Effects of Tax Treaties on Foreign Direct Investment in Nigeria

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Abstract

A country's tax regime is always a key factor for anybusiness considering moving into new markets. The major reason states sign tax treaties is to avoid international double taxation which usually arise as a result of cross-border trade and investment. For a capital importing or developing country like Nigeria, attracting foreign direct investment (FDI) which will facilitate the transfer of technology and drive economic development and growth is a good reason for entering into tax treaty negotiations and agreements with capital exporting or developed countries. The study adopted the exploratory assessment method by reviewing research work done by other researchers on the relevant topic, effects of tax treaties on foreign direct investment, using secondary data. The researcher, finds out that signing more tax treaty agreements will increase the foreign direct investment in Nigeria, as such, Nigeria should leverage on her status as 26theconomy of the world and as the largest in Africa to attracts more foreign investments by entering more tax treaties.

Keywords: Tax Treaties, Foreign Direct Investment, Nigeria

INTRODUCTION

The role of bilateral tax treaties attracts a lot of attention nowadays. Although bilateral tax treaties are originally used to avoid double taxation, it seems that multinational firms use the network of these treaties to avoid taxation by establishing shell companies in countries with attractive treaties (treaty shopping0, resulting sometimes even in double non taxation. Many people are worried about tax base erosion and profit shifting of multinationals resulting in lower profit tax payments using these treaties (OECD, 2013). Few would doubt the assertion that foreign direct investment (FDI) has been a key element of the globalization drive that has generated much of the world's economic growth over recent decades. Government is aware of the benefits derived from FDI and take positive steps to attract foreign capital. These may include unilateral changes to domestic law and policy and adoption of bilateral agreements with jurisdictions from which FDI may be sourced. The latter includes trade agreements reducing tariff levels, investment protection agreements, and tax conventions (Fabian Barthel, et al, 2013). Based on international trade convention, every country is allowed to adopt laws, rules and regulations that govern its trade relationships with other countries in a way that enables it achieve the desired strategic objectives. One key aspect of such trade laws is the taxation regulations, which govern how the income derived from the different countries is subjected to tax. Since the laws of one country can be different from that of another country, there can be potential conflicts that can expose the same income to tax in different countries. This creates the need for international agreements or treaties to set out terms on which residents of different countries can conduct trade with one another with minimal conflict and reduce the incidence of double taxation on their income. (Adersen tax digests, 03 September, 2019).

Nations enter into double taxation arrangement for variety of reasons, which includes, to foster diplomatic or other relations with one another, to strengthen regional diplomatic, economic and trade ties, to send a message of readiness and willingness to abide and adopt international tax norms, to facilitate out bond investment by residents, to enhance and encourage inbound investment and inbound transfers of technology and skills by residents of the other country, to reduce to the barest minimum cross-border tax avoidance and evasion through mutual assistance in collection of taxes and exchange of information, to attracts foreign direct investments, etc. Foreign Direct Investment (FDI) is the practice of starting or investing in businesses in foreign countries. For example, if an Nigeria multinational firm opens up operations in Ghana or South Africa, either by opening up its own premises or by partnering with a local firm, that investment would be considered part of FDI (Investopedia). Foreign investment inflow, particularly foreign direct investment (FDI) is perceived to have a positive impact on economic growth of

a host country through various direct and indirect channels. It augments domestic investment, which is crucial to the attainment of sustained growth and development. Consequently, many developing countries, Nigeria included, have offered generous incentives to attract FDI inflows and, in addition, undertaken macroeconomicreforms. Part of these incentives is tax treaties. This article try to pin point the effects of tax treaties on foreign direct investment in Nigeria over the years.

LITERATURE REVIEW

Conceptual Framework

A tax treaty is a bilateral (two-party) agreement made by two countries to resolve issues involving double taxation of passive and active income of each of their respective citizens. Tax treaty can also be called double taxation agreement (DTA), it determining the amount of tax to be imposed on a tax payers income, capital, estates etc.(Julia Kagon, Investopedia Dec 14,2020). A treaty is a formal, written agreement between sovereign states or between states and international organizations. Bilateral tax treaties confer rights and impose obligations on the two contracting states, but not on third parties such as tax payers. However, tax treaties are obviously intended to benefittax payers of the contracting states. Whether treaties do so or not depends on the domestic law of each state. In some states, treaties are self-executing, that is once the treaty is conclude, it confers rights on the residents of the contracting states. Articles 26 of the Vienna convention, treaties are binding on the contracting states and must be performed by them in good faith. This is the pacta sunt servanda principle.

Taxation is a significant consideration for foreign investors who sees todo business in Nigeria(deloitte). All over the world, residence and source based taxation are two principles which drive the taxation of corporate players in international markets/ economies. Accordingly, an inevitable risk for multinational companies with cross-border investments/operations is double taxation. Multinational will continue to invest in various economies outside their home countries/market, this makes double taxations a clear and present risk exposure for such business. In order to promote worldwide economic development and to lessen the effects of double taxation on the companies, the organization for economic cooperation and development (OECD) and united nations development model conventions on income and capital. These models define the principles of a permanent establishment, allocate taxing rights amongst nations and providethe basis of information sharing and dispute resolution between contracting states. In Nigeria, the OECD model has served as the basis on which most of the current double taxation treaties (DTTs) with other countries have be formulated. Nigeria currently have DTTs with thirteen countries , they are, the united kingdom, Netherlands, Canada, South Africa, china, Philippines, Romania, Belgium, France, Mauritius, south Korea and Italy. All the treaties are comprehensive except the treaty with Italy which covers air and shipping agreement only.

Empirical Literature

Hong (2017) took a network approach in examining the relationship foreign direct investment and tax-minimizing treaties among 70 countries. His empirical results show that the availability of direct tax treaty route is positively and significantly associated with the inward flow of FDI than the FDI inflow when there is absent tax-minimizing incentives. Olaleye (2016) included DTTs as one of the proxies for tax incentive in his study on the impact of tax incentives on FDI in Nigeria. The study took a survey approach using a sample size of 352 participants from selected manufacturing companies. He also made use of archival data extracted from the Nigerian Stock Exchange and the National Bureau of Statistics from year 2005 to 2014. With the aid of OLS regression technique, he find that a strong positive relationship between DTT and FDI. Lejour (2014) examined the FDI effect of tax treaties using a panel OLS regression technique and fixed effects on the database of all OECD countries starting from 1985. He found that the application of bilateral and multilateral tax treaties significantly increases bilateral FDI by up to 21 percent. Baker (2012) conducted an empirical analysis on the effect of DTTs on FDI using 30 OECD countries and all the 206 non-OECD countries using a propensity score matching and difference-

in-differences estimation strategy. His study covers the period 1991 to 2006 in which he found that DTTs do not have any effect on FDI across board. Blonigen, Oldenski and Sly (2011) studied the effect of bilateral tax treaties on the agreeing parties using data of individual companies based in the US with an apriority expectation that tax treaties will likely promote FDI and related affiliations due to tax reliefs. Their findings show that tax treaties enhanced outward FDI between 1987 and 2007. They also show that the effect become smaller or even negative when the company uses a lot of intermediate supplies from foreign companies.

The study by Barthel et al (2010) examine the relationship between double taxation treaties and foreign direct investment using a panel data analysis technique applied on a broad data-set comprising 135 countries (30 FDI source countries and 105 FDI host countries) from 1978 to 2004. Their findings show that countries that entered in treaties received greater FDI than those without a treaty agreement. Coupe, Orlova and Skiba (2008) examined the effect of DTTs on the FDI flows from OECD into transition economies covering 17 source countries and nine host economies over the period of 1990-2001. Their findings show that no significant relationship exists. They also suggest that the sign and statistical significance of the estimated treaty coefficients depends largely on the estimator technique adopted such as OLS, random effects, fixed effects and two-stage least squares. Neumayer‘s (2007) study investigates whether or not U.S. double taxation treaties increase FDI in low and middle-income countries over the period 1970 to 2001 using random-effect and fixed-effects estimation techniques. The finding shows that developing countries that have several DTTs with capital-exporting developed countries gained higher FDI inflows and higher shares from inflows. Egger et al (2006) estimate the effect of tax treaties on bilateral outward FDI from OECD source countries over the period of 1985 to 2000 with a two-step selection model. This treatment group covers 67 observations, while the control group without treaties encompasses 719 observations. They find that new treaties have negative effect on FDI using matching propensity score methods comparing FDI stocks two years pre and post-treaty agreement. Thus, it is much more likely that a treaty is concluded if bilateral investment is substantial, compared to the situation that there is hardly any investment between the two countries.

The study of Blonigen and Davies (2004) equally explored the impact of tax treaties on FDI in OECD countries during the period of 1983 to 1992 using an ordinary least squares and fixed effects analytical techniques. Their result contradicts the expected assumption that tax treaties increase FDI by showing a significant negative relationship between new treaty activities and FDI. Summarily, the review reaffirmed the position of previous literature on the relevance of DTTs in the encouragement of FDI among countries. Considering the implicational costs that has to be borne by the two contracting parties, which may be more excruciating for the lesser economically developed country; there is possibility that DTT can lead to a huge loss of tax revenue on the part of developing countries that may not be commensurate to the size of FDI they get in return. This could be the explanation for the several negative relations between DTT and FDI as discovered by the review of extant studies. Also, majority of the studies captures more than one country in their analysis. There is a possibility that country-specific peculiarities could have twisted the findings of these extant studies. The distinction of this study, therefore, is the focus on one particular developing country which is expected to be pivotal is addressing the eventual policy implication. In line with the role of taxations as a tool for wealth and employment creation, the national tax policy (NTP) of Nigeria identifies international and regional treaties as one way of attracting foreign direct investments to Nigeria. To this end, it is imperative that Nigeria leverage on itsstatus as the largest economy in Africa and takes advantages of the benefits DTTs offers.

Theoretical framework

Louie and Rousland (2002) find a non-significant effect of DTTs on the rates of return that America companies require for their foreign investment in the years 1992, 1994 and 1966, while Paul L Baker, believes that despite the intentions and the significant of developing countries entering into DTTs, which are intended to eliminate double taxation and thereby increase foreign direct investment, the treaties have no effects on the flows of FDI. Developed countries unilaterally provide for the relief of double taxation

and the prevention of fiscal evasions regardless of the treaty status of a host country. This eliminates the key economicbenefits and risk that these treaties would otherwise create for the FDI location decisions of multinational enterprises (Paul L. Baker, international journal of the economics of business, volume 2, 2014). Blonigen and Davies (2005) find that bilateral tax treaties are often correlated with more FDI in an analysis of FDI flows between OECD countries and other countries in the period 1982 to 1992. Another study by the same authors(Blonigen and Davies (2004) finds insignificant or even negative effects on the in- and outward FDI flows of the US between 1980 and 1999. Egge et al (2006) concludes that new treaties have a negative effect on FDI using matching propensityscore methods comparing FDI stocks two years before and two years after treaties and concluded using OECD data between 1985 2000, while Neumaye(2007) examines whether tax treaties between developing countries and developed countries lead to more FDI to these countries in the period 1970 2001, the study concluded that tax treaties has a significant effect for the middle income countries.

METHODOLOGY

The study adopted the exploratory assessment method by reviewing research work done by other researchers on the relevant topic, effects of tax treaties on foreign direct investment, using secondary data.

RESULT AND CONCLUSIONS

Countries enter into DTTs/agreements on the basis that it would ultimately be beneficial to both their economy, however, this is not always the case as some countries seems to have benefitted more than the others from DTT arrangements. In this light, the federal government should also review the tax treaties it currently has with other countries to determine if Nigeria is truly benefitting from these DTTs. Where it is established that Nigeria is not, re-negotiating and amending key clauses of the DTTs should not be out of place.

CONCLUSION AND RECOMMENDATION

Necessity is on Nigeria economically to leverage strategically its status as the 26th largest economy in the world and biggest in Africa by proactively harnessing its every potential, promise and prospects in the continent and globally through useful economic partnership enshrined in double tax arrangement. Meanwhile it is worthy of note that Nigeria's few double tax treaties are a far cry from the number which other developed and developing countries have. The UK currently has DTTs with 131 countries; Canada 92 DTTs and Malaysia 68 DTTs. Statistic have shown that there is a positive correlation between DTT and the level of foreign direct investments inflow to Nigeria. It is clear that Nigeria has to widen its current DTT network.

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