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Trade Liberalization, Public Governance, Foreign Direct Investment and Tax Revenue - Evidence from East Africa Community Member Countries

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Abstract

Tax revenue is a fundamental source of government financing and plays an important role in supporting economic development, provision of public services and fiscal sustainability. However, East African Community (EAC) member countries continue to experience challenges in mobilizing adequate domestic tax revenue amid increasing regional economic integration, trade liberalization and competition for foreign direct investment. This study examined the relationship between trade liberalization, public governance and foreign direct investment on tax revenue of EAC member countries. Trade liberalization was operationalized using trade openness ratio, public governance using the Corruption Perception Index, foreign direct investment using net foreign direct investment flows, and tax revenue using the tax-to-GDP ratio. The study adopted a longitudinal panel research design covering EAC member countries over the period 2000 to 2023. Panel data was employed to establish the joint relationships between the explanatory variables and tax revenue. The findings revealed a statistically significant relationship between trade liberalization, public governance, foreign direct investment and tax revenue. The findings demonstrated that economic openness, investment flows and institutional quality are important dimensions of domestic tax revenue mobilization in the EAC. As a result, this study recommended strengthening domestic tax administration alongside trade liberalization, improving governance and accountability, and developing investment policies that encourage productive FDI while safeguarding the domestic tax base as strategies for enhancing tax revenue of EAC affiliated countries.

Keywords: Trade liberalization, public governance, foreign direct investment, tax revenue, EAC.

1. INTRODUCTION

Tax revenue constitutes one of the most important sources of domestic financing for governments. It provides resources for financing public infrastructure, education, healthcare, security, social protection and other government projects. A strong domestic tax revenue base also enables countries to reduce excessive dependence on external borrowing and development assistance. For developing economies, therefore, the capacity to mobilize adequate tax revenue is closely

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associated with the ability to achieve sustainable economic development (Kassim, 2024). The challenge of domestic tax revenue mobilization has become increasingly important for developing countries such as countries situated in East African Community. EAC member countries have progressively pursued regional integration through increased trade, investment and economic cooperation. To this end, trade liberalization has reduced barriers to the movement of goods and services and created opportunities for countries to participate more actively in regional and international markets. While increased trade stands to stimulate economic activity and broaden the tax base, trade liberalization also comes with possibility of reducing tax revenue previously obtained from tariffs and other trade-related taxes (Ndoye, 2021).

The link between trade liberalization and domestic tax revenue is not straightforward because greater openness can produce both tax revenue gains and tax revenue losses. Increased trade may generate additional economic activity, consumption, corporate income and employment, which can expand the domestic tax base. Conversely, reductions in tariffs can reduce customs tax revenue (Ho, Tran & Nguyen, 2023). The fiscal effect of liberalization therefore depends on the ability of governments to replace declining trade-related revenues with taxes collected from expanding domestic economic activity. FDI similarly occupies an important position in the economic development strategies of EAC member countries. Governments attract foreign investors with the expectation that external capital will supplement domestic savings, increase productive capacity, generate employment, support technological advancement and strengthen export-oriented activities. Foreign-owned enterprises can contribute to government revenue through corporate taxation, employment-related taxes, consumption taxes and other domestic taxes. Nevertheless, the fiscal contribution of FDI largely depends on investment incentives, tax exemptions, the sector receiving investment and the effectiveness of tax administration (Nguyen & Zhang, 2022).

Moreover, the trading atmosphere which is displayed by the existing public governance conditions plays a critical institutional role in shaping how trade liberalization and foreign direct investment translate into domestic tax revenue. Effective public governance strengthens tax administration, improves regulatory enforcement, promotes transparency and accountability, and helps to curb corruption and tax revenue leakages. These institutional factors influence the capacity of governments to capture tax revenues arising from increased economic activity, trade and

investment. Consequently, the relationship between trade liberalization, FDI and tax revenue cannot be understood solely in terms of economic openness and investment flows alone, but it must also be considered within the public governance environment in which these activities occur. The EAC therefore provided an important context for examining how trade liberalization, FDI and public governance jointly influence domestic tax revenue (Mohammed & Raji, 2022).

Despite the potential benefits associated with trade liberalization and FDI, EAC member countries continue to face challenges in mobilizing adequate domestic tax revenue. These challenges include narrow tax bases, large informal sectors, tax exemptions and incentives, weak compliance, cross-border tax avoidance, corruption and limited administrative capacity. Increased regional integration may also create opportunities for multinational enterprises to shift profits across jurisdictions, thereby reducing the amount of taxable income reported within individual member states. In this context, the effectiveness of public governance has been viewed as a critical step because transparent institutions, effective regulatory systems and accountable tax administrations can enhance tax compliance and reduce tax revenue leakages (Mohammed & Raji, 2022). Hence, understanding how trade liberalization and FDI interact with the quality of public governance is therefore important for explaining differences in tax revenue performance across EAC member countries. Against this background, this study sought to establish the relationship between trade liberalization, public governance, foreign direct investment and tax revenue of EAC member countries.

2. METHODOLOGY

The study adopted positivist research paradigm and adopted longitudinal panel research design covering EAC member countries for the period between 2000 to 2023. The population of the study comprised of six EAC member countries and collected published secondary data. The analysis was done with aid of regression estimation. The findings obtained were presented in a table.

3. RESULTS

Table 1: Trade Liberalization, FDI, Public Governance and Tax Revenue

Variable	β	SE	Std. β	T	Prob.	R	R ²	Adj. R ²
Model	–	–	–	–	–	0.452	0.204	0.187
Constant	10.005	1.228	–	8.147	0.001*	–	–	–
Trade ratio	0.013	0.02309	0.050	0.563	0.0474	–	–	–
CPI	0.127	0.030	0.316	4.176	0.001*	–	–	–
FDI	-0.585	0.168	-0.311	-3.485	0.001*	–	–	–
F	11.989	–	–	–	–	–	–	–
P (F)	0.001	–	–	–	–	–	–	–

Note: *Statistically significant at the 5% level.

As shown in table 1 above, the study established that trade liberalization, public governance and foreign direct investment jointly have a statistically significant relationship with tax revenue ($F=11.989$, $P=0.001$). The results further indicate that trade openness ($\beta = 0.013$) and public governance ($\beta = 0.127$) are positively associated with tax revenue, implying that increases in these variables are accompanied by corresponding increases in tax revenue. In contrast, foreign direct investment exhibited a negative relationship with tax revenue ($\beta = -0.585$), suggesting that increased FDI may be associated with declining domestic tax revenue. This negative association may partly reflect the influence of multinational enterprises, particularly where profit-shifting practices, tax incentives, exemptions and other mechanisms reduce the taxable income captured by host-country tax authorities. This demonstrates that domestic tax revenue mobilization is influenced by both economic and institutional governance factors.

4. DISCUSSION

The findings demonstrate that trade liberalization, public governance and foreign direct investment jointly have a statistically significant relationship with tax revenue among EAC member countries ($F = 11.989$, $p = 0.001$). This result suggests that tax revenue performance of the EAC member countries cannot be explained by a single economic factor but instead is influenced by the interaction of economic openness, foreign investment and the institutional environment within

which economic activities take place. The joint significance of the model indicates that changes in trade openness, governance and FDI collectively provide important information for understanding variations in domestic tax revenue across EAC member countries.

The positive relationship between trade openness and tax revenue ($\beta = 0.013$) suggests that greater integration into international trade may contribute to the expansion of the domestic tax base. Trade liberalization can stimulate economic activity by increasing the movement of goods, services and capital across borders, while also encouraging investment, production and consumption. As economic activity expands, governments may generate additional revenue through corporate income taxes, value-added taxes, employment-related taxes and other domestic sources. The finding therefore suggests that although trade liberalization may reduce reliance on traditional trade taxes such as tariffs, the resulting expansion in economic activity can potentially compensate for part of the revenue lost from custom-based taxation. This relationship, however, depends on the capacity of EAC governments to effectively broaden and administer domestic tax bases.

The positive coefficient for public governance ($\beta = 0.127$) further demonstrates the importance of institutional quality in domestic tax revenue mobilization. Effective governance comes with benefits of strengthening tax administration, improving regulatory enforcement, enhancing accountability and reducing opportunities for corruption and tax revenue leakage. Where public institutions function effectively, economic activities generated through trade and investment are more likely to be captured within the formal tax system. Good and effective public governance also promotes taxpayer confidence and compliance by creating a more transparent and predictable institutional environment. The finding therefore indicates that increasing economic activity alone may not be sufficient to improve tax revenue; the ability of governments to convert such activity into actual public revenue is also dependent on the quality and effectiveness of public governance institutions. In contrast, foreign direct investment exhibited a negative relationship with tax revenue ($\beta = -0.585$) suggesting that an increase in FDI does not necessarily translate into a corresponding increase in domestic tax revenue of the EAC member countries especially where a country extensively uses investment incentives, tax holidays and generous tax exemptions to attract foreign investors. While such measures may encourage investment and employment, they can simultaneously reduce the immediate tax contribution of foreign-owned enterprises.

The negative relationship may also be associated with the activities of multinational corporations that operate across several jurisdictions and may have greater opportunities to structure their transactions in ways that reduce taxable income in host countries. In particular, profit shifting may contribute to the observed negative association between FDI and tax revenue. Multinational enterprises can undertake cross-border transactions involving related entities, financing arrangements, royalties, management fees and transfer pricing, which may affect where profits are reported for tax purposes. Where tax administration and enforcement capacity are limited, some of the economic value generated within an EAC country may therefore not be fully reflected in the domestic tax base. The finding should not, however, be interpreted to mean that FDI is inherently harmful to tax revenue. Rather, it highlights the importance of the institutional and policy conditions under which FDI operates, including the design of tax incentives, enforcement of transfer-pricing rules and capacity of revenue authorities.

4.1 Conclusion

The study concludes that trade liberalization, public governance and foreign direct investment significantly affect tax revenue, demonstrating that tax revenue is shaped by a combination of both economic and institutional conditions. This suggests that the capacity of developing countries such as EAC member countries to mobilize tax revenue does not depend solely on the level of taxation or the efficiency of tax administration but also depends on the broader economic and institutional environment within which taxation takes place. Opening economies to international trade creates opportunities for tax revenue mobilization, but the extent to which these opportunities are converted into sustainable domestic tax revenue depends on the capacity of governments to manage investment, regulate economic activity and administer taxation effectively. This implies that EAC member countries need to view trade integration, investment promotion, public governance reforms and domestic tax revenue mobilization as interconnected components of regional economic policy rather than as separate policy areas.

4.2 Recommendations

Governments should carefully evaluate the use of tax holidays, exemptions, deductions and other fiscal incentives provided to investors. While such incentives may be used to attract investment, excessive or poorly targeted incentives can reduce government revenue without necessarily

generating proportional economic benefits. EAC member countries should therefore establish clear criteria for granting investment incentives and regularly assess their economic and fiscal outcomes. Investment promotion should be balanced against the need to maintain a sustainable domestic tax base. Where incentives are provided, they should preferably be targeted towards investments that generate substantial employment, technology transfer, exports, domestic value addition and linkages with local enterprises. A transparent and coordinated approach to investment incentives would help EAC countries avoid unnecessary competition for investment at the expense of domestic revenue mobilization.

EAC member countries should strengthen cooperation among their respective tax authorities in response to the increasing movement of goods, services, capital and investment across national borders. Greater regional integration creates more cross-border transactions and increasingly complex business arrangements, requiring coordinated approaches to tax administration. Tax authorities should therefore strengthen information exchange, joint compliance initiatives and cooperation in addressing cross-border tax risks. Regional cooperation can also support the identification of taxable activities that may otherwise remain outside the reach of individual national tax authorities. Harmonization and coordination of selected tax policies and administrative practices would further reduce opportunities for tax avoidance and improve the effectiveness of domestic revenue mobilization within the Community.

EAC governments should pursue policies that strengthen the relationship between economic growth and tax revenue rather than relying primarily on increases in tax rates. Sustainable revenue growth requires expansion of productive economic activity and development of a broad and formal tax base. Governments should therefore promote policies that encourage business productivity, entrepreneurship, investment, employment creation and domestic value addition. The expansion of formal economic activities can increase the number of businesses and individuals participating in the tax system and consequently broaden the revenue base. Similarly, improvements in infrastructure, access to finance, skills development and the business environment can support productive investment and economic expansion. A broader and more productive economy provides a more sustainable foundation for tax revenue than repeated increases in tax rates. The

objective should therefore be to create an economic environment in which growth, investment and formalization reinforce domestic revenue mobilization over the long term.

Tax authorities within the EAC should invest in modern and efficient tax administration systems capable of responding to the increasingly integrated nature of regional economies. This should include strengthening taxpayer registration, information management, electronic filing and payment systems, data analytics and compliance monitoring. Digitalization can enable revenue authorities to obtain timely information about businesses and transactions, thereby improving their capacity to identify taxable economic activities. Greater integration of tax information can also help revenue authorities monitor transactions involving businesses operating across national borders. As trade and investment become increasingly interconnected within the EAC, tax administrations need to move beyond traditional methods of revenue collection and adopt technology-based systems that improve efficiency, transparency and compliance.

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