a decrease in production, resulting in a decrease in national income and a reduction in job opportunities. Therefore, tax legislators have attempted to solve this problem by amending some tax laws or resorting to international agreements, whether through the signing of agreements between countries or through concluding collective agreements. This highlights the need to define the role of double taxation treaties in attracting foreign direct investment to developing countries. Implementing a double taxation treaty does not happen overnight (Sujarwati, & Qibthiyah, 2020).

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 negotiations 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 analyze potential tax impact on FDI decisions. (Khursanaliev, 2022).

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 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 (Cadzow, 2021).

On the other hand, DTTs may hamper FDI, it also allows for the exchange of information between tax authorities. Hence, it is an empirical question as of whether or not DTTs help to attract FDI (Kunka, Andrzej, 2020). So far, the empirical evidence on this issue is inconclusive. Consequently, from the

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above, this study a review of literature to what extent double taxation treaties attracting foreign direct investment.

### **2. Review of Studies on the Effect of DTTS on FDI:**

Several studies have investigated the effect of double taxation treaties on foreign direct investment. The findings of these studies are conflicting, which can be classified into three categories based on evidence of a positive impact, negative impact and no impact of the DTTs on FDI, however my findings found that the DTTs that have been concluded by Libyan tax legislation have positive effect on FDI.

Easson (2000) argues that, until the late 1960s the DTTs were mainly concluded among developed countries but since then, an increasing number of treaties have been concluded between developed and developing countries as a result of a positive effect of the DTTs on FDI in developing countries. Foreign investors always look for tax facilities during drive their investments. More evidence by Habas (2008), he provided evidence that, a DTT that has been concluded between Algeria with France has contributed to an increase of French investments in Algeria of 6%.

In contrast, (Egger & Merlo, 2011) find a negative impact of DTTs on FDI by potential for tax avoidance by multinational enterprises, which in turn discourage foreign investment. The study has pointed to the prevention of tax evasion clauses as possibly explaining the evidence for a negative effect on FDI. Also, Habas (2008) claims that, the DTTs that have been concluded by Iraqi government lead to decrease FDI of 8%.

On the other hand, Dagan (1999) asserts that, the use of treaties to promote foreign direct investment is a myth. He claims that, no relationship between the DTTs and FDI. Since a parent, country could unilaterally adjust its tax policy to eliminate distortions caused by differing parent and host country tax policies. Also, Chaudhry mentions that in 2012. More support by Ramadan (2005), he highlights that, the DTTs, which signed between Arab countries, are not effective to raise trade among them, and recommend that Arab government should adjust their tax system to reach that.

### **3. The International Double Taxation:**

In a globalized economy, relations between countries are becoming more extensive and diverse, with natural and legal persons of one country

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receiving income from sources in other countries. Since each country may claim tax jurisdiction over all or part of the persons involved, this creates a coexistence of multiple, complementary or competing tax systems, resulting in double or multiple taxation of income. Thus, international taxation is a double taxation, which may represent an excessive taxation of the taxpayer or an obstacle to capital movements, the process of increasing cooperation between countries and increasing economic and financial relations between them.

International double taxation is defined by the diversity of national systems, the specificities of tax policies, and the ways in which these taxes and duties are used to stimulate or restrict economic activity (Kunka, Andrzej, 2020). Its negative impact is not limited to society as a whole, but also affects export efficiency and the external competitiveness of goods, as duties and taxes affect commodity prices, and the tax burden is greater than if income or wealth were subject to the tax legislation of a single country.

Come in a more complete and as large definition, the double taxation is imposing a two or more taxes, which are similar, on the same taxable subject, for the same taxable purpose and to the same period of time. The phenomenon is encountered only to direct taxes in the income tax and to the tax on wealth. Double Taxation cannot occur in the indirect taxes as citizens of a state found on the territory of other state, as buyers of goods, bears the same taxes contained in prices that citizens of the state concerned. For the goods that are purchased by the citizens of a state, from a foreign country, there is no longer pay (in their country) indirect tax similar to those included in the purchase price of goods or services concerned.

### **4. Foreign Direct Investment:**

In recent decades, foreign direct investment (FDI) has turned out to be one of the driving forces of economic development. Foreign investment leads economic development. Foreign investment leads to economic growth for both advanced and emerging countries. However, the advantages of foreign investment for growing countries are greater than for developed countries. To build a strong economic foundation, governments do not have enough capacity to support the economy (Pribadi, & Rosdiana, 2019).

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To support economic development, foreign investment has a significant influence on the economic growth of third world countries by bridging the gap between domestic savings and investment. That is why every country is striving for growth of direct. Studies show that, foreign direct investment increases competition in the market and expands access to world markets for exported goods. Indeed, a significant increase in global investment began in the mid-1980s. While foreign direct investment totaled \$ 60 million in 1985, the trend was \$ 1.3 trillion in 2023, with some exceptions (UNCTAD, 2023). Various factors affect FDI.

However, important factors can perform the functions in selecting fixed-oriented foreign investment, organized, local guidelines for trade, tax system, exchange rates, transaction costs, monetary management, labor costs, economic risks, accessibility to the market, and factor-funds of the adopted countries (Eiya, & Okaiwele, 2019).

### **5. 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, this called double taxation (Davies, 2024). 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.
- (II) or 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.

### **6. The significance of analyzing the DTTs:**

Signing bilateral tax treaties with developed countries may pose some risks, as these treaties are typically based on the residence principle. Least developed countries already suffer from a disadvantage, burdened by high debt, trade deficits, and potentially very weak infrastructure. Therefore, even if tax treaties are implemented, they may not be able to attract foreign direct investment (Arjan, 2023).

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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), he argues that some tax treaties are somewhat linked to the creation of tax havens, which is illegal because it promotes tax evasion. Such nexus brings about some cloudiness and more criticisms to cross country capital movement and accumulation.

### **7. The benefits of Double Taxation Treaties:**

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 (Van & Lejour, 2020).

The main objective is the eradication of double taxation, as identified by the OECD as a major challenge to FDI inflow. 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 an attracting foreign capital.

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.

Customarily, DTTs are signed to avoid double taxation that results when two or more countries intend to tax the same income. 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 (Sohail & Rabie, 2015).

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.

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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 of the expected ceiling on their tax liabilities in foreign countries. They also provide protection against discrimination in tax treatment of foreign companies or citizens. Furthermore, they help alleviate 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.

### **8. 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 (Sohail & Rabie, 2015). 1.1 below summarizes both the advantages and the disadvantages of implementing double taxation.

**Table (1.1) advantages and disadvantages of double taxation:**

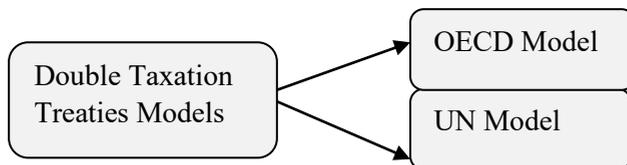
<b>Advantages of double taxation</b>	<b>Disadvantages of double taxation</b>
<ul style="list-style-type: none"> <li>✓ Increase in tax revenues.</li> <li>✓ Keep national capital to within the borders of the country.</li> <li>✓ may lead to reduce some harmful activities.</li> <li>✓ Reallocation of income</li> </ul>	<ul style="list-style-type: none"> <li>✓ Increasing tax burden on individuals, which encourages people to evade tax.</li> <li>✓ It leads to capital flight to another country.</li> <li>✓ It damages Developed countries to find investment opportunities</li> </ul>

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within countries.	surplus funds. ✓ Reducing the ability of Developing countries to attract foreign investment.
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### 9. 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 (Figuroa, 1992). Besides, Lang (2012), 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, 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, 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 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.

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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 may argue that, double taxation exemplifies a major obstacle to attracting FDI to less developed nations. *Ceteris paribus*, double tax avoidance can brand a country as more attractive to foreign investors. According to Egger et al. (2006) Double taxation is a major impediment to FDI flow to a country. Similarly, BITs are considered as positive signals to.

### **10. Conclusion:**

Double taxation treaties are crucial in mitigating the negative effects of double taxation and attracting foreign direct investment to developing countries. However, implementing these treaties does not 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 negotiations 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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