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# REVENUE IMPLICATIONS OF EPA ON TANZANIA

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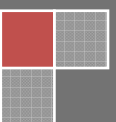


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# 1. The Background and Rationale

## 1.1 The Background

Tanzania is one of the partner states in the East African Community (EAC).<sup>1</sup> The total population of the EAC in 2007 stood at 127 million, while the combined GDP in the same year for the Community was US\$63.4 billion (see Table A1 in the appendix). Notwithstanding the low GDP per capita of the partner states, the EAC is a large market compared to most individual countries in Africa and thus, it presents significant potential for firms to utilize its vast natural resources for increasing productivity.

The EAC was “reborn” in 2001 after its collapse in 1977. One of the key objectives of the “new” EAC is to promote free trade, with an ultimate aim of forming a political union. Since its resumption, there has been a speedy progress in cementing the integration of the region that culminated in a customs union in 2005. Currently, the EAC is engaged in negotiations to establish a common market by 2010.<sup>2</sup> While negotiations are steadily progressing, some issues are yet to be resolved. For example, Tanzania is reluctant to allow free access to land, and hence the land issue is a vexing problem in the negotiation. Tanzania views with scepticism the huge inequality in land ownership in some of her neighbours and is afraid that the current practice of land ownership in Tanzania which is largely devoid of speculation and has proven to be rather equitable and respects communal sentiments and aspirations, must not be compromised by acceding to the demands of some other members of East African Community of allowing free access of land across the East African Community.

The Community is currently negotiating with the EU an Economic Partnership Agreement (EPA). The full EPA, which was expected to come into force in July 2009, is being negotiated between the EU and regional blocks of the African, Caribbean and Pacific countries. Tanzania had earlier indicated willingness to negotiate as part of SADC, but later decided to negotiate as part of the EAC.

The general objectives of the EU-EAC EPA are outlined in Article 2 of the agreement, and they encompass the establishing of a strong trade and development partnership that will help to contribute to development, promoting regional integration as well as integration of EAC in the global economy, economic cooperation and good governance, helping to build trade policy capacity, developing the EAC’s production and trade capacity, establishing a transparent regulatory system that will attract investment, and strengthening relations that exist between the EU and the EAC (EAC and EU, 2009, p.7).

One of the key objectives of EPA relates to regional integration. The aim is to enhance trade by removing trade barriers. Specifically, the EU-EAC EPA aims to establish a free trade area between the EU and the EAC. While a full EPA is being negotiated, this study will only focus

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<sup>1</sup> The other partner states are Kenya, Uganda, Rwanda and Burundi.

<sup>2</sup> The draft protocol was expected to be out in April 2009, after the last round of negotiations that occurred in Kampala in March 2009 (<http://www.eac.int>).

on an area that has so far been agreed and concluded. This relates to the aspect of the trade regime in goods, whose objectives are specified in Article 5 as;

- Eventually providing full duty free and quota free market access for products from the EAC into the EU,
- Progressively and gradually liberalizing the market for goods in the EAC, and
- Preserving and improving market access conditions so that the EAC countries are prevented from being worse off (EAC and EU, 2009, p.9).

The schedule of liberalizing the market for goods that has been agreed is given in Table 1. It summarizes the amount of trade that will be liberalized of goods originating from the EU. Liberalization will proceed in phases, and the agreement contains the schedule of import duty reductions till 2033. The first phase will involve the liberalization of 65.4% of imports originating from the EU into EAC by 2010. It will involve goods that are zero rated, namely machinery, raw materials, industrial chemicals and essential medicines.

The second phase will involve gradually reducing goods that are 10 percent rated, which include intermediate goods for a period of 15 years. The last phase will involve goods that attract 25 percent duty, which are consumer goods. These will be phased down in 10 years. In terms of goods originating from the EAC going to the EU, they will be imported in the EU free of duties. The liberalization process will thus be asymmetrical.

**Table 1: Summary Table of EAC Market Access Offer**

YEAR	VALUE, USD LIBERALIZED	% OF TRADE LIBERALIZED	VALUE, USD, EXCLUDED	EAC EXCLUSION	EC LIBERALIZATION
2010	1,615,331,216	65.4%	428,818,834	17.4%	100%
Within 15 years	361,011,102	14.6%			
2033	64,864,379	2.6%			
Exclusion					
Total trade liberalized EAC	2,041,206,694	82.6%			
Total EAC Imports from EU	2,470,025,527				

*Source: EAC and EU, 2009.*

The liberalization of trade between the EU and the EAC will have revenue implications that will ultimately have developmental implications on the countries. This is because the EAC partner countries significantly rely on trade taxes as major sources of revenue (see Table 2). It is thus important to examine these implications. This study examines the revenue and development implications of an EU-EAC EPA on Tanzania.

## 1.2 The Rationale

The question of revenue implications of EPA on the ACP countries has been widely studied and debated (see studies by Karingi *et al*, 2005; Milner *et al*, 2005; Zouhon-Bi and Nielsen, 2007, among others). The debate is a valid one given the development implications of the reduction in government revenue that will result from the elimination of customs duties. Table 2 below shows the extent to which three of the EAC partner countries are reliant on trade taxes. Uganda tops the group with the highest percentage of trade taxes in its total revenue, followed by Tanzania. Such a high reliance on trade taxes as a source of government revenue is a threat to development objectives of these countries, if alternative sources are not found.

While there are many issues that research could help in understanding the implications of various aspects of EPA, this research will limit itself to addressing the following two questions;

- What are the revenue implications of EPA on Tanzania?
- Given that there will be reduced fiscal revenues due to removal of import duties, what are the budgetary implications of EPA on Tanzania?

**Table 2: The Importance of Trade Taxes to Total Revenue**

	2006	2007
Kenya	39.5	38.6
Uganda	49.9	50.8
Tanzania	44.3	44.2

*Source: EAC Trade Report 2007.*

This research combines a desk review of studies done by other researchers, as well as our own analysis of revenue and development implications of EPA. The desk review has been necessitated by a lack of time and funding for more technical research.

The research report is organized as follows; after giving a background and rationale of the study in Section 1, Section 2 presents an overview of the theory of issues relevant for examining revenue and development implications of regional trade agreements, as well as the methods employed in such studies. Section 3 presents results of studies on revenue implications on Tanzania. This section also gives our own analysis of the revenue implications of EPA on Tanzania as well as the policy challenges that the Tanzanian government must confront. Section 4 gives some concluding remarks.

## 2. Theoretical and Methodological Overview

### 2.1 Theoretical Overview

The EPA's aim is to establish a free trade area between the EU and the ACP countries. It is important to examine the theoretical literature on the implications of such a preferential trade arrangement on the ACP countries, before examining the likely implications found.

The theoretical literature on effects of any preferential trade area is based on the pioneering work by Viner (1950), that examines the following effects; trade creation, trade diversion, and revenue effects. Although the theoretical work is based on Viner (1950), it is important to remember that in the case of the EU-EAC EPA, the framework needs slight modification from the standard one. This is because, with the EU-EAC EPA, a free trade area is going to have an agreement to remove tariffs on trade with another economic grouping. That is, the EAC is already a free trade area that is going to have an economic agreement to have duty free trade with another regional grouping, the EU. As such, the theoretical framework has been clearly presented bearing in mind this twist, by Milner *et al* (2005) on how the various effects of this agreement will play out<sup>3</sup>. This review thus follows that work. This theoretical review also examines the structural and employment effects of a free trade area.

### *Trade creation*

In standard analysis, when countries form a free trade area, trade creation can occur when the removal of tariffs changes the prices of imported goods, such that less efficient domestic production is replaced by imports from members of the free trade area whose products are now cheaper with the removal of tariffs. As Milner *et al* (2005) explain, “trade creation usually describes the displacement of less efficient home production by globally efficient extra-regional production” (p.334). In the case of the EU-EAC EPA, the EAC already constitutes a customs union, and it will have a free trade agreement with the EU, which is an economic union. Such a partnership will result in trade creation by lowering the prices of imports from the EU to the EAC, hence displacing production in the EAC. The EPA will entail “replacement of intra-regional imports by more efficient extra-regional imports from the EU” (p.334). Clearly, the change in the prices of goods will change the level of domestic demand for imports. In the case of imports from the EU that are demanded by consumers in Tanzania and the EAC, after the fall in prices that occurs with the removal of tariffs, the demand for the imports would increase. This is a positive consumption effect that will benefit consumers.

The trade creation effect is thus welfare improving, since consumers of the imports whose prices fall enjoy the goods at a lower cost. The fact that the prices are reduced also allows many more consumers to afford the cheaper goods that are of a potentially higher quality when tariffs are eliminated.

### *Trade diversion*

Again, in standard analysis, trade diversion occurs when after the formation of a free trade area, the elimination of tariffs leads to a substitution of goods from countries that are not part of the free trade area but are more efficient, to goods from countries that form the free trade area. Or as Milner *et al* (2005) define it, “trade diversion usually relates to diverting trade from more efficient extra-regional suppliers to less efficient intra-regional suppliers (p. 333). In the case of the EU-EAC EPA, trade diversion will occur when products from more efficient non-EU and non-EAC countries are diverted in preference for the EU sources that are less efficient.

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<sup>3</sup> The reader is referred to Milner *et al* (2005) for their complete analytical framework that even presents a figure for a clear exposition.

Trade diversion is welfare reducing as the elimination of tariffs leads to the switching of the source of imports from a more efficient and low cost source (in this case a non-EAC source or non-EU source) to a less efficient producer from the EU or EAC (who are part of the preferential treatment under the agreement), which only become cheaper on account of the preferential treatment that it gets under the EPA. However, Milner *et al* (2005) note that the cost of trade diversion is likely to be smaller, and hence increasing the probability of a welfare improving EU-EAC EPA, if the EU is more efficient than non-EU sources.

### *Revenue Effect*

The revenue effect relates to the loss in government revenue that occurs when the elimination of tariffs leads to a loss in customs duties charged on imported goods. The loss in customs duties means a loss in funds going to the government's budget. The extent of loss of customs revenue from imports depends on the extent of trade between countries involved; in this case between Tanzania and the EU, or between the EAC and the EU.

A key debate in the literature is the implication of such revenue losses on development objectives in countries involved. Concern stems from the fact that a reduction in government revenue resulting from a loss of customs duties can affect a government's ability to provide essential public services. Important public services such as education and health can be in real danger, and as such, the developmental effects of such losses in revenue can be enormous unless alternative funds for such losses are found.

The revenue effect of a preferential trade agreement such as a free trade area is a major concern of most countries. Specifically, the revenue impact of EPA is a major concern to the EAC. This is not surprising, since most developing countries' source of revenue is from import duties (see Table 2). As such, a reduction in these revenues will have *budgetary* implications that can affect development goals.

Studies have quantified the loss of revenue from import duties to provide an indication of the extent to which development goals will be affected. Studies that have been done on other African countries have estimated figures of around 20-30 percent loss in government revenue as a result of reciprocal free trade with the EU (see Karingi *et al*, 2005). In a study on ECOWAS, Zouhoun-Bi and Nielsen (2007) found the following government revenue losses; Cape Verde (15.8%), Senegal (10.4%), Ghana (7.1%), and Nigeria (2.4%). Another study by Busse *et al* (2004) on ECOWAS confirmed this finding that Cape Verde would have the largest loss in government revenue from having a tariff barrier-free trade regime with the EU (Karingi *et al*, 2005).

The study by Karingi *et al* (2005) also reports findings from a study by Tekere and Ndlela (2003) that was done on SADC countries; that "countries like Tanzania will experience at least 37 percent decline in tariff revenues" (p.17). That is a substantial loss in revenue, and one of the aims of this study is to estimate the losses and see if they are close to those found by other researchers. Indeed, such losses for Tanzania will have significant development implications, which this study will offer some debate on.

### *Structural and Employment effects*

The structural and employment effects can be understood by considering the amount and level of competition that industries in Tanzania will face once tariff barriers are removed on imports from the EU. It is common knowledge that the EU's industrial base is much more advanced in terms of technology, and that the products from the EU are of a higher quality. Once tariffs are removed, the goods will additionally be cheaper, and it is thus likely that the demand for local products will fall, and hence affecting the local industries in terms of production activities, as well as their employment levels.

Therefore, the effect of EPA on industries in Tanzania will depend on the level of competitiveness of industries. There are two scenarios to consider; first, if industries in Tanzania are able to raise their efficiency and competitiveness with the opening up of competition so that they reach the same quality of goods produced in the EU, then they will be in a position to out-compete the EU firms and even expand their markets. The employment effect of this first scenario is that of increased demand for labour in these firms. The second scenario, the worst case, is that the EU firms out rightly out-compete the Tanzanian firms. This is likely to lead to a closure of firms and a loss in employment of thousands of people. This scenario is likely to arise if the following conditions obtain;

- Firms in Tanzania are unable to access inputs at a cheaper cost than EU firms (e.g. if electricity supply is erratic or more costly, or they cannot access finance at a reasonable interest rate); or
- EU producers are more heavily subsidized than their Tanzanian competitors (as is the case for many EU agricultural producers); or
- Tanzanian firms are less able to upgrade production facilities or acquire technology to compete with EU competitors (adapted from South Centre, 2007).

The South Centre (2007) predicts and argues that EAC industries are likely to be out-competed and not likely to remain profitable owing to the many supply-side constraints that they face that limit their competitiveness. The supply-side constraints include; a lack of infrastructure (particularly in energy); weak institutions, notably firms, domestic financial systems and domestic knowledge system; and the lack of demand (p.8).

In this study, although we will focus on the revenue implications, we think that it would still be interesting, at a later stage, to examine the effect that EPA will have on various sectors in Tanzania, and the likely employment effects resulting from the increase in competition from products from the EU.

## **2.2 Methodological Overview**

Studies on the effect of trade integration on revenue and welfare is dominated by the use of two key methods of analysis, namely, general equilibrium models (GEM) and partial equilibrium models (PEM). The use of GEM is justified by the fact that whenever there is a change in trade policy, it has inter and intra-sectoral effects that can only be captured by modeling the whole economy, and by extension, including the global flows. The popular approach in the literature has been the use of the GTAP model (see for example, Karingi *et al*, 2005, and Keck and Piermartini, 2007). The use of GEM is however hampered by the lack of data on mostly developing countries, as they require the use of input-output tables.

Other weaknesses of GEM is that it uses a number of assumptions, which implies that the results are sensitive to the changes in the assumptions, and since it works in large aggregates, it results in losses in the level of detail of analysis.

To avoid the problems associated with GEM, and to supplement the findings from GEM, PEM is used. PEM enables the calculation of direct trade effects (trade creation and trade diversion), price, revenue, and welfare effects of commercial policy changes. An advantage with PEM is that unlike its aggregate counterpart, it allows analysis at a detailed disaggregated level. Popular models used in PEM are the UNCTAD model and the WITS/SMART model (see Laird and Yeats, 1986; Karingi *et al*, 2005; Milner *et al*, 2005). An obvious criticism of PEM is that it does not take into account economy-wide effects of changes in commercial policy (Laird and Yeats, 1986).

Our analysis on the revenue effects on Tanzania follows a fairly tractable method by Milner *et al* (2005), which they used to estimate the trade and welfare effects of the EU-EAC EPA. Our study though focuses on revenue effects only due to time and resource limitations.

According to the Milner *et al* (2005) methodology, the revenue effects of an EU-EPA, given that the EU is the dominant supplier and that the regional supply capability is limited, can be found by the following equation:

$$\Delta R^C = -t \cdot UV_0^{EU} M_0^{EU} \quad [1]$$

where  $t$  is the current tariff on imports from the EU,  $UV_0^{EU}$  is the unit value of imports from the EU, and  $M_0^{EU}$  is the volume of imports from the EU.

There is a possibility that non-EU and non-EAC countries are dominant suppliers. If it is assumed that the EU is more efficient than the non-EU and non-EAC, then as discussed in the theoretical section, such a situation would divert all non-EU imports to the EU. The tariff revenue from this diversion of trade is given by:

$$\Delta R^{TD} = -t \cdot UV_0^{ROW} M_0^{ROW} \quad [2]$$

where the variables are as defined above, except for the ROW superscript, which relates to the rest of the world, which in our case refers to non-EU sources.

### 3. The Findings

This section presents findings from studies done on the revenue implications of EPA on Tanzania. It also contains our own analysis of the implications of tariff revenue reductions on development.

#### 3.1 Findings on Tanzania by Other Researchers

The Karingi *et al* (2005) estimated the revenue impacts on Tanzania of EPA and found that Tanzania was going to face revenue losses amounting to \$US32.5 million from tariff removal. Another study by Milner *et al* (2005), which is based on trade data for the mid 1990s, found that Tanzania would lose Tshs.36.9 billion in revenue for sectors with consumption effects only, while Tshs.28.9 billion would be lost for sectors with trade diversion and consumption effects (p.340).

#### 3.2 Our Findings on Tanzania – The Revenue Effects

As indicated, the findings reported here are based on the method outlined by Milner *et al* (2005) and presented in the methodology section. The estimates of the revenue losses are found using equations [1] and [2].

The data for the estimations were sourced from the Tanzania Revenue Authority (TRA), and it contained products at the 8-digit HS code for 2008. The data contains the CIF value of the imports and the import duty on the products. This data enabled us to calculate the tariff rate for the products.<sup>4</sup>

#### 3.3 Revenue Losses from Trade Creation [Equation 1]

The estimations started by recognizing the fact that in 2010, hardly no revenue losses will be incurred, since the products that are zero rated and are scheduled to be imported duty-free are already liberalized. This finding involved comparing the products on the list of products to be zero-rated in 2010 with the imported products from the EU in 2008. We found that the zero-rated products are already duty-free now. Hence, we do not expect any major change come 2010. Thus, the customs revenue estimated from the 2008 import data, amounting to approximately Tshs.46.5 billion will still be forthcoming (see Table 3).

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<sup>4</sup> The tariff rate is calculated as;  $\frac{\text{Import duty}}{\text{CIF value}}$ .

**Table 3: Estimated Revenue Losses from Trade Creation**

	ESTIMATED CUSTOMS REVENUE (IN TSHS. BILLION)	ESTIMATED CUSTOMS REVENUE LOSS (IN TSHS. BILLION)	LOSS AS % OF TOTAL CUSTOMS REVENUE FROM EU IMPORTS*
1. Current custom revenue from EU imports (2010)	46.5		
2. Customs revenue from products attracting 10% duty (2023)	31.9	(46.5-31.9)=14.6	31.4
3. Customs revenue from products attracting 25% duty (2033)	25.6	(31.9-25.6)=6.3	13.5
4. Total losses		(14.6+6.3)= 20.9	44.9

*Note: These estimates are based on trade data for 2008 sourced from TRA. \*From EU imports only.*

However, after 15 years (in 2023), it is expected that products that are 10% rated will then be zero-rated. This will result in total customs revenue collected amounting to Tshs.31.9 billion, implying that the losses from making the 10% rated products zero-rated will amount to approximately Tshs.15 billion. In other words, this is the amount of customs revenue that the 10% rated products are attracting, but will no longer be available, and hence it constitutes a loss. This amount is approximately 31% of the total customs revenue on imports from the EU.

The next phase of tariff removal will involve products that attract 25% duty. These will be eliminated in 2033. The revenue that will be collected when these products are all zero rated will amount to approximately Tshs.25.6 billion (Table 3). The loss translates to Tshs.6.3 billion, and it is approximately 14% of total customs revenue from imports from the EU. The total revenue losses as a result of the agreement based on 2008 data amounts to Tshs.20.9 billion, which is approximately 45% of total customs revenue from imports from the EU.

It is important to note that the EPA agreement contains an exclusion list (or excluded products).<sup>5</sup> That is, the duty on these products will not be phased out once the agreement comes into effect. What this implies is that there will still be customs revenue received from these excluded products.

<sup>5</sup> See EAC-EU EPA Agreement.

### 3.4 Revenue Losses from Trade Diversion [Equation 2]

As in indicated in the theoretical section, what trade diversion implies is when trade between the EU and EAC becomes duty-free, import sources from non-EU countries will still attract duty, as these sources are not part of the EPA agreement. But what is important is the possibility of imports from these non-EU countries being diverted to the EU. If imports will as a result be sourced from the EU, it implies customs revenue losses will be incurred from imports that originate from these non-EU sources.

To estimate the revenue losses that will be incurred from possible diversion of imports, we were guided by the paper by Milner et al (2005). We looked at the following scenarios;

- That all imports from the EAC will be diverted to the EU. That is, a 100% diversion of imports from non-EU sources;
- That 30% of all imports from non-EU sources will be diverted to the EU;
- That 20% of all imports from non-EU sources will be diverted to the EU;
- That 10% of all imports from non-EU sources will be diverted to the EU.

Based on these scenarios, we calculated the revenue losses that will be incurred in 2010.<sup>6</sup> Table 4 gives estimates of the customs revenue losses.

**Table 4: Estimated Revenue Losses from Trade Diversion**

	TOTAL CUSTOMS REVENUE LOST ASSUMMING 100% DIVERSION (IN BILLION TSHS.)	TOTAL CUSTOMS REVENUE LOST ASSUMMING 30% DIVERSION (IN BILLION TSHS.)	TOTAL CUSTOMS REVENUE LOST ASSUMMING 20% DIVERSION (IN BILLION TSHS.)	TOTAL CUSTOMS REVENUE LOST ASSUMMING 10% DIVERSION (IN BILLION TSHS.)
ALL NON-EU SOURCES	267.3	80.2	53.5	26.7

*Note: These estimates are based on trade data for 2008 sourced from TRA.*

Table 4 shows that the biggest loss in customs revenue will be under the assumption that all imports (100%) from non-EU will be diverted to the EU. The assumption we make of a total diversion of imports is of course extreme. This is because it is not possible for all imports to be diverted from non-EU sources once that agreement comes into effect. For example, consider Tanzania’s source of oil; the Middle East. It is not possible that oil imports can be diverted from the Middle East to the EU because oil is naturally available in the Middle East. Another example are products for which transport costs from the EU are prohibitively high and as such, cheaper sources closer to Tanzania would dominate. Further, one can think of products from the EU that might be too expensive even if they are of good quality. Given these qualifications, the assumption here that all imports from non-EU sources will be diverted to the EU is extreme. It nevertheless serves as a starting point.

<sup>6</sup>*Similar calculations can be done for 2023 and 2033.*

In order to get a more realistic indication of trade diversion, the study requires a product by product and sector by sector assessment of the possible diversion of imports to the EU for each region, given the dominant supplier. The estimations above assume that the EU is dominant in all sectors, and hence gives estimates that are higher than if a product by product assessment was done.

We now look at the scenario in which trade diversion would only be 30%, 20% and 10% . Under these assumptions, the customs revenue losses will amount to Tshs.80.2 billion, Tshs.53.5 billion, and Tshs.26.7 billion respectively (see Table 4).

### 3.5 An Attempt to Make the Estimations Dynamic

The approach used to provide the estimates of the customs revenue losses is static. The estimates are based on trade figures for 2008, and thus the implicit assumption made is that the structure of trade would remain constant. Given this assumption, these figures are merely indicative of the outcome.

On average, Tanzania's GDP grew at 6% between 2000 and 2005 (URT, 2008), and thus based on that, we assumed that the economy will grow at a constant rate of 5%. We further assumed that imports will also grow at the same rate, implying that even the customs revenue will grow at the same rate of 5%. These assumptions provided customs revenue losses to be incurred from the EPA agreement given in Table 5.

**Table 5: Customs Revenue Losses from Trade Creation Based on a Growth Rate of 5%**

	PROJECTED CUSTOMS REVENUE (IN TSHS. BILLION)	PROJECTED CUSTOMS REVENUE LOSS (IN TSHS. BILLION)	LOSS AS % OF TOTAL CUSTOMS REVENUE FROM EU IMPORTS*
1. Current custom revenue from EU imports	51.3		
2. Customs revenue from products attracting 10% duty	35.2	(51.3-35.2)=16.1	31.4
3. Customs revenue from products attracting 25% duty	28.2	(35.2-28.2)=7.0	13.6
5. Total losses		(16.1+7.0)=23.1	45.0

The figures in Table 5 are for the year 2010, given that imports will grow at the assumed rate. It is once again important to note that while the assumed rate is fairly reasonable, it is however possible that trade relates to the GDP in a non-linear way, perhaps increases at a higher rate than the GDP. A more realistic approach would be more involving and beyond the time and resources available for this work.

The next section discusses the development implications of such revenue losses on Tanzania, as well as the policy challenges to be faced.

### 3.6 The Implications of Revenue Losses and Policy Challenges

We have illustrated that customs revenue makes up a large percentage of Tanzania's total revenue. This is shown in Table 2. The development implications of the reduction in customs revenue must be seen in that context; the extent to which public finances will be affected by the reduction in the major sources of such public resources.

Given the huge reliance on customs revenue as a source of government revenue, it is quite possible that as a result of the loss in revenue, the government will be forced to cut back on expenditure on key social services that rely on government budgetary allocation. This will result in declining quality and provision of such services.

A reduction in critical social services such education will, for example, set back the objectives of providing free quality basic education and increasing gross and net enrolment rates in primary schools for boys and girls that the government has been spearheading in its Primary Education Development Programme. Such a setback will undoubtedly affect the long-run human resource development of the country.

Another possibility is that the government might resort to increasing user fees on social services to counteract the revenue losses. Such a response will aggravate the already high cost of living that the Tanzanian citizens already face, which will lead to an increase in the number of people who cannot afford these services. An increase in the number of people excluded from basic services will aggravate poverty levels.

The policy challenges that the Tanzanian government will have to confront involve finding ways of making up for the losses in the customs revenue that will be incurred due to the EPA agreement. The immediate need is to undertake fiscal reforms to enable the government to optimise revenue collection. The issues that need confronting include among others;

- Widening the tax base to capture more tax payers – the existence of a large informal sector in Tanzania provides a key avenue for capturing more tax payers. According to the Integrated Labour Force Survey of 2005/2006, the informal sector absorbed 9.3% of the total labour force.<sup>7</sup> The informal sector is the second largest employer after the agriculture sector (URT, 2008). This possibility of widening the base of tax payers to include the informal sector will entail gradual formalisation of the informal sector through registration.
- Reviewing tax concessions provided to foreign investors; specifically in the mining sector. The mining sector has witnessed significant growth in the past decade or so<sup>8</sup>, making it a major sector that can contribute to sustained growth of the Tanzanian economy. However, the mining sector's contribution to tax revenue is low. According to the Policy Forum (n.d.), its contribution to total tax revenues is a mere 3.6%.

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<sup>7</sup>The percentage of people of employment in the informal sector increased from 5.7% in 2000/2001 (URT, 2008).

<sup>8</sup>Between 1996 and 2005, the mining sector's growth rate averaged 15.5% (URT, 2005).

#### 4. Concluding Discussion

The vast reduction in government revenue that we have found, and as well as what other researchers have found, that will result from elimination of tariffs from trade between the EU and the EAC calls for major fiscal reforms to counteract the development implication of such reduction.

The findings from various studies on the impact of EPA on government revenue show that customs revenues will be reduced significantly. A reduction in government revenue from custom duties implies a reduction in government spending if the governments in the EAC do not mitigate the reduction in the revenue. The questions that need to be answered then are;

- To what extent will the government mitigate the loss of revenue so that key aspects of its expenditure in the budget such as social spending are not affected?
- Are there other ways the government can raise revenue so that important budgetary expenses are not cut?
- Is the liberalization grace period given in the EPA sufficient for the government to devise and undertake fiscal reforms?
- What compensation measures by the EU can be devised to counteract the revenue losses?

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## 5. Appendix

**Table A1: Key Indicators for EAC**

	2005	2006	2007
<b>Kenya</b>			
GDP (current US\$bn)	18.7	22.8	29.5
GDP growth (annual %)	6	6	7
Population, total (million)	35.6	35.5	37.5
GDP per capita US\$	526.1	623.2	786.3
<b>Burundi</b>			
GDP (current US\$bn)	0.8	0.9	1.0
GDP growth (annual %)	1	5	4
Population, total (million)	7.8	8.1	8.5
GDP per capita US\$	101.3	110.5	114.6
<b>Rwanda</b>			
GDP (current US\$bn)	2.4	2.8	3.3
GDP growth (annual %)	7	5	6
Population, total (million)	9.2	9.4	9.7
GDP per capita US\$	257.7	303.2	341.0
<b>Tanzania</b>			
GDP (current US\$bn)	14.1	14.2	16.2
GDP growth (annual %)	7	7	7
Population, total (million)	38.5	39.5	40.4
GDP per capita US\$	367.5	359.3	400.2
<b>Uganda</b>			
GDP (current US\$bn)	8.7	9.5	11.2
GDP growth (annual %)	7	5	6
Population, total (million)	28.9	29.9	30.9
GDP per capita US\$	301.9	317.6	362.6

Source: World Bank, World Development Indicators online, <http://www.worldbank.org>.