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Abstract

Purpose: This study sought to examine the effect of trade liberalization on tax revenue of East Africa community member countries.

Methodology: The study used descriptive research design and collected secondary data from 6 east Africa community member countries for the period between 2000 and 2023. The data was analyzed by use of simple linear regression analysis.

Findings: The study revealed that trade liberalization has a statistically positive relationship with tax revenue of east Africa community member countries.

Unique Contribution to Theory, Practice and Policy: This study contributes to validation of Hecksher-Ohlin (H-O) model in supporting the need for countries to embrace trade liberalization as a developmental strategy for developing nations to benefit from global integration, skills transfer, knowledge transfer and productive capabilities from developed nations. The study also contributes to development of optimal tax policy and trading policies with a view of enabling developing countries to maximize their potential on tax revenue for funding their development programs while at the same time remaining globally competitive to be able to attract foreign direct investments. This study also contributes to knowledge advancement by providing a framework for understanding how developing countries can achieve global economic integration by embracing trade liberalization and its impacts on the overall tax revenue processes of countries within a given trading bloc such as EAC.

Keywords: *Trade Liberalization, Tax Revenue, East Africa Community Member Countries*

JEL Codes: *F13, H20, 055*

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INTRODUCTION

Today, the urge to foster global integration amongst nations has stood out as one of the profound economic features of the world trade system. Undoubtedly, this development has led to numerous trade reforms including trade liberalization with view that it would help substantially expand trade, capital movements, information flow and facilitate technology transfer as well as mobility of labor across borders. Nonetheless, the implementation of trade liberalization initiatives particularly by least developing countries has raised fundamental questions regarding the usefulness of adopting trade liberalization policy as a strategy for enhancing tax revenue under context of declining tax revenue among EAC affiliated countries (Economic Policy Research Centre, 2020). The resultant quest to understand the nature of trade liberalization-tax revenue relationship has yielded an academic controversy. For instance, Ho, Tran & Nguyen (2023) argues that trade liberalization reduces tax revenue by exposing their nascent industries to intense competition from mature and well-developed industries from developed nations. However, Watson (2023) asserts that trade liberalization enhances tax revenue and facilitate free flow of production inputs such as capital, investment, information, labor and technological which not only support economies of scale and economic growth but also improve fiscal outcomes. Moreover, while Dama (2021) argue liberalization erodes trade taxes, others like Omodero and Yado (2024) suggest broader economic growth offsets this loss.

Trade Liberalization

Trade liberalization refers to the process of removing trade barriers to promote international trade amongst countries. Some of the non-tax trade barriers to international trade includes: restrictive quotas on imports, restrictive trade regulations and embargo. Trade liberalization also calls for the removal of trade-distorting policies so as to promote free access to market information as well as promote free movement of capital and labor amongst countries through creation of free trade zones like EAC. Trade liberalization is multi-dimensional concept and manifests in various forms of liberalization like free trade area, free trade blocs and free trade agreements which characterize world economic system as it is evident through bilateral, regional or multilateral trade agreements (Dragusha, Hasaj, Kruja, & Lulaj, 2023). In the East African Community, trade liberalization scope has included formalization of regional agreements such as the EAC Customs Union Protocol which seeks to achieve regional integration by promoting free trade through harmonizing custom procedures, establishing common external tariff for products imported outside the bounds of EAC and trade policies.

Tax Revenue

Tax refers to the compulsory payment made by the citizens to the state. From the foregoing definition of tax, it therefore follows that tax revenue refers to amount of revenue collected by government from citizens for purposes of funding governmental operations and development programmes. Some of the common examples of tax which yields tax revenue to the state includes: value added tax (VAT), pay as you earn (PAYE), presumption tax, turnover tax, stamp duty, withholding tax, housing levy tax, exercise duty tax, corporation tax, among others (Amos and Isaya, 2023). Taxes in developing countries with no exception to East Africa community member countries constitute largest percentage of national budgets. For instance, VAT rates typically range from 16% in Kenya to about 18% in Uganda, Tanzania, Rwanda, and Burundi (EAC, 2024). Moreover, Corporate Income Tax generally stands at 30% for resident companies across most EAC member states, though some countries like Rwanda offer preferential rates for certain investors or newly listed companies (EAC, 2024).

Statement of the Problem

The relationship between trade liberalization and tax revenue has been subject of serious academic controversies and debates. While Kurusic, Kurtes and Amidzic (2023) argue that trade liberalization results to increased tax revenue due to inherent tax reforms instituted by countries that adopts trade liberalization, Brautigam, Arezki, Dama and Graziosi (2021) argue that trade liberalization comes at a cost of depriving countries international trade tax revenue hence sabotaging the capacity of developing countries to finance their development projects sustainably. Moreover, Qamruzzaman (2021) put forwards that promotion of trade liberalization has an effect of reducing government tax revenue and predicating cycles of budget deficit unless efficient tax reforms are undertaken to substitute the loss of tax revenue from international trade to domestic tax revenue. However, Mugun (2021) view trade liberalization as an economic enabler which allows nations particularly those situated in developing countries to have unequivocal access bigger markets which results to more production and improved fiscal growth.

Moreover, past empirical studies have yielded mixed and conflicting findings. For instance, Raji, & Yaru (2022) examined the effect of trade liberalization on tax Revenue in Developing Economies and concluded that trade liberalization negatively affects tax revenue, Dramane (2023) examined the effect of trade liberalization on tax revenue and established that trade liberalization adversely affects tax revenue while Jabuya, Suleand and Ndwiga (2023) examined the effect of the effect of agricultural trade openness on economic growth in the east African community and established that increased openness in agricultural trade contributes to sustained economic growth and improved fiscal outcome over time. Moreover, Gnangnon & Brun, 2019) carried out a study on trade openness, tax reform and tax revenue in developing countries and concluded that trade openness positively affects tax revenue arguing that countries that liberalize trade and simultaneously implement effective domestic tax reforms tend to experience higher tax-to-GDP ratios. Given these mixed findings and the lack of region-specific studies, this research seeks to examine the following question: What is the effect of trade liberalization on tax revenue in EAC member countries?

Theoretical Framework

Hecksher-Ohlin (H-O) model

The Heckscher-Ohlin theory was developed by Heckscher and Ohlin around 1920s. This theory provides a foundational framework for understanding international trade based on differences in resource endowments amongst countries. The theory posits that due to the unequal global distribution of factors of production such as land, labor and capital, countries should specialize in producing goods and services for which they have a comparative advantage, that is, goods that they can produce more efficiently due to their resource abundance while importing goods that are less efficiently produced domestically due to resource scarcity. This theory is founded on the principle of specialization and trade forms which emphasizes that global trade patterns are largely shaped by differences in national resource endowments (Heckscher & Ohlin, 1920).

Within the context of trade liberalization, the theory suggests a positive relationship between trade liberalization and increased tax revenue and argues that the removal of quotas, and other restrictions trade practices enhances global integration, facilitates the flow of capital and technology and promotes the transfer of knowledge across borders. These developments often result in increased foreign direct investment (FDI) and the establishment of multinational corporations (MNCs), both of which contribute to broader economic growth. The economic

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activities of MNCs in liberalized economies are believed to stimulate productivity, expand the tax base, and ultimately lead to higher tax revenues (Kurusic *et al.,* 2023).

Nonetheless, the theory has faces substantial critique, primarily due to its core assumption that the only difference between trading nations lies in their resource endowments. This assumption overlooks crucial institutional and governance-related variables such as corruption, regulatory inefficiencies, and illicit financial flows. In many developing economies, these governance challenges undermine the potential benefits of trade liberalization including boost on tax revenue. For instance, although trade may expand and attract MNCs, the presence of weak institutions often facilitates tax evasion, transfer pricing, and bribery, resulting in significant revenue losses for governments. Thus, while the Heckscher-Ohlin model offers an optimistic view of trade's potential, its applicability is limited in real-world scenarios where governance quality significantly influences economic outcomes. The theory does not inherently predict tax revenue outcomes. While H-O model focuses on production specialization, its application to tax revenue assumes that liberalization-driven economic expansion leads to a broader taxable base. However, the validity of this assumption wholly depends on the governance context prevailing within the East African Community (EAC). It is notable that EAC member countries continually grapple with challenge of collecting ample tax revenue due to structural and institutional barriers which adversely affect tax administrations resulting to limited automation, low taxpayer compliance and insufficient capacity for audit and related enforcement. For example, tax revenue authorities in countries like Uganda and Tanzania continue to grapple with outdated systems, limited data integration and high levels of tax evasion, particularly among small and medium enterprises (SMEs). Moreover, the existence of porous borders and the prevalence of informal cross-border trade pose serious constraints to tax revenue collection. Particularly, Informal trade routes, often used to evade tariffs and regulatory controls contribute to substantial losses in customs and VAT revenue (EAC, 2020). Further, induced formal trade by trade openness is often curtailed by the challenge compounded by weak inter-agency coordination, underdeveloped transport infrastructure and rampant bureaucratic delays at border posts creating opportunities for corruption and smuggling (Ouma and Nganga, 2023).

Dependency Theory

The theory, originally was advanced by Raúl Prebisch and Hans Singer in the late 1950s. the theory sought to explain the persistent disparities in economic development between developed nations and those regarded as least developing nations. It emerged as a direct response to the limitations of modernization theory, which had failed to adequately address the unique developmental challenges faced by many countries, particularly across Latin America, Africa, and Asia. While modernization theory assumed that all countries follow a uniform path to development, this alternative perspective challenged that assumption by highlighting the structural inequalities embedded within the global economic system. Central to this theory is the argument that international trade, as promoted by proponents of modernization, disproportionately benefits developed nations while disadvantaging developing economies. It posits that world trade system represent an unequal exchange system in which developing countries are relegated to the role of exporting raw materials and agricultural produce at minimal prices, while being compelled to import finished goods from industrialized countries at significantly higher costs. This imbalance in trade terms systematically hinders the economic advancement of developing nations.

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The theory is notably critical of trade liberalization and instead advocates for developing nations to embrace protective trade policies to support domestic industries, enhance employment, and improve tax revenue generation. It warns that exposing emerging local industries to international competition through premature trade liberalization can lead to their collapse, resulting in widespread job losses and reduced government revenue. Moreover, opening up domestic markets increases reliance on a narrow range of primary export commodities, limiting economic diversification and exposing countries to vulnerabilities from global price and demand fluctuations. Additionally, the theory expresses concern over the influence of multinational corporations, which often enter developing markets under liberalized trade regimes. While their presence is typically justified on the basis of foreign investment and technology transfer, this theory contends that many MNCs engage in practices such as transfer pricing and complex accounting maneuvers that ultimately reduce their tax obligations in host countries. As such, these corporations extract local resources and repatriate profits to their home countries, contributing minimally to the socio-economic development of the host nations. In this way, MNCs are viewed not as development partners but as instruments for deepening economic dependency and reinforcing global inequality (Kurauone *et al.,* 2021).

Typically, in East Africa Community, the proliferation of MNCs under liberalized regimes has led to concerns over tax base erosion, particularly due to transfer pricing (EAC Secretariat, 2022). For instance, investigations in Kenya have revealed that several subsidiaries of multinational retail and manufacturing firms underreport profits through inflated intra-group service charges. Similarly, in Uganda, the Uganda Revenue Authority has flagged extractive sector MNCs for shifting profits through overpricing of imported capital equipment and underpricing of exports to affiliated entities. Moreover, in some sectors like telecommunications and mining sectors which are often dominated by large international players due to their profit potential are often subject of frequent tax scrutiny due to aggressive tax planning strategies which shift profits out of the host country, thereby reducing the taxable income declared locally (UNECA, 2023). This issue has escalated the tension between the need to attract Foreign direct investments by lowering taxes and the need to rise tax rates to guarantee ample tax revenue for nation development. It is arguable that while trade liberalization aims to attract investment and foster economic growth, the existence of weak regulatory environments in developing countries such as EAC coupled by limited capacity of tax authorities to effectively implement and enforce tax laws has inadvertently created avenues for profit shifting and compromised the potential tax revenue gains from increased economic activity due to trade liberalization. Consequently, the anticipated positive impact of the presence of multinational corporations on the domestic tax base have in most cases fallen short of the expectations raising fundamental questions about the true developmental benefits derived from liberalizing trade policies particularly in East Africa community region (AfDB, 2024).

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Conceptual Framework

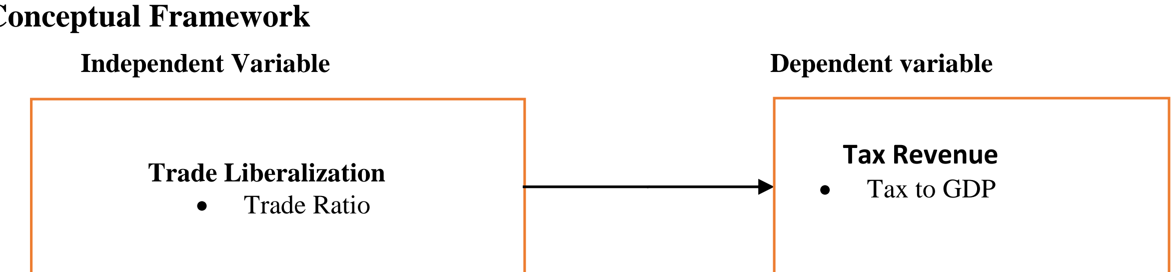

Figure 1: Conceptual Framework

Empirical Review

Omodero and Yado (2024) carried out a study on trade Liberalization on Market Expansion: Evidence from Emerging Economies. The study adopted a quantitative research design using panel data regression analysis to evaluate the relationship between international border openness and the adoption of liberal trade policies. The study covered a sample of 30 emerging economies from 2000 to 2022, drawing data from sources such as the World Bank, World Trade Organization (WTO) and International Monetary Fund (IMF). The study used trade Openness Index as a proxy for liberal trading policies, Foreign Market Penetration Ratio as a proxy for untapped international market opportunities while tariff Rates, FDI inflows, and Export Growth Rate were used as a control variable. The findings revealed that Liberal trade policies were shown to stimulate greater foreign market penetration, particularly in non-traditional export sectors. Moreover, the study emphasized that trade liberalization enabled by international cooperation not only boosts economic integration and increased tax revenue but also enhances competitiveness of domestic industries.

Dama (2021) carried out a study on the relationship between trade liberalization and domestic revenue mobilization in Developing Economies: Evidence from a Cross-Country analysis. The study adopted a cross-sectional research design using panel data from 25 low- and middle-income countries over the period 2000 to 2019. The study aimed to investigate the impact of trade liberalization on domestic tax revenue mobilization, with a focus on how open trade policies affect tax revenue performance. Data were sourced from the World Bank, IMF and the World Trade Organization. Domestic tax revenue mobilization was measured by tax revenue as a percentage of GDP while trade openness was measured by ratio of total trade to GDP. GDP per capita, inflation rate, foreign direct investment, exchange rate volatility and quality of public governance were used a control variable. The findings revealed that trade liberalization has a negative effect on tax revenue especially in countries characterized by weak public governance institutions and high reliance on trade taxes. The study however never considered EAC trading bloc and this necessitated the need for this study to establish how trade liberalization influence tax revenue of EAC affiliated countries.

METHODOLOGY

The study adopted positivism research philosophy approach and descriptive research design. The population of the study was made up of 6 EAC member countries. Secondary data was collected from the year 2000 to 2023. The data was analyzed by use of simple linear regression analysis with aid of the following regression model.

$TR_{It} = ạ + ß_1 X_{1It} + ἕ$ Where: ß= Regression coefficients, X_1=Trade openness ratio, TR= Tax revenue, ἕ= Error terms.

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FINDINGS

Regression Analysis

This was conducted to examine the effect of trade liberalization on tax revenue of east Africa community member countries

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.221[a]	.049	.042	3.83488533

a. Predictors: (Constant), Trade Ratio

The result indicated that the model could explain about 4.9% of the total variations in the value of the tax revenue.

Table 2: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	107.632	1	107.632	7.319	.008[b]
	Residual	2088.301	142	14.706		
	Total	2195.933	143			

a. Dependent Variable: Tax Revenue
b. Predictors: (Constant), Trade Ratio

The result indicated that the model was statistically significant (F=7.319, P=0.08) implying that it could be used in estimating future values of tax revenue.

Table 3: Regression Coefficients

	Model	Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	13.825	.957		14.447	.000
	Trade Ratio	.056	.021	.221	2.705	.008

a. Dependent Variable: Tax Revenue

The findings from this analysis revealed that trade liberalization has a statistically significant and positive relationship with tax revenue implying that a unit increase in the value trade liberalization would result to 0.056 increase in the value of tax revenue.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The study concludes that trade liberalization has a positive and significant impact on the tax revenue of East African Community (EAC) member countries. This finding suggests that opening up to international trade not only enhances economic activity but also strengthens the capacity of governments to mobilize domestic tax revenue. Moreover, by facilitating the free flow of goods and services, trade liberalization expands the tax base through increased trade volumes, higher business turnover and the formalization of cross-border economic activities which collectively leads to increased tax revenue. As trade increases, so does the collection of value-added taxes (VAT), corporate income taxes, and other consumption-related levies which improve the overall fiscal outcome. However, the potential gains from trade liberalization within the East African Community (EAC) may be severely undermined by structural

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limitations in tax systems, the prevalence of weak public governance institutions and the dominance of informal economies, all of which constrain effective tax collection and governance.

Recommendations

The study therefore recommends that east Africa community member countries should endeavor to embrace trade liberalization policies by removing trade barriers in order to take advantage of spillage of manpower resources and capital flows from developed nations. By eliminating restrictive quotas, and non-tariff restrictions, EAC countries can position themselves as attractive destinations for foreign capital, particularly from developed nations seeking new markets, lower production costs and favorable investment returns. Trade liberalization enables the free flow of goods, services, and capital, which can stimulate economic activity, create jobs, and promote technological advancement.

Moreover, EAC affiliated countries should embrace trade liberalization in order to facilitates the movement of manpower across borders which can allow skilled professionals from developed countries to bring expertise, innovation, and global best practices to the region. At the same time, local workers can benefit from exposure to international standards through training and collaboration, leading to human capital development. Additionally, labor mobility can result in increased remittances from EAC nationals working abroad, contributing to household incomes and national revenue.

The study recommends implementation of public institutional reforms in order to among other things strengthen tax administration through digitalization of records, training of tax officers and capacity building to enhance transparency, reduce delays in tax processing at strategic border points like ports and curb tax leakages through illicit trade. This is based on the realization that despite the clarion call for regional integration to tap the potential of trade liberalization including enhanced tax revenue growth, nearly all EAC member countries face persistent challenges of collecting ample tax resources due to weak tax administration, inadequate infrastructure and inefficiencies at border points which limit the capacity of member states to fully capture the fiscal benefits of increased trade liberalization.

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