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BUSINESS PROFITS, WITHHOLDING TAXES, AND CROSS-BORDER ECONOMIC ACTIVITY: EVIDENCE FROM DOUBLE TAXATION TREATY PROVISIONS

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Abstract
This study examines whether specific provisions relating to business profits, dividends, interest, and royalties influence bilateral trade and foreign direct investment more effectively than the conventional treaty-existence approach. The analysis employs panel data for Pakistan and twelve treaty partner countries covering the period 2000–2022. Bilateral trade and foreign direct investment are modeled separately using panel least squares with country fixed effects and the generalized method of moments to address potential endogeneity arising from treaty design. The findings indicate that treaty provisions exert heterogeneous effects on international economic activity. Higher withholding taxes on interest consistently discourage foreign direct investment, while royalty taxation significantly reduces both trade and investment after correcting for endogeneity. Permanent establishment provisions also emerge as an important determinant of bilateral economic activity, highlighting the importance of business profits in shaping cross-border commercial decisions. Furthermore, larger host-country markets stimulate trade and investment, whereas greater geographic distance continues to constrain international economic integration. The results also demonstrate that free trade agreements strengthen bilateral trade, while bilateral investment treaties play a significant role in influencing foreign direct investment. By shifting the analysis from treaty existence to provision-level characteristics, this study provides more precise evidence on the channels through which double taxation treaties affect international economic outcomes. The findings offer practical guidance for policymakers by emphasizing that carefully designed treaty provisions can improve trade and investment performance while supporting more balanced and effective treaty negotiations.
Keywords: *Double Taxation Treaties, Foreign Direct Investment, Bilateral Trade, Treaty Provisions*

INTRODUCTION

The expansion of international trade, cross-border investment, and global economic integration has substantially increased the complexity of international taxation (Frenkel et al., 1991; Tanzi, 2000; Umeaduma, 2022; Avi-Yonah, 2023). As multinational enterprises and investors operate simultaneously across multiple jurisdictions, the same income may become subject to taxation in both the country where it is generated and the country where the recipient resides (Ali & Naeem, 2017; Ali, 2022; Ault et al., 2025; Richter, 2025; Zamir et al., 2026; Hardika et al., 2026). Such overlapping tax claims create international double taxation, which increases the cost of cross-border business activities, reduces after-tax investment returns, and discourages international trade and foreign direct investment (Ali, 2015; Abbaa Gadaa, 2022; Ali, 2022; Andrew, 2025; Bird & Kisska-Schulze, 2026). From an economic perspective, double taxation creates a fiscal burden that distorts capital allocation decisions, weakens international competitiveness, and reduces the efficiency of global resource allocation (Ali, 2018; Adebiyi, 2023; Ali et al., 2026; Ottoni Uébe Mansur, 2026). Consequently, eliminating or mitigating double taxation has become an important objective of international tax policy to facilitate international economic cooperation and promote sustainable cross-border investment (Ali & Bibi, 2017; Ali & Audi, 2018; Ali, 2022; Marc et al., 2023; Bulgac, 2025; Datta, 2025; Kachalia et al., 2026; Irawati et al., 2026).

To address these challenges, countries have established extensive networks of bilateral Double Taxation Treaties (DTTs), largely based on the OECD and United Nations Model Tax Conventions (Vier, 2025; Boukal et al., 2026). These treaties allocate taxing rights between contracting states and reduce the possibility of double taxation through standardized provisions governing business profits, permanent establishments, dividends, interest, royalties, and methods for relieving double taxation (Altawyan, 2023; Machkhoshvili & Berishvili, 2025; Farooq et al., 2026). By lowering withholding taxes, clarifying taxing jurisdiction, and providing greater legal certainty for investors, DTTs are expected to reduce fiscal barriers, encourage foreign direct investment, expand bilateral trade, and improve the predictability of international business transactions (Allen, 2022; Ali & Audi, 2023; Hebous et al., 2026). The global treaty network has expanded rapidly over recent decades, with more than 5,100 bilateral

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tax treaties currently in force worldwide, reflecting the central role of DTTs in contemporary international taxation (OECD, 2025; Naseer et al., 2026; Azam, 2026).

Despite their widespread adoption, the empirical evidence regarding the economic effectiveness of DTTs remains inconclusive. Numerous studies report that tax treaties stimulate foreign direct investment by lowering tax burdens and reducing uncertainty (Neumayer, 2007; Egger & Merlo, 2011; Mann, 2023; Silva et al., 2024; Audi et al., 2026; Ayesu, 2026). In contrast, other studies find insignificant or even negative effects after accounting for treaty endogeneity and country-specific characteristics (Blonigen & Davies, 2004; Baker, 2014; Marc et al., 2022; Audi & Ali, 2023; Adil et al., 2026). The empirical literature examining bilateral trade has likewise produced inconsistent findings, with some studies reporting positive trade effects while others conclude that treaty provisions exert little measurable influence on international trade flows (Zagler, 2023; Garg et all., 2026). These conflicting results raise important questions regarding whether DTTs themselves promote economic integration or whether their effectiveness depends on the specific fiscal provisions contained within individual treaty articles (Davidson, 2025; Esu, 2026).

Most empirical studies rely on a simple binary indicator that records only whether a treaty exists between two countries, without considering the substantive differences contained in individual treaty provisions (Ali & Rehman, 2015; Ali, 2015; Ali et al., 2016; Ashraf & Ali, 2016; Arshad & Ali, 2018; Audi et al., 2021; Marc et al., 2021; Affinito et al., 2024; Al-Masri & Audi, 2026; Alsan et al., 2026). This approach ignores considerable variation in the fiscal incentives created by Articles 7, 10, 11, and 12 governing business profits, dividends, interest, and royalties (Yuan, 2026; Erickson et al., 2026). For example, two treaties may both be coded identically despite imposing substantially different withholding tax rates or permanent establishment thresholds, thereby creating very different incentives for cross-border investment and commercial activity. Such aggregation masks important treaty heterogeneity and may explain the inconsistent empirical evidence reported throughout the existing literature. This issue is particularly important for Pakistan, whose treaty network includes more than fifty bilateral tax treaties negotiated under both the OECD and United Nations Model Conventions (Sajid & Ali, 2018; Marc et al., 2021; Roussel et al., 2021; Ahmad et al., 2022; Naeem et al., 2026; Afzal, 2026). These treaties contain substantial variation in withholding tax rates, permanent establishment provisions, and the allocation of taxing rights across different categories of cross-border income (Majeed et al., 2026; Morriss & Ku, 2026). Pakistan maintains significant economic relationships with both developed and developing economies, including Germany, the United Kingdom, Japan, China, the United Arab Emirates, Saudi Arabia, Turkey, and Malaysia. At the same time, persistent fiscal constraints and revenue mobilization challenges have intensified policy debates regarding whether treaty-based tax concessions generate sufficient gains in trade and foreign direct investment to justify the associated revenue losses. These concerns have become increasingly relevant as Pakistan reviews its treaty network in response to international tax reforms, including the OECD Multilateral Instrument.

Although several studies have examined Pakistan's bilateral tax treaty network, the available evidence remains limited. Atif & Siddiqui (2019) concluded that Pakistan's treaties reduce the effective tax burden on foreign investment but impose considerable fiscal costs through lower withholding taxes. Shakoor et al., (2025) identified structural weaknesses in the interest and royalty provisions that may facilitate base erosion by multinational enterprises. Similarly, Kiran et al. (2026) found that double taxation treaties positively influence inward foreign direct investment but produce no statistically significant effect on trade openness. However, these studies evaluate treaties at the aggregate level and do not examine how individual treaty provisions independently influence bilateral trade and investment outcomes. This study addresses these limitations by conducting a comparative analysis of the major treaty provisions contained in Articles 7, 10, 11, and 12 of bilateral double taxation treaties to evaluate their individual effects on bilateral trade and foreign direct investment. Using cross-country panel data and provision-level treaty information, the study moves beyond the conventional binary treaty approach to identify which specific treaty articles contribute most effectively to promoting international trade and investment while providing more precise policy implications for treaty design and renegotiation.

LITERATURE REVIEW

DOUBLE TAXATION TREATIES AND FOREIGN DIRECT INVESTMENT

Double taxation treaties have long been regarded as one of the principal institutional mechanisms for facilitating international investment by reducing fiscal barriers associated with cross-border economic activities (Frenkel et al., 1991; Tanzi, 2000; Avi-Yonah, 2023; Ault et al., 2025; Bukhari et al., 2025; Fatima et al., 2026). By allocating taxing rights between residence and source countries, limiting withholding taxes, and providing procedures for the

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elimination of double taxation, these agreements are expected to reduce the tax burden faced by multinational enterprises and improve the predictability of international taxation (Altawyan, 2023; OECD, 2025; Khalid et al., 2025; Tosun, 2026). Consequently, lower tax uncertainty and reduced fiscal costs should encourage firms to undertake foreign direct investment by increasing the expected after-tax return on overseas projects (Zagler, 2023; Umeaduma, 2022; Ali et al., 2025; Khan et al., 2025; Daud et al., 2026).

One of the earliest comprehensive studies by Blonigen and Davies (2004) reported that the existence of bilateral tax treaties did not consistently increase foreign direct investment after accounting for treaty endogeneity, suggesting that many treaties are negotiated between countries with already established investment relationships. Similarly, Baker (2014) concluded that the investment effects of tax treaties become considerably weaker once endogenous treaty formation and country-specific characteristics are properly controlled, indicating that previous studies may have overstated treaty benefits.

Conversely, several studies provide evidence supporting a positive role of tax treaties in promoting international investment. Neumayer (2007) found that bilateral tax treaties significantly increase foreign direct investment inflows, particularly among developing countries seeking to improve investment certainty and reduce fiscal obstacles facing foreign investors. Egger and Merlo (2011) further demonstrated that tax treaties positively influence multinational firms' investment decisions by lowering effective tax burdens and reducing uncertainty surrounding cross-border taxation. Their findings suggest that treaty provisions enhance the attractiveness of host countries by improving the fiscal environment under which multinational enterprises operate (Atif & Siddiqui, 2019; Rafique et al., 2025; Ali et al., 2026; Tahir et al., 2026).

More recent evidence generally supports the view that treaty effectiveness depends on institutional quality and treaty design rather than merely on treaty existence. Pribadi and Rosdiana (2019) showed that tax treaties encourage foreign direct investment when accompanied by stable institutional environments and effective tax administration. Likewise, Petkova et al. (2020) argued that the investment effects of tax treaties vary substantially across countries because differences in treaty provisions, withholding tax rates, and anti-abuse measures influence investors' expected after-tax returns differently. Extending this argument, Petkova et al. (2025) emphasized that modern treaty provisions increasingly reflect concerns regarding tax avoidance, profit shifting, and base erosion, implying that the economic effects of bilateral treaties depend not only on whether treaties exist but also on their substantive legal provisions (Ditta et al., 2025; Richter, 2025; Umair et al., 2025; Vier, 2025; Datta, 2025; Aman et al., 2025; Bird & Kisska-Schulze, 2026; Boukal et al., 2026; Javed et al., 2026). Collectively, these studies suggest that while double taxation treaties can facilitate foreign direct investment, their effectiveness varies considerably according to treaty content, institutional quality, and the economic relationship between contracting countries (Zagler & Zanzottera, 2023; Silva et al., 2024; Shakoor et al., 2025; Iqbal et al., 2025; Ali et al., 2025; Kiran et al., 2026; Karim et al., 2026; Morriss & Ku, 2026).

DOUBLE TAXATION TREATIES AND BILATERAL TRADE

Compared with foreign direct investment, considerably less empirical attention has been devoted to the influence of double taxation treaties on international trade (Ali & Naeem, 2017; Zagler & Zanzottera, 2023; OECD, 2025). From a theoretical perspective, treaties reduce the fiscal costs associated with cross-border commercial activities by lowering withholding taxes on business income, royalties, dividends, and interest payments while providing greater certainty regarding the taxation of international business profits (Frenkel et al., 1991; Tanzi, 2000; Ault et al., 2025; Ali et al., 2025; Kumar et al., 2025; Rauf et al., 2026; Tosun, 2026). These improvements are expected to encourage firms to expand exports, imports, technology transfers, and other cross-border commercial transactions (Avi-Yonah, 2023; Aziz et al., 2025; Datta, 2025; Hardika et al., 2026).

Empirical findings, however, remain mixed. Zagler (2023) found that bilateral tax treaties generally promote international trade by reducing tax uncertainty and improving market integration, although the magnitude of the effects varies across trading partners and institutional settings. Similarly, a recent gravity-model analysis of India's bilateral trade relationships during 1990–2022 reported that tax treaties positively influence bilateral trade flows, particularly where treaties provide favorable provisions for business income and withholding taxes. Nevertheless, the authors noted that treaty effectiveness depends on broader institutional and economic conditions, including governance quality, trade openness, and existing commercial relationships (Ahmad et al., 2022; Silva et al., 2024; Ali et al., 2023; Humza et al., 2025; Khan et al., 2025; Zahid et al., 2026). Despite these positive findings, the empirical literature on treaty effects on trade remains relatively underdeveloped compared with studies on foreign direct investment. Most existing analyses continue to employ a simple binary indicator identifying whether a treaty

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exists, without distinguishing between specific treaty provisions that directly influence cross-border commercial activities (Petkova et al., 2020; Petkova et al., 2025; Aqeel et al., 2025; Choudhary et al., 2026; Tosun, 2026). Consequently, relatively little is known about which components of tax treaties contribute most to promoting bilateral trade (Shakoor et al., 2025; Shahid et al., 2025; Morriss & Ku, 2026; Kiran et al., 2026).

TREATY PROVISIONS AND THE ECONOMIC EFFECTS OF INDIVIDUAL ARTICLES

Although thousands of bilateral tax treaties are currently in force worldwide, empirical research has largely treated treaties as homogeneous legal instruments, despite substantial differences in their legal provisions and economic implications (OECD, 2025; Tosun, 2026). Most studies employ a binary treaty indicator that assigns a value of one when a treaty exists and zero otherwise, implicitly assuming that all treaties generate identical economic incentives (Blonigen & Davies, 2004; Baker, 2014; Petkova et al., 2020; Shahi et al., 2025). This assumption is inconsistent with the substantial variation observed across treaty provisions governing business profits, dividends, interest, and royalties (Zagler & Zanzottera, 2023; Kanwal et al., 2025; Ault et al., 2025; Sattar et al., 2025; Gillani et al., 2026).

Among the provisions most directly affecting international investment and trade are Article 7 governing business profits, Article 10 regulating dividend taxation, Article 11 covering interest income, and Article 12 concerning royalties. These provisions allocate taxing rights differently and establish varying withholding tax rates that directly influence firms' expected after-tax returns from cross-border economic activities (Frenkel et al., 1991; Tanzi, 2000; Audi, 2016; Altawyan, 2023). Consequently, treaties containing lower withholding taxes or more favorable permanent establishment provisions should theoretically create stronger incentives for international trade and investment than treaties containing relatively restrictive provisions (Avi-Yonah, 2023; Richter, 2025; Machkhoshvili & Berishvili, 2025; Ahmad et al., 2025).

Recent scholarship increasingly recognizes this limitation within the traditional literature. Tosun (2026) argued that substantial heterogeneity exists among treaty provisions and that individual articles generate different behavioural responses from multinational enterprises depending on the fiscal incentives they create. Likewise, Petkova et al. (2025) demonstrated that modern treaty negotiations increasingly focus on specific provisions related to withholding taxation, permanent establishment rules, anti-abuse measures, and profit allocation rather than merely expanding treaty networks. Their findings suggest that analysing individual treaty provisions provides substantially richer insights than simply examining whether a treaty exists. These studies therefore indicate that provision-level analysis represents an important advancement over conventional binary treaty specifications (Petkova et al., 2020; Allen, 2022; Ghauri et al., 2025; Khalil et al., 2025’ Davidson, 2025).

EVIDENCE FROM PAKISTAN

Empirical evidence concerning Pakistan's bilateral tax treaty network remains relatively limited despite the country's extensive participation in international tax agreements and its growing reliance on foreign trade and investment as drivers of economic development (Atif & Siddiqui, 2019; OECD, 2025; Nasir et al., 2025; Shakoor et al., 2025; Anus et al., 2025). Existing studies primarily examine aggregate treaty effects without distinguishing among individual treaty provisions, thereby overlooking the heterogeneous economic incentives created by different articles (Petkova et al., 2020; Tosun, 2026). Atif and Siddiqui (2019) investigated Pakistan's treaty network and concluded that bilateral tax treaties substantially reduce the effective tax burden on foreign investment. However, the resulting investment gains are accompanied by significant reductions in withholding tax revenues, raising concerns regarding the fiscal costs associated with treaty concessions. Their analysis focused primarily on aggregate treaty impacts rather than the individual effects of specific treaty articles (Baker, 2014; Atif & Siddiqui, 2019).

More recently, Shakoor et al. (2025) examined Pakistan's treaty provisions relating to interest and royalties and reported that certain provisions create opportunities for profit shifting and base erosion by multinational enterprises. Their findings emphasize the importance of carefully designing treaty provisions to balance investment promotion with domestic revenue protection, consistent with recent international discussions on treaty reform and anti-abuse measures (Shakoor et al., 2025; Petkova et al., 2025; Bird & Kisska-Schulze, 2026). Similarly, Kiran et al. (2026) employed panel data techniques to evaluate Pakistan's international economic agreements and found that double taxation treaties positively affect inward foreign direct investment while exerting no statistically significant influence on trade openness. Although their findings provide useful evidence regarding aggregate treaty effects, the study does not distinguish among individual treaty articles, leaving unanswered questions regarding which provisions generate the strongest economic impacts (Zagler & Zanzottera,

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2023; Kiran et al., 2026). This study extends the existing literature by moving beyond the conventional binary treaty approach and conducting a comparative analysis of the economic effects of individual treaty provisions governing business profits, dividends, interest, and royalties. Using Pakistan's bilateral tax treaty network as the empirical setting, the study jointly examines the influence of these treaty articles on bilateral trade and foreign direct investment, thereby providing more detailed evidence regarding the specific provisions through which double taxation treaties promote international economic integration.

THEORETICAL FRAMEWORK

International trade and foreign direct investment are influenced not only by market size and comparative advantage but also by the legal, institutional, and fiscal environment governing cross-border economic activities (Frenkel et al., 1991; Tanzi, 2000; Avi-Yonah, 2023; Ault et al., 2025). Taxation represents one of the most significant costs affecting multinational enterprises because income generated across borders may be taxed simultaneously by both the source and residence countries, increasing the effective tax burden, compliance costs, and investment uncertainty (Richter, 2025; Datta, 2025; Hardika et al., 2026). Bilateral double taxation treaties seek to mitigate these distortions by allocating taxing rights between contracting states, reducing withholding taxes, and providing greater certainty regarding international tax obligations (OECD, 2025; Tosun, 2026). This study is grounded in Internalization Theory, which explains that firms expand internationally when institutional arrangements reduce transaction costs, minimize market imperfections, and increase the expected net returns from cross-border operations (Buckley & Casson, 1976). Within this perspective, double taxation treaties improve the institutional environment through Articles 7, 10, 11, and 12 by lowering withholding taxes on business profits, dividends, interest, and royalties and by establishing clearer permanent establishment rules. These provisions reduce the fiscal cost of international investment, technology transfer, and commercial transactions, thereby encouraging bilateral trade and foreign direct investment (Petkova et al., 2020; Zagler & Zanzottera, 2023; Petkova et al., 2025). However, the economic effects of double taxation treaties are expected to depend on the design of individual treaty provisions rather than merely on the existence of a treaty (Baker, 2014; Tosun, 2026). Accordingly, this study evaluates the effects of Articles 7, 10, 11, and 12 on bilateral trade and foreign direct investment while controlling for market size, institutional quality, geographic distance, and other determinants of international economic integration (Kiran et al., 2026; Ali et al., 2026). The theoretical relationship is represented by the following functional models:

$$BT_{ij,t}=f(WDIV_{ij,t}, WINT_{ij,t}, WROY_{ij,t}, PETHR_{ij,t}, GDP_{ij,t}, GDP_{ij,t}, DIST_{ij,t}, INST_{ij,t}\ FTA_{ij,t}) \quad (1)$$

$$FDI_{ij,t}=f(WDIV_{ij,t}, WINT_{ij,t}, WROY_{ij,t}, PETHR_{ij,t}, GDP_{ij,t}, GDP_{ij,t}, DIST_{ij,t}, INST_{ij,t}, BIT_{ij,t}) \quad (2)$$

Where:

BT = Bilateral Trade Flows
FDI = Bilateral FDI Inflows
WDIV = Withholding Tax Rate on Dividends (Article 10)
WINT = Withholding Tax Rate on Interest (Article 11)
WROY = Withholding Tax Rate on Royalties (Article 12)
PETHR = Permanent Establishment Threshold in months (Article 7)
GDP_i = Gross Domestic Product of the Home Country
GDP_j = Gross Domestic Product of the Host Country
DIST = Bilateral Geographic Distance
INST = Institutional Quality
FTA = Free Trade Agreement (binary indicator)
BIT = Bilateral Investment Treaty (binary indicator)

Table 1: Measurement and Definition of Variables

Variables	Measurement	Definition
BT	Natural logarithm of total bilateral exports and imports (constant US$)	Total value of bilateral trade between country pair *i* and *j* in year *t*, representing the intensity of international trade flows.
FDI	Natural logarithm of bilateral foreign direct investment inflows (constant US$)	Net inward foreign direct investment from source country *i* to host country *j* in year *t*.

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WDIV	Treaty withholding tax rate on dividends (%)	Maximum withholding tax rate on cross-border dividend payments specified under Article 10 of the bilateral double taxation treaty. Higher rates increase the tax burden on foreign equity income.
WINT	Treaty withholding tax rate on interest (%)	Maximum withholding tax rate on cross-border interest payments under Article 11 of the bilateral double taxation treaty. Higher rates increase the cost of international debt financing.
WROY	Treaty withholding tax rate on royalties (%)	Maximum withholding tax rate on royalty payments for intellectual property under Article 12 of the bilateral double taxation treaty. Higher rates discourage technology transfer and licensing.
PETHR	Permanent establishment threshold (months)	Minimum duration required for business activities to constitute a permanent establishment under Article 7 of the bilateral treaty. Longer thresholds generally reduce source-country taxation and may encourage cross-border business activities.
GDP_i	Natural logarithm of GDP (constant US$)	Gross domestic product of the source (home) country, representing economic size and export capacity.
GDP_j	Natural logarithm of GDP (constant US$)	Gross domestic product of the host (partner) country, representing market size and investment opportunities.
DIST	Great-circle distance (kilometres, logarithm)	Geographic distance between the economic centers of the two countries, capturing transportation costs and informational barriers.
INST	Rule of Law and Regulatory Quality Index	Composite indicator reflecting institutional quality, governance effectiveness, and regulatory environment of the host country.
FTA	Dummy variable (1 = Free Trade Agreement exists; 0 = otherwise)	Indicates whether a bilateral free trade agreement exists between the country pair in a given year.
BIT	Dummy variable (1 = Bilateral Investment Treaty exists; 0 = otherwise)	Indicates whether a bilateral investment treaty is in force between the country pair in a given year.

This study employs a quantitative panel-data research design to examine the effects of bilateral double taxation treaty provisions on bilateral trade and foreign direct investment. The analysis uses an unbalanced panel of country-pair observations covering the period 2000–2022, comprising countries that have at least one bilateral double taxation treaty in force during the sample period. The sample includes both developed and developing economies, allowing substantial variation in treaty provisions and institutional characteristics across bilateral relationships. Bilateral trade data are obtained from the International Monetary Fund (IMF) Direction of Trade Statistics (DOTS), while bilateral foreign direct investment data are collected from the OECD International Direct Investment Statistics and the UNCTAD Bilateral FDI Database. Information on treaty-specific withholding tax rates on dividends, interest, royalties, and permanent establishment thresholds is hand-collected from the IBFD Tax Research Platform and individual bilateral treaty texts. Macroeconomic variables are sourced from the World Bank World Development Indicators, institutional quality indicators from the Worldwide Governance Indicators, geographic distance from the CEPII GeoDist Database, free trade agreement information from the WTO Regional Trade Agreements Database, and bilateral investment treaty data from the UNCTAD Investment Policy Hub.

RESULTS AND DISCUSSION

Table 2 presents the descriptive statistics for the variables included in the analysis of bilateral trade and foreign direct investment. The results indicate considerable variation in both dependent variables across the sampled country pairs, suggesting substantial differences in the intensity of international trade and investment relationships. The positive skewness of bilateral trade and foreign direct investment implies that a relatively small number of

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country pairs account for a disproportionately large share of economic activity, while most bilateral relationships exhibit comparatively lower levels of trade and investment. This distribution is consistent with the heterogeneous nature of international economic integration among countries. The treaty-related variables also exhibit meaningful cross-country variation, reflecting the diversity of bilateral tax treaty provisions. The withholding tax rates on dividends, interest, and royalties vary substantially across treaties, indicating that countries adopt different fiscal strategies to regulate cross-border income flows. Likewise, differences in permanent establishment thresholds demonstrate that bilateral treaties allocate taxing rights under varying legal conditions, providing an appropriate basis for examining the independent effects of individual treaty articles rather than treating treaties as homogeneous agreements. Among the control variables, the economic size of both home and host countries displays notable heterogeneity, indicating that the sample includes countries with substantially different market capacities. Geographic distance also varies considerably, reflecting the inclusion of both geographically proximate and distant trading partners. Institutional quality shows moderate variation across countries, capturing differences in governance and regulatory environments that may influence international economic activity. Finally, the distribution of free trade agreements and bilateral investment treaties indicates that investment agreements are considerably more prevalent than preferential trade agreements within the sample.

Table 2: Descriptive Statistics

Variables	Mean	Median	Std. Dev.	Min	Max	Skewness	Kurtosis
BT (USD mn)	2882.086	1399.850	3406.013	137.300	17803.200	1.952	3.656
FDI (USD mn)	241.439	150.700	254.918	16.700	1775.700	2.639	9.824
WDIV (%)	11.250	10.000	6.507	5.000	30.000	1.820	3.098
WINT (%)	10.583	10.000	7.230	0.000	30.000	1.290	1.922
WROY (%)	11.625	10.000	6.490	5.000	30.000	1.662	2.753
PETHR (months)	11.000	12.000	2.240	6.000	12.000	-1.799	1.244
GDP_i (USD bn)	140.391	134.300	45.678	73.100	222.100	0.140	-1.173
GDP_j (USD bn)	2880.108	1075.050	4498.313	94.000	23289.000	2.614	6.729
DIST (km)	5573.333	5944.000	2356.721	2232.000	11858.000	1.209	1.796
INST (index)	-0.787	-0.780	0.076	-0.910	-0.670	-0.063	-1.386
FTA (binary)	0.112	0.000	0.316	0.000	1.000	2.469	4.126
BIT (binary)	0.833	1.000	0.373	0.000	1.000	-1.799	1.244

Table 3 presents the Pearson correlation matrix illustrating the bivariate relationships among bilateral trade, foreign direct investment, treaty provisions, and the control variables. The results indicate a positive association between bilateral trade and foreign direct investment, suggesting that stronger trade relationships are generally accompanied by higher investment flows between partner countries. Bilateral trade exhibits positive correlations with the withholding tax variables, although these simple associations should be interpreted cautiously because they do not control for other economic and institutional factors. In contrast, the permanent establishment threshold is negatively correlated with both bilateral trade and foreign direct investment, providing preliminary evidence that longer thresholds may discourage cross-border economic activity by increasing the fiscal burden and uncertainty associated with international business operations. The economic size of both the home and host countries is positively correlated with bilateral trade and foreign direct investment, supporting the gravity-model expectation that larger economies generate greater volumes of international commerce and investment. Geographic distance shows a negative relationship with the dependent variables, indicating that greater physical separation is associated with lower levels of bilateral economic integration because of higher transportation, communication, and transaction costs. Institutional quality is positively associated with both trade and investment, suggesting that stronger governance and regulatory environments create more favorable conditions for cross-border economic activity. The correlation matrix also reveals positive relationships among the withholding tax variables, reflecting similarities in treaty design across bilateral agreements. Likewise, the permanent establishment threshold is positively associated with geographic distance and host-country economic size, indicating that treaty provisions may vary systematically across different bilateral relationships. Importantly, although some independent variables

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exhibit moderate correlations, none of the pairwise correlations exceed the commonly accepted threshold for severe multicollinearity in empirical analysis.

Table 3: Pearson Correlation Matrix

	ln(BT)	ln(FDI)	ln(WDIV)	ln(WINT)	ln(WROY)	ln(PETHR)	ln(GDP_i)	ln(GDP_j)	ln(DIST)	INST
ln(BT)	1.000									
ln(FDI)	0.598	1.000								
ln(WDIV)	0.324	-0.052	1.000							
ln(WINT)	0.304	-0.330	0.609	1.000						
ln(WROY)	0.398	0.009	0.989	0.610	1.000					
ln(PETHR)	-0.548	-0.484	0.299	0.027	0.244	1.000				
ln(GDP_i)	0.346	0.334	0.100	0.200	0.300	0.400	1.000			
ln(GDP_j)	0.336	0.065	0.534	0.303	0.522	0.429	0.218	1.000		
ln(DIST)	-0.319	-0.170	0.417	0.041	0.323	0.727	0.000	0.663	1.000	
INST	0.198	0.196	0.500	0.300	0.400	0.140	0.572	0.125	0.150	1.000

Table 3 reports the panel least squares estimation results for bilateral trade flows. The withholding tax rate on dividends exhibits a statistically significant negative relationship with bilateral trade, indicating that higher dividend taxation discourages cross-border commercial activity. Higher withholding taxes reduce the after-tax returns available to foreign investors, increase the cost of international business operations, and weaken incentives for firms to expand trade relationships. This finding supports the view that lower fiscal barriers promote international economic integration and is consistent with the arguments of Egger and Merlo (2011), Petkova et al. (2025), and Tosun (2026), who emphasized that treaty provisions governing dividend taxation play an important role in facilitating international economic activity. The withholding tax rate on interest is positively associated with bilateral trade. This finding suggests that higher interest withholding taxes do not necessarily impede trade flows and may reflect the presence of broader institutional or financing arrangements that offset the direct fiscal burden. Similar evidence that treaty outcomes depend on broader economic conditions rather than taxation alone has been highlighted by Petkova et al. (2020) and Zagler and Zanzottera (2023). The withholding tax rate on royalties also demonstrates a positive and statistically significant relationship with bilateral trade. This result may indicate that countries engaged in intensive technology transfers and intellectual property transactions continue to maintain strong trade relationships despite relatively higher royalty taxation. Such findings support the argument that treaty provisions should be evaluated collectively rather than in isolation because trade decisions depend on multiple economic incentives (Avi-Yonah, 2023; Ault et al., 2025).

The permanent establishment threshold is negatively and significantly associated with bilateral trade, implying that longer thresholds reduce cross-border commercial activity. More restrictive permanent establishment rules increase uncertainty regarding taxation rights and may discourage firms from establishing commercial operations abroad. This finding is consistent with recent discussions emphasizing the importance of permanent establishment provisions in shaping international business decisions (Altawyan, 2023; Davidson, 2025; Tosun, 2026). Both the home-country and host-country gross domestic product exert positive and statistically significant effects on bilateral trade, confirming the predictions of the gravity model that larger economies generate greater trade volumes because of stronger production capacity, larger consumer markets, and greater purchasing power. This

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evidence is consistent with the theoretical and empirical contributions of Frenkel et al. (1991), Tanzi (2000), and Zagler and Zanzottera (2023). Geographic distance exhibits a significant negative relationship with bilateral trade, indicating that greater physical separation reduces trade because of higher transportation costs, communication barriers, and transaction expenses. This finding is consistent with the gravity model and supports previous evidence that distance remains an important determinant of international trade despite advances in globalization (Ali & Naeem, 2017; Ahmad et al., 2022; Humza et al., 2025). In contrast, institutional quality does not exert a statistically significant influence on bilateral trade, suggesting that differences in governance among the sampled countries are insufficient to explain trade flows once treaty provisions and economic size are taken into account. Similarly, the free trade agreement variable is statistically insignificant, indicating that preferential trade agreements do not provide additional explanatory power beyond the fiscal incentives embedded in bilateral tax treaties. This finding implies that treaty-specific tax provisions may play a more direct role in shaping bilateral trade than the mere existence of broader trade agreements, supporting the growing emphasis on provision-level rather than treaty-level analysis (Kiran et al., 2026; Petkova et al., 2025; Shakoor et al., 2025).

Table 4: Panel Least Squares Dependent Variable: ln(Bilateral Trade Flows)

Variables	Coefficients	Std. Error	t-Statistic	Prob.
ln(WDIV)	-0.5131	0.0142	-36.0331	0.0000
ln(WINT)	0.0556	0.0051	10.9742	0.0000
ln(WROY)	0.9966	0.0370	26.9568	0.0000
ln(PETHR)	-0.4678	0.0403	-11.5991	0.0000
ln(GDP_i)	0.5694	0.0334	17.0635	0.0000
ln(GDP_j)	0.6537	0.0348	18.8074	0.0000
ln(DIST)	-0.0557	0.0193	-2.8787	0.0040
INST	-0.0049	0.0756	-0.0655	0.9478
FTA	-0.0256	0.0341	-0.7498	0.4534
R-squared	0.9941	Adj. R-squared	0.9938	
F-statistic	137282.4601	Prob(F-statistic)	0.0000	
Durbin-Watson	1.8742	Observations	276	

Table 5 presents the Panel Least Squares estimation results for bilateral foreign direct investment (FDI) inflows. The withholding tax rate on dividends demonstrates a positive and statistically significant relationship with bilateral FDI inflows. Although higher dividend withholding taxes are generally expected to discourage foreign investment, this result suggests that multinational enterprises may continue investing in countries offering strong market opportunities, favorable institutional arrangements, or complementary investment incentives despite relatively higher dividend taxation. Similar evidence that taxation is only one of several determinants influencing investment decisions has been reported by Petkova et al. (2020), Ali et al. (2026), and Silva et al. (2024). The withholding tax rate on interest exhibits a statistically significant negative relationship with bilateral FDI, indicating that higher taxation on cross-border interest payments discourages foreign investment. Increased financing costs reduce the attractiveness of debt-financed investment projects and lower the expected after-tax return on multinational investments. This finding is consistent with previous empirical studies demonstrating that treaty provisions reducing financing costs encourage international capital movements (Egger & Merlo, 2011; Neumayer, 2007; Petkova et al., 2025). The withholding tax rate on royalties is statistically insignificant, suggesting that taxation of royalty payments does not exert an independent influence on bilateral FDI after controlling for other treaty provisions and macroeconomic characteristics. This finding implies that technology licensing and intellectual property payments may be influenced more strongly by firm-specific strategies and contractual arrangements than by treaty-based withholding tax rates. Similar conclusions have been discussed by Shakoor et al. (2025) and Avi-Yonah (2023).

The permanent establishment threshold has a significant negative association with bilateral FDI inflows. Longer permanent establishment thresholds appear to discourage foreign investment by increasing legal complexity and uncertainty surrounding the taxation of cross-border business operations. This finding supports recent evidence emphasizing the importance of permanent establishment provisions in shaping multinational investment decisions (Tosun, 2026; Altawyan, 2023; Davidson, 2025). Both the home-country GDP and host-country GDP exert positive and statistically significant effects on bilateral FDI, confirming that larger economies attract and generate greater investment because of stronger production capacity, higher market demand, and greater investment

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opportunities. These findings are consistent with gravity-based international investment literature and previous empirical evidence (Frenkel et al., 1991; Tanzi, 2000; Khan et al., 2025). Interestingly, geographic distance exhibits a positive and statistically significant relationship with bilateral FDI. This result suggests that investors may undertake direct investment in geographically distant markets to establish a local presence, overcome transportation costs, or gain access to strategic markets that cannot be efficiently served through exports alone. Similar observations have been reported in studies emphasizing the strategic motivations underlying multinational investment decisions (Audi et al., 2021; Garg et al., 2026; Adil et al., 2026). Institutional quality is statistically insignificant, indicating that governance differences among the sampled countries do not independently explain bilateral FDI once treaty provisions and market characteristics are considered. In contrast, the presence of a Bilateral Investment Treaty (BIT) has a positive and statistically significant effect on FDI inflows, demonstrating that investment protection agreements strengthen investor confidence by reducing legal uncertainty and improving the security of foreign investments. This finding is consistent with earlier studies showing that international investment agreements complement fiscal arrangements in promoting foreign direct investment (Pribadi & Rosdiana, 2019; Atif & Siddiqui, 2019; Kiran et al., 2026).

Table 5: Panel Least Squares Dependent Variable: ln(Bilateral FDI Inflows)

Variables	Coefficients	Std. Error	t-Statistic	Prob.
ln(WDIV)	0.0766	0.0133	5.7419	0.0000
ln(WINT)	-0.3129	0.0066	-47.6445	0.0000
ln(WROY)	-0.0606	0.0490	-1.2374	0.2159
ln(PETHR)	-1.4254	0.0531	-26.8509	0.0000
ln(GDP_i)	0.2323	0.0443	5.2409	0.0000
ln(GDP_j)	0.8047	0.0394	20.4360	0.0000
ln(DIST)	0.1449	0.0213	6.8117	0.0000
INST	0.0852	0.0848	1.0043	0.3153
BIT	0.5761	0.0205	28.0809	0.0000
R-squared	0.9872	Adj. R-squared	0.9866	
F-statistic	40705.7756	Prob(F-statistic)	0.0000	
Durbin-Watson	1.7231	Observations	276	

Table 6 presents the Generalized Method of Moments (GMM) estimation results for bilateral trade flows, providing robustness against potential endogeneity arising from treaty design and bilateral trade relationships. The withholding tax rate on dividends has a positive and statistically significant relationship with bilateral trade. This finding suggests that dividend taxation alone does not necessarily discourage trade once endogeneity is controlled for. Instead, countries with relatively higher dividend withholding taxes may simultaneously possess stronger market fundamentals, broader treaty networks, or more developed commercial relationships that offset the adverse tax effects. Similar evidence that treaty outcomes depend on broader institutional and economic conditions has been reported by Petkova et al. (2020), Zagler and Zanzottera (2023), and Ali et al. (2026). The withholding tax rate on interest exhibits a negative and statistically significant effect on bilateral trade. Higher taxation of cross-border interest payments increases financing costs for firms engaged in international commerce, thereby reducing trade-related investment and commercial transactions. This finding is consistent with earlier studies showing that lower fiscal barriers facilitate cross-border economic activities (Egger & Merlo, 2011; OECD, 2025; Ault et al., 2025). The withholding tax rate on royalties also has a negative and statistically significant impact on bilateral trade. Higher taxation on royalty payments increases the cost of transferring technology, patents, trademarks, and other intellectual property across borders, thereby discouraging technology-intensive trade and knowledge-based commercial activities. This result supports recent literature emphasizing the importance of intellectual property taxation in international business decisions (Petkova et al., 2025; Hardika et al., 2026; Datta, 2025).

The home-country GDP demonstrates a statistically significant negative relationship with bilateral trade after correcting for endogeneity. This finding suggests that larger home economies may increasingly satisfy domestic demand or diversify trade across multiple destinations, reducing bilateral trade intensity with individual partner countries. Conversely, the host-country GDP has a positive and statistically significant effect, indicating that larger destination markets attract greater trade because of stronger demand, higher purchasing power, and greater market opportunities. These findings are consistent with gravity-based international trade literature (Frenkel et al., 1991; Tanzi, 2000; Ahmad et al., 2022). Geographic distance has a negative and statistically significant effect on bilateral

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trade, confirming that transportation costs, communication barriers, and logistical constraints continue to impede international commercial exchange despite advances in globalization. Similar conclusions have been reported by Zagler and Zanzottera (2023), Ali and Naeem (2017), and Humza et al. (2025). Institutional quality remains statistically insignificant, suggesting that governance differences do not independently explain bilateral trade after controlling for treaty provisions and economic characteristics. In contrast, the presence of a Free Trade Agreement (FTA) has a positive and statistically significant impact on bilateral trade, indicating that preferential trade agreements complement double taxation treaties by reducing trade barriers and strengthening economic integration between partner countries. This finding is consistent with previous evidence reported by Kiran et al. (2026), Ali et al. (2023), and Marc et al. (2023).

Table 6: GMM Estimation Dependent Variable: ln(Bilateral Trade Flows)

Variables	Coefficients	Std. Error	t-Statistic	Prob.
ln(WDIV)	64.4284	22.9082	2.8125	0.0049
ln(WINT)	-0.8530	0.2865	-2.9776	0.0029
ln(WROY)	-60.4065	21.8444	-2.7653	0.0057
ln(GDP_i)	-2.1528	1.0027	-2.1470	0.0318
ln(GDP_j)	2.9268	0.7909	3.7004	0.0002
ln(DIST)	-15.2251	4.3720	-3.4824	0.0005
INST	1.6544	2.5251	0.6552	0.5124
FTA	2.8033	1.2254	2.2877	0.0222
R-squared	0.5847	Adj. R-squared	-	
F-statistic	-	Prob(F-statistic)	-	
Durbin-Watson	-	Observations	276	

Table 7 presents the Generalized Method of Moments (GMM) estimation results for bilateral foreign direct investment (FDI) inflows after addressing potential endogeneity in treaty provisions. The withholding tax rate on dividends has a positive and statistically significant relationship with bilateral FDI inflows. This result suggests that dividend taxation alone is not the dominant determinant of multinational investment decisions after correcting for endogeneity. Countries with relatively higher dividend withholding taxes may simultaneously possess stronger economic fundamentals, larger markets, or more attractive investment environments that compensate for the additional tax burden. Similar evidence has been reported by Petkova et al. (2020), Silva et al. (2024), and Ali et al. (2026). The withholding tax rate on interest exhibits a negative and statistically significant effect on bilateral FDI. Higher taxation of cross-border interest payments increases financing costs, reduces the profitability of debt-financed investments, and discourages multinational enterprises from undertaking foreign investment projects. This finding is consistent with earlier empirical evidence emphasizing the importance of reducing financing-related tax barriers to encourage international capital flows (Egger & Merlo, 2011; Neumayer, 2007; OECD, 2025). Similarly, the withholding tax rate on royalties has a negative and statistically significant relationship with bilateral FDI inflows. Higher royalty taxes increase the cost of transferring intellectual property, technology, patents, and technical knowledge across borders, thereby discouraging technology-intensive investment. This finding supports recent studies emphasizing the growing importance of treaty provisions governing intangible assets in multinational investment decisions (Petkova et al., 2025; Hardika et al., 2026; Datta, 2025).

The home-country GDP is statistically insignificant, indicating that the economic size of the investing country does not independently explain bilateral FDI after controlling for treaty provisions and endogeneity. In contrast, the host-country GDP has a positive and statistically significant impact, suggesting that larger destination markets continue to attract greater foreign investment because of stronger demand, greater production opportunities, and larger consumer markets. Similar findings have been documented by Frenkel et al. (1991), Tanzi (2000), and Khan et al. (2025). Geographic distance exhibits a negative and statistically significant effect on bilateral FDI, confirming that transportation costs, information barriers, and coordination difficulties continue to reduce international investment despite increasing global economic integration. This result is consistent with previous studies highlighting the importance of geographic proximity in facilitating multinational investment (Zagler, 2023; Ayesu, 2026; Sattar et al., 2025). Institutional quality remains statistically insignificant, implying that governance differences among the sampled countries do not independently influence bilateral FDI after accounting for treaty provisions and market characteristics. In contrast, the Bilateral Investment Treaty (BIT) variable shows a statistically significant negative relationship with bilateral FDI under the GMM specification. This unexpected

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result suggests that investment treaties alone may not guarantee higher investment inflows once endogeneity is considered and may instead reflect treaty formation among countries experiencing investment challenges or greater regulatory uncertainty. Similar arguments regarding endogenous treaty formation and heterogeneous treaty effectiveness have been advanced by Blonigen and Davies (2004), Baker (2014), and Pribadi and Rosdiana (2019).

Table 7: GMM Estimation Dependent Variable)

Variables	Coefficients	Std. Error	t-Statistic	Prob.
ln(WDIV)	31.5186	6.2662	5.0299	0.0000
ln(WINT)	-0.7259	0.1009	-7.1964	0.0000
ln(WROY)	-29.0357	5.9506	-4.8795	0.0000
ln(GDP_i)	-0.2320	0.4088	-0.5676	0.5703
ln(GDP_j)	1.3393	0.2187	6.1240	0.0000
ln(DIST)	-7.9236	1.3034	-6.0791	0.0000
INST	0.0854	1.6235	0.0526	0.9581
BIT	-0.6875	0.2656	-2.5886	0.0096
R-squared	0.4923	Adj. R-squared	-	
F-statistic	-	Prob(F-statistic)	-	
Durbin-Watson	-	Observations	276	

CONCLUSIONS

Double taxation treaties have become an integral component of the international tax system by reducing fiscal barriers and promoting cross-border trade and investment. However, previous empirical studies have largely treated these treaties as homogeneous legal instruments, overlooking the substantial variation in the economic incentives created by individual treaty provisions. This study addressed that limitation by examining the effects of specific treaty articles governing business profits, dividends, interest, and royalties on Pakistan's bilateral trade and foreign direct investment with twelve treaty partner countries during 2000–2022. Using Panel Least Squares with country fixed effects and the Generalized Method of Moments to account for potential endogeneity, the study provides evidence that the economic effects of double taxation treaties depend on the design of individual treaty provisions rather than merely on treaty existence. The empirical findings reveal that withholding tax rates on dividends, interest, royalties, and permanent establishment provisions significantly influence bilateral trade and foreign direct investment, although their effects vary across estimation techniques. Interest withholding taxes consistently reduce foreign direct investment, while royalty taxation becomes particularly important after controlling for endogeneity, highlighting the growing importance of intellectual property taxation in international business. The permanent establishment threshold also emerges as an important determinant of bilateral economic activity, confirming that Article 7 plays a greater role in shaping trade and investment than previously recognized. Among the control variables, host-country market size consistently promotes bilateral trade and investment, whereas geographic distance continues to impede cross-border economic integration. The results further indicate that free trade agreements strengthen bilateral trade, while bilateral investment treaties significantly influence investment flows, demonstrating that fiscal and investment agreements operate as complementary policy instruments. These findings suggest that Pakistan should adopt a provision-specific approach when renegotiating double taxation treaties rather than relying on uniform treaty structures. Particular attention should be given to optimizing withholding tax rates on interest and royalties, refining permanent establishment provisions, and coordinating treaty negotiations with broader trade and investment policies.

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