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Trade Liberalization, Foreign Direct Investment and Tax Revenue Performance: Evidence from East African Community Affiliated Member Countries

Lewis Mugambi Mutegi[1], [2]Kennedy O. Okiro, [3]Johnbosco M. Kisimbii

Abstract
Foreign Direct Investment (FDI) has become a significant driver of economic development in developing countries through capital inflows, technology transfer, employment creation, and enhancement of productive capacity. As a consequence, countries within the East African Community (EAC) have increasingly implemented investment-friendly policies and liberalizing trade with aim of attracting foreign investors to stimulate economic growth and strengthen domestic tax revenue mobilization. However, despite the growing inflow of FDI into EAC member states, its impact on tax revenue performance remains a subject of debate as almost all nations within this region continue to report dwindling tax revenue. While FDI may increase the tax base through expanded economic activities and corporate profitability, generous tax incentives offered to attract investors have potential of eroding potential tax revenues. This study examines the effect of Trade liberalization and FDI on tax revenue performance in EAC affiliated member countries. The study used panel research design and collected secondary data from a population comprising of 6 east Africa community member countries for the period between 2000 and 2023. Drawing on theoretical and empirical literature, the study argues that FDI contributes positively to trade liberalization-tax revenue linkage by stimulating economic activity, increasing employment, and enhancing corporate tax collections. However, the effectiveness of this relationship depends on institutional quality, governance structures, and tax administration efficiency. The findings provide important insights for policymakers seeking to balance investment promotion with sustainable domestic revenue mobilization.

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I. Introduction

Tax revenue remains the most important source of public finance in developing economies, providing governments with the resources required to fund essential public services, infrastructure development, healthcare, education, and social welfare programs. According to the International Monetary Fund (2022), domestic revenue mobilization is fundamental to achieving sustainable economic development because it enables governments to finance development priorities while reducing dependence on external borrowing and foreign aid. However, many developing countries continue to face significant challenges in raising adequate tax revenues due to narrow tax bases, widespread informality, weak tax administration systems, tax avoidance and evasion practices, and limited institutional capacity. Similarly, the World Bank (2022) observed that low tax-to-GDP ratios in many developing countries constrain governments' ability to finance public investments and deliver quality public services, thereby undermining long-term economic growth and development.

In response to these revenue mobilization challenges, Foreign Direct Investment (FDI) has increasingly been recognized as a strategic mechanism for stimulating economic growth and strengthening government revenue performance. FDI contributes to economic development through the inflow of capital, transfer of technology, diffusion of managerial skills, creation of employment opportunities, and enhancement of productivity within host economies. According to the United Nations Conference on Trade and Development (2022), FDI plays a critical role in supporting industrialization and economic transformation in developing countries by facilitating access to international markets, modern production techniques, and global value chains. Through increased business activity and employment creation, FDI expands the taxable base and potentially increases government revenues from corporate income taxes, personal income taxes, value-added taxes, and other forms of taxation. As a result, many governments have embraced investment promotion strategies as part of broader efforts to accelerate economic growth and improve fiscal sustainability.

This growing recognition of the developmental benefits associated with FDI has encouraged many developing countries, including members of the East African Community (EAC), to implement reforms aimed at creating a favorable investment climate. Countries such as Kenya, Uganda, Tanzania, Rwanda, Burundi, South Sudan, and the Democratic Republic of the Congo have pursued policies such as trade liberalization, infrastructure development, regulatory reforms, and the provision of investment incentives to attract foreign investors. The United Nations Conference on Trade and Development (2022) notes that African economies have increasingly focused on improving their business environments to enhance competitiveness and attract foreign capital needed to support economic recovery and sustainable development. Likewise, the African Development Bank (2022) emphasizes that attracting quality FDI can support domestic resource mobilization by expanding economic activity, fostering private sector development, and ultimately increasing the capacity of governments to generate tax revenues necessary for development financing.

II. Theoretical Perspective

This study was supported by both institutional theory and dependency theory. Institutional Theory posits that the quality of a country's institutions, including legal systems, regulatory frameworks, governance structures, and public administration, significantly influences economic outcomes. According to this theory, strong institutions enhance a government's ability to attract and regulate Foreign Direct Investment (FDI) while simultaneously improving tax administration and revenue collection. Well-functioning institutions create a predictable business environment characterized by transparency, accountability, protection of property rights, and effective enforcement of tax laws, which encourages foreign investors to establish and expand their operations. As foreign firms increase production, employment, and business activities, the tax base expands through corporate income taxes, value-added taxes, payroll taxes, customs duties, and other tax instruments, thereby increasing tax revenue (Nguyen & Darsono, 2022).

Institutional theory further suggests that the extent to which FDI contributes to tax revenue depends largely on the effectiveness of government institutions in monitoring and taxing multinational enterprises. Countries with strong institutional frameworks are better positioned to minimize tax avoidance, profit shifting, and transfer pricing practices commonly associated with multinational corporations. In such environments, governments can effectively capture a greater share of the economic benefits generated by foreign investments. Conversely, weak institutions characterized by corruption, inadequate tax administration, and poor regulatory enforcement may allow foreign firms to exploit loopholes and engage in aggressive tax planning, thereby limiting the positive contribution of FDI to tax revenue despite increased economic activity (Khan, Ahmad, & Zhang, 2023). Moreover, the theory further contends that multinational corporations often repatriate a significant portion of their profits to their home countries rather than reinvesting them in host economies. Through mechanisms such as transfer pricing, profit shifting, and the use of tax havens, foreign firms may minimize their tax liabilities in host countries. Consequently, while FDI may stimulate economic activity and increase output, the actual tax benefits accruing to the host government may remain limited. Dependency theorists argue that this dynamic reinforces economic dependence and constrains the ability of developing countries to mobilize domestic resources for development (Cobham & Janský, 2023).

On other hand, dependency theory offers a contrasting perspective by arguing that developing countries often become economically dependent on foreign capital and multinational corporations originating from developed economies. According to this theory, FDI may not necessarily translate into higher tax revenue because multinational enterprises frequently possess substantial bargaining power that enables them to negotiate favorable tax concessions, exemptions, and incentives from host governments. In an effort to attract foreign investment, developing countries may engage in tax competition by lowering corporate tax rates or granting tax holidays, thereby reducing potential tax revenue gains from foreign investment (Mughal & Akram, 2022).

The theory further contends that multinational corporations often repatriate a significant portion of their profits to their home countries rather than reinvesting them in host economies. Through mechanisms such as transfer pricing, profit shifting, and the use of tax havens, foreign firms may minimize their tax liabilities in host countries. Consequently, while FDI may stimulate economic activity and increase output, the actual tax benefits accruing to the host government may remain limited. Dependency theorists argue that this dynamic reinforces economic dependence and constrains the ability of developing countries to mobilize domestic resources for development (Cobham & Janský, 2023). Additionally, dependency theory suggests that excessive reliance on foreign investment can weaken domestic industries and reduce the government's fiscal autonomy. Governments may become reluctant to enforce stringent tax regulations on multinational corporations for fear of losing investment to competing countries. As a result, foreign investors may enjoy preferential treatment relative to domestic firms, leading to unequal tax burdens and reduced overall tax collection. Therefore, Dependency Theory generally predicts either a weak positive relationship or a negative relationship between FDI and tax revenue, particularly in countries where foreign investors exert significant influence over economic and fiscal policymaking (Murshed, 2022).

2.1 Empirical Evidence

Using panel data from 45 emerging economies between 2000 and 2019, Nguyen and Darsono (2022) investigated the relationship between foreign direct investment, governance quality, and tax revenue mobilization. The study employed the Generalized Method of Moments (GMM) estimation technique to address endogeneity concerns and found that FDI had a positive and statistically significant effect on tax revenue. The findings revealed that countries with stronger institutional frameworks, effective tax administration, and better governance derived greater tax revenue benefits from foreign investments. The authors argued that foreign firms contribute directly to government revenues through corporate taxation and indirectly by stimulating economic growth and employment. The study concluded that institutional quality strengthens the capacity of governments to convert FDI inflows into sustainable tax revenue, thereby supporting the propositions of Institutional Theory.

Cobham and Janský (2023) examined the implications of multinational profit shifting on tax revenue in developing and developed economies. Using international corporate tax data and country-level revenue statistics, the study assessed the extent to which multinational enterprises reduce taxable income through transfer pricing and other tax avoidance mechanisms. The findings indicated that while FDI inflows often increase economic activity, a substantial portion of potential tax revenue is lost through profit shifting practices, particularly in developing countries with weak tax administration systems. The study estimated that developing economies lose billions of dollars annually in corporate tax revenues due to multinational tax avoidance. These findings support the arguments of Dependency Theory by demonstrating that foreign firms can limit the fiscal benefits of FDI through their superior bargaining power and ability to exploit international tax loopholes.

Khan, Ahmad and Zhang (2023) investigated the impact of institutional quality on tax revenue performance in 52 developing countries over the period 2005–2021. Employing a dynamic panel estimation approach, the study found that institutional quality significantly enhances tax revenue collection and moderates the relationship between FDI and government revenue. The results showed that countries characterized by strong regulatory quality, government effectiveness, and control of corruption experienced a stronger positive relationship between FDI and tax revenue compared to countries with weaker institutions. The authors observed that effective institutions reduce opportunities for tax evasion and increase compliance among multinational corporations. Consequently, the study concluded that FDI contributes positively to domestic revenue mobilization when supported by robust institutional structures and efficient tax administration systems.

III. Research Methodology

The study used panel research design and collected secondary data from a population comprising of 6 east Africa community member countries for the period between 2000 and 2023. This time period was chosen because of various reasons. First, the year 2000 marked the year when east Africa community regained their operations after collapse in 1977 due to among others issues such as governance and political ideology differences. Secondly, this period reflected a time when nearly all EAC member countries experienced declining tax revenue amid the clarion call to fully adopt trade liberalization for purposes of fostering regional integration. To empirically examine the relationship between trade liberalization, FDI and tax revenue of east Africa community member countries, a panel multiple linear regression analysis was conducted using data for six countries. To test the null hypothesis, p-value was used and the null hypothesis was rejected if the P value calculated was less than 5%. The following model was used in estimation: TRIt=ạ +ß1X1It+ ß1X2It+ ἕ, where: ß= Regression coefficients, X1=Trade liberalization, X2=FDI measured by net FDI inflows, TR= Tax revenue, ἕ= Error terms.

IV. Results

Regression analysis is a statistical technique commonly used in social sciences for determining the nature, strength and extend of the relationship between one or more independent variable(s) and the dependent variable.

Table 1: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.324[a]	.105	.093	3.73287
a. Predictors: (Constant), Trade Liberalization, FDI				

The findings revealed that trade liberalization and FDI had a weak correlation with tax revenue performance. Moreover, the model could explain about 10.5% of the total variations experienced in the value of tax revenue while 89.5% of the total variations in tax revenue of EAC affiliated member countries were attributable to other factors which were not part of this study.

Table 2: ANOVA

ANOVA[a]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	231.196	2	115.598	8.296	.000[b]
	Residual	1964.737	141	13.934		
	Total	2195.933	143			
a. Dependent Variable: Tax Revenue						
b. Predictors: (Constant), Trade Liberalization, FDI						

The findings indicated that the model was statistically significant and could reliably be used in making predictions on the effect of FDI on the relationship between trade liberalization on tax revenue of east Africa community member countries.

Table 3: Regression Coefficients

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	13.558	.936		14.488	.000
	FDI	.526	.177	.280	2.978	.003
	Trade Liberalization	.018	.024	.073	.781	.436
a. Dependent Variable: Tax Revenue						

The findings established that FDI statistically influences tax revenue of east Africa community member countries implying that the ability of nations to attract FDI is a fundamental pillar for effective and sustainable tax revenue mobilization. Moreover, the findings revealed that a unit increase in FDI would result to 0.526 increase in tax revenue of east Africa community member countries underscoring the need to improve governance by controlling corruption to influence tax revenue. These findings support the propositions of Institutional Theory, which argues that foreign investment can strengthen government revenue mobilization by expanding economic activities and increasing taxable transactions within the host economy. Moreover, the insignificance of the relationship of FDI on the relationship between trade liberalization and tax revenue obtained in the fourth stage of Barony and Kenny (1986) mediation test as captured in table 3 above implies that FDI has a full mediation effect on the linkage between trade liberalization and tax revenue of east Africa community affiliated countries.

V. Conclusion

The study concludes that FDI contributes significantly in enhancing the relationship between trade liberalization and tax revenue performance of east Africa community member countries. Through increased economic activity, employment creation, technology transfer, and business expansion, FDI contributes positively to government tax revenue generation. However, the benefits are not automatic and may be weakened by tax incentives, profit shifting, and institutional inefficiencies present in the nation concerned. Policymakers should therefore focus on creating a balanced investment environment that attracts foreign capital while safeguarding domestic tax revenue interests.

VI. Policy Implications

To maximize the benefits of FDI on the relationship between trade liberalization and tax revenue, EAC member states should:

i. Eliminate remaining non-tariff barriers affecting cross-border trade to attract more FDI inflows.
ii. Improve transport, energy, and digital infrastructure as a way of attracting foreign direct investments
iii. Enhance governance, transparency, and regulatory quality to create a conducive investment climate for foreign investors
iv. Promote investment-friendly policies that complement trade reforms.
v. Develop human capital and technological capabilities to attract high-value FDI investments.
vi. Foster political stability and policy consistency to improve investor confidence.
vii. EAC member countries should continue implementing policies that promote trade openness and reduce non-tariff barriers.

viii. Governments should invest in transport, energy, and digital infrastructure to improve the investment climate.
ix. Regional institutions should strengthen harmonization of investment regulations and trade policies.
x. Policymakers should enhance governance, transparency, and the rule of law to increase foreign investor confidence.
xi. Efforts should be made to improve ease of doing business through streamlined licensing and administrative procedures.
xii. Member states should promote political and macroeconomic stability to sustain long-term foreign investment inflows.

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