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Revenue Implications of the EC-EAC EPA: The Case of Tanzania

Introduction

The East African Community (EAC) was "reborn" in 2001 after its demise in 1977. Among its key objectives is to promote free trade within its members, and ultimately become a political union. Since its resumption, there has been 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.

The EAC is also negotiating an Economic Partnership Agreement (EPA) with the European Community (hereafter referred to as the EC-EAC EPA), whose objectives include: establishing a strong trade and development partnership that will contribute to development, promoting regional integration as well as integration of the EAC in the global economy, economic cooperation and good governance, helping to build trade policy capacity, developing EAC production and trade capacity, establishing a transparent regulatory system that will attract investment, and strengthening relations that exist between the EC and EAC.

Specifically the EC-EAC EPA aims at establishing a free trade agreement (FTA), and negotiations are ongoing. This paper focuses on the trade in goods regime for which an interim agreement has been agreed.

The objectives spelt out in the agreement on goods include: duty free and quota free (DFQF) market access for EAC products in the EC market; progressive and gradual liberalisation of the EAC goods market for EC products; and preserving and improving market access conditions so that the EAC countries are prevented from being worse off.

Liberalisation will proceed in phases, and the agreement contains the schedule of import duty reductions till 2033. The first phase will involve the liberalisation of 65.4 percent of imports originating from EC to EAC by 2010. This involves goods that are zero rated, namely, machinery; raw materials; industrial chemicals; and essential medicines. The second phase will see the gradual liberalisation of goods that are 10 percent tariff rated during a period of 15 years and these include intermediate goods. In the last phase the goods currently attracting 25 percent duty will be liberalised within a period of 10 years, mostly consumer goods. In the case of the EAC goods accessing the EC market, these will have full DFQF market access – the liberalisation is hence asymmetrical.

The liberalisation of trade between the EC and EAC will have revenue implications that will ultimately have an impact on the development needs of the EAC. This is because the region significantly relies on trade taxes as a major source of revenue. This study examines the revenue and development implications of an EC-EAC EPA on Tanzania.

Rationale of the Study

The issue of revenue implications of EPAs on the African, Caribbean and Pacific (ACP) countries has been widely debated (see Karingi *et al*, 2005; Milner *et al*, 2005; Zouhon-Bi and Nielsen, 2007, among others). The debate is valid given the development implications of the reduction in government revenue that will result from the elimination of customs duties. Table 1 shows the extent to which three of the EAC member states 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 the development objectives of these countries, if alternative sources are not found.

Table 1: 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

Theoretical Overview

Theoretical literature on the effects of any preferential trade area is based on the pioneering work by Viner (1950) that examines the following effect: trade creation, trade diversion, and revenue effects. However, in the case of the EC-EAC EPA, the Viner framework needs slight modification since the parties involved are already economic groupings in themselves.

Structural and Employment Effects

These 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 EC. It is common knowledge that the EC's industrial base is more advanced in terms of technology, and that products from the EC are of 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, hence affecting the local industries in terms of production activities, as well as their employment levels.

From the foregoing there are two scenarios to consider. First, if industries in Tanzania are able to raise their efficiency and competitiveness with the liberalisation so that they reach the same quality of goods produced in the EC, then they will be in a position to out-compete the EC firms and even expand their markets, also leading to increased demand of labour in the EAC. The second scenario is that the EC firms will out rightly out-compete the Tanzania firms and this will likely lead to closure of firms and loss in employment.

The latter case is likely to arise especially if the following conditions obtain:

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

Though this paper focuses on the revenue implications, it would also be important in another study to examine the effect of the EPA on various sectors in Tanzania, and the likely implication on employment, as a result of the competition from products from the EC.

Revenue Effect

The revenue effect relates to the loss in government revenue that occurs when the elimination of tariffs leads to 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 the loss of revenue from imports depends on the extent of trade between the countries involved; in this case Tanzania and the EC, or between the EC and EAC.

A reduction in government revenue resulting from a loss in customs duties can affect a government's ability to provide essential public services, such as education and health unless alternative funds for such losses are found.

Studies that have been conducted on other African countries estimate between 20-30 percent losses in government revenue resulting from reciprocal free trade with the EC (see Karingi et al, 2005). Another study on the Economic Community of West African States (ECOWAS) region by Zouhon-Bi and Nielsen (2007) found the following government revenue losses; Cape Verde 15.8, Senegal 10.4, Ghana 7.1 and Nigeria 2.4 percent respectively.

The study by Karingi et al (2005) also reports findings from a study by Tekere and Ndlela (2003) that was done on Southern African Development Community (SADC) countries. It states that countries like Tanzania will experience at least 37 percent decline in tariff revenues (p.17). This is a substantial loss in revenue and would have significant development implications.

Research Findings

Previous studies have been conducted on the revenue impact that the EPA is likely to have on Tanzania. Karinji et al (2005) found that the country would face revenue losses amounting to US$32.5mn upon tariff removal; another study by Milner *et al* (2005), which was based on trade data for the mid 1990's found that Tanzania would lose US$0.029bn (TShS.36.9bn) in revenue for sectors with consumption effects only, while US$0.022bn (TShS.28.9bn) would be lost for sectors with trade diversion and consumption effects (p.340).

In this study the methods outlined by Milner *et al* (2005) was applied. The data upon which the estimates were based was sourced from the Tanzania Revenue Authority (TRA), and it contained products at the 8-digit HS code level for 2008.

Revenue Losses from Trade Creation

It was recognised that up-to 2010, no revenue losses will be incurred, since only products that are zero rated are scheduled to be imported duty free. This finding involved comparing the list of products to be zero rated in 2010 with the imported products from the EC in 2008. It was found that these products are already duty-free now and hence no major change is expected in 2010. Thus, the customs revenue estimated from the 2008 import data, amounting to approximately US$0.035bn (TShS.46.5bn) will still be forthcoming (see table 2).

However, after 15 years (2023), it is expected that products that are 10 percent duty rated will be reduced to zero rate in the FTA. The estimated loss that will result stands at US$0.024bn (TShS.31.9bn) (see table

Table 2: Estimated Revenue Loss			
	Estimated Customs Revenue in TSHS.bn	**Estimated Customs Revenue Loss in TSHS.bn**	**Loss as percent of Total Customs Revenue from EC Trade**
Current customs revenue from EC imports (2010)	46.5		
Customs revenue excluding the revenue from products attracting 10 percent duty,	31.9	(46.5-31.9)=14.6	31.4
Customs revenue excluding revenue from products attracting 10 and 25 percent duty	25.6	(31.9-25.6)=6.3	13.5
Total Losses		**(14.6+6.3)=20.9**	**44.9**
Estimates based on trade data for 2008 sourced from TRA.			

2). This is the amount of customs revenue that the 10 percent duty rated products are attracting, but will no longer be available, and hence it constitutes a loss. This amount is approximately 31 percent of the total customs revenue on trade from the EC.

The next phase of tariff removal will involve products that attract 25 percent duty. These will be eliminated in 2033 and the study estimates the resulting revenue loss amounting to approximately US$0.020bn (TShS.25.6bn) (Table 2), which translates to approximately 45 percent of total customs revenue from trade with the EC.

It is important to note that the EPA agreement contains an exclusion list which means duty on the listed products will not be phased out once the agreement comes into effect. This implies that there will still be customs revenue received from these excluded products.

Revenue Losses from Trade Diversion

Trade diversion implies that when trade between the EC and EAC becomes duty-free, import sources from non-EC countries will still attract duty, as these sources are not part of the EPA. If as a result imports formerly from other sources are now sourced from EC, it implies that custom revenue losses will be incurred from the imports that originate from non-EC sources.

To estimate the revenue losses that will be incurred from possible diversion of imports, the following scenarios were considered:

- All imports by EAC will be diverted to EC (100 percent diversion of imports from non-EC sources).
- 30 percent of all imports from non-EC sources will be diverted to the EC.
- 20 percent of all imports from non-EC sources will be diverted to the EC.
- 10 percent of all imports from non-EC sources will be diverted to the EC.

Based on the above scenarios the estimated losses that will be incurred in 2010 are as follows:

The biggest loss will be under the assumption that all imports (100 percent) from non-EC sources will be diverted to the EC. This scenario is unlikely, since for instance Tanzania's source of oil from the Middle East is unlikely to be diverted to the EC. Another instance are products for which transport costs from the EC are prohibitively high and as such, cheaper sources closer to EAC would dominate.

A more realistic indication of trade diversion requires a product by product and sector by sector assessment of the possible diversion of imports to the EC, taking into account the dominant supplier.

Table 3: Revenue Losses from Trade Diversion				
	Total Customs Revenue Lost Assuming 100 percent Diversion (In TSHS.bn)	**Total Customs Revenue Lost Assuming 30 percent Diversion (In TSHS.bn)**	**Total Customs Revenue Lost Assuming 20 percent Diversion (In TSHS.bn)**	**Total Customs Revenue Lost Assuming 10 percent Diversion (In TSHS.bn)**
All Non EC-Sources	267.3	80.2	53.5	26.7
Note: These estimates are based on trade data for 2008 sourced from TRA.				

Table 4: Revenue Losses Incurred from the EPA			
	Projected Customs Revenue (In TSHS.bn)	**Projected Customs Revenue Loss (In TSHS.bn)**	**Loss as percent of Total Customs revenue from EC imports**
Current Customs revenue from EC imports	51.3		
Customs revenue excluding from products attracting 10 percent duty	35.2	(51.3-35.2)=16.1	31.4
Customs revenue excluding from products attracting 10 and 25 percent duty	28.2	(35.2-28.2)=7.0	13.6
Total Losses		**(16.1+7.0)=23.1**	**45.0**

An Attempt to make the Estimates Dynamic

The approach used above to estimate the revenue losses is static, based on trade figures for 2008, and thus the implicit assumption is that the structure of the trade would remain constant, making the outcome only indicative.

On an average, Tanzania's gross domestic product (GDP) grew at six percent between 2000 and 2005 (URT, 2008), and thus, it is assumed that the economy will grow at a constant of six percent. It is also assumed that the imports will grow at the same rate, implying that even the customs revenue will grow at the same rate of six percent. Under this assumption the estimated revenue losses that will be incurred from the EPA are indicated in table 4.

The above figures are for 2010 given that imports will grow at the assumed rate. It is also important to note here that while the assumed rate is fairly reasonable, it is possible that trade relates to GDP in a non-linear way, perhaps increasing at a higher rate than GDP. A more realistic approach would be more involving and beyond the time and resources for this study.

Implications of Revenue Losses

Given the huge reliance on customs revenue by Tanzania (see Table1), it is possible that as a result of the loss in revenue due to the EC-EAC EPA, the government will be forced to cut back on expenditure on key social services, leading to declining quality and provision of such services. The other possibility is that the government might increase the user fees on social services to counteract the revenue loss. Such a response will aggravate the already high cost of living in the country.

Conclusion

The findings indicate that customs revenue will be reduced significantly as a consequence of the EPA. This may result in less available funds for EAC governments to spend on their public sectors if the loss is not mitigated. The questions that need to be addressed are the following:

- To what extent will the government mitigate the loss of revenue so that key aspects of its expenditure in the budget are not affected?
- Are there other ways the government can raise revenue so that important budgetary expenses are not affected?
- Is the liberalisation grace period entailed in the interim EPA sufficient for the government to devise and undertake fiscal reforms that will mitigate the anticipated loss?
- To what extent can the EPA negotiations, in the development chapter, include budgetary assistance by the EC to compensate for the revenue implications of the market access commitments of Tanzania?
- To what extent will the other policy measures, for instance those resulting from the Diagnostic Trade Integration Study (DTIS), mitigate the revenue loss?

The above questions need to be thoroughly addressed, in the ongoing negotiations so as to prevent the EC-EAC EPA from negatively affecting the livelihood of the people in the EAC.

This Briefing Paper is adapted from the Research Paper titled "**Revenue Implications of the EC-EAC EPA: The Case of Tanzania"** written by Dr Beatrice K. Mkenda and Monica Hangi for CUTS GRC as part of the project entitled "Building an Inclusive East African Community (BIEAC) with the support of the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ).