THE IMPACT OF MOST FAVOUED NATION TARIFF RATE ON ZIMBABWE

Gift Mugano*

Pierre Le Roux*

Michael Brookes**

Abstract

This study provides a quantitative assessment of the potential imports, exports, revenue and welfare implications of the WTO FTA on Zimbabwe. The study uses the Software for Market Analysis and Restrictions on Trade (SMART) partial equilibrium model for analysis. The findings of the study reveal that the WTO FTA will be beneficial to the country in terms of trade expansion valued at US$ 158 million and gains in consumer welfare to the tune of US$ 21 million. However, the country will lose revenue amounting to US$131.8 million. Total imports and exports increased by US$159 million and US$106.6 million, respectively. The implementation of the WTO FTA to be accompanied by steps to improve revenue collection from other sources such as Value Added Tax and income tax.

Key words: WTO FTA, revenue, welfare, exports, Imports, Zimbabwe

* Department of Economics, Nelson Mandela Metropolitan University

** Senior Lecturer, Middlesex University, United Kingdom

1.0 INTRODUCTION

Economists believe that the movement towards freer trade on balance provide positive benefits (Amponsah, 2002). There is also consensus that developing countries have a great deal to gain from free trade (Krueger, 1999; Srinivasan, 1999; Stiglitz, 2000; Tangermann and Josling, 1999; Huff, 2000).

Some economists such as Villarreal and Spanu argue that international trade contribute to growth. Most investigations confirmed Nurske's (1959) and Kravis (1970) conclusion that international trade provides an important stimulus to growth. As a result of these findings attention shifted to the identification of factors that constrained a country's capacity to fully engage in international trade and experience its associated beneficial effects (Ng & Yeasts, 2000).

According to UNCTAD (2002) trade liberalisation leads to an increase in welfare derived from an improved allocation of domestic resources. Import restrictions of any kind create an anti – export bias by raising the price of importable goods relative to exportable goods (Tussie & Aggio, 2005). The removal of this bias through trade liberalisation will encourage a shift of resources from the production of import substitutes to the production of export – oriented goods (Tussie and Aggio, 2005). This, in turn, will generate growth in the short to medium term as the country adjusts to a new allocation of resources more in keeping with its comparative advantage (McCulloch, Winters & Cirera, 2001).

On the contrary, trade liberalisation is expected to create adjustment costs, encompassing a wide variety of potentially disadvantageous short-term outcomes. Outcomes of trade liberalisation may include a reduction in employment and output, the loss of industry - and - firm specific human capital (Matusz and Tarr, 1999). Macroeconomic instability arising from balance - of - payments difficulties or reductions in government revenue is another economic ill of trade liberalisation. The size of the adjustment costs depends on the speed with which resources make the transition from one sector to another (Matusz and Tarr, 1999).

However, trade liberalisation in and of itself has not yet been unambiguously and universally linked to subsequent economic growth (UNCTAD, 2000). Despite the vast literature looking at this link, numerous empirical studies have not found the evidence conclusive. Rodriguez and Rodrik (1999) argue that the literature is largely uninformative. There is a significant gap between the conclusions derived from theory and the "facts". According to the authors, a number of factors explain this gap. In many cases, the indicators of "openness" used by researchers are problematic, as measures of trade barriers are highly correlated with other sources of poor economic performance.

1.2 Statement of the Problem

Zimbabwe pronounced Economic Structural Adjustment Programme (ESAP) in July 1990 (Government of Zimbabwe, 1991). The programme contains all the elements of the orthodox Washington package, and trade liberalisation has been the main area of action (Rattso and Torvik, 1998). The economy has not responded favourably to quick trade liberalisation. The immediate experience involved contraction in output and employment, a consumption boom, the inflow of imports and a rising trade deficit.

Notwithstanding the controversy regarding trade liberalisation on economic development, and social welfare, the momentum of trade liberalisation continues in Zimbabwe. ESAP was followed by further liberalisation within the multilateral (WTO) context, regional framework as well as at bilateral level. Because of the forces of globalisation, Zimbabwe like other African countries have no choice but to integrate into the global markets or risk being further marginalised.

It is in light of these past developments and the increased negotiations in trade it is imperative and intuitive at this juncture to carry out a detailed study. The study will show the effects of previous trade liberalisation. Therefore, will provide the best way in which Zimbabwe negotiators can position themselves to ensure that any further negotiations will not bring about disastrous effects to the economy.

1.5 Objectives of the Study

The purpose of this paper is to estimate and discuss the expected impact a World Trade Organisation unilateral liberalisation on Zimbabwe. Specifically, this study intends to;

- Evaluate the impact of WTO FTA on Zimbabwe imports and exports;
- Estimate tax revenue and welfare implications of WTO FTA on Zimbabwe;
- Estimated the impact of trade liberalisation on trade creation and diversion in Zimbabwe;
- Analyse the implication of the study's findings on trade policy in Zimbabwe.

2.0 LITERATURE REVIEW

This section looked at selected literature on economic integration and specifically on the welfare and revenue implications of a WTO FTA. The assessment will cover both theoretical and empirical literature.

2.1 Theoretical Literature

Theoretical literature considered in this section includes trade creation and diversion, static and dynamic benefits of an FTA and revenue and welfare effects of an FTA.

2.1.1 Trade Creation and Diversion

Trade creation means that more efficient or lower-cost producers in any of the WTO countries displace the less efficient or higher-cost producers in Zimbabwe and consumers therefore benefit from lower prices. However, some producers in Zimbabwe will be negatively affected as their products are substituted by products efficiently produced in other countries in the WTO group. This implies that Zimbabwean industries have to improve their production efficiency and competitive edge in preparation for the FTA. Trade diversion on the other hand implies that more efficient suppliers from outside the WTO FTA are displaced by less efficient producers within the WTO FTA

The key question about free trade arrangement is whether the benefits of trade creation exceed the costs of trade diversion (Amponsah, 2002). Thus, a free trade arrangement is likely to be viewed more beneficial if, on balance, it gives greater trade creation than diversion (Amponsah, 2002).

2.1.2 Static and Dynamic Benefits of an FTA

In theory, the formation of an FTA is associated with some static welfare effects and dynamic benefits. One of the benefits is the administration savings from the elimination of customs officers, border patrols for trade among member states and reduction of delays at the border (Salvatore, 2007). The elimination of trade barriers among member states are also associated with increased competition which stimulates development through efficiency and reduction in the cost of doing business.

Free trade agreement will create a huge market access for member states thereby promoting export growth. Elimination of customs duties is also expected to increase the import bill which will spur economic growth if the imports are coming in as inputs of production.

2.1.3 Revenue and Welfare Effects of an FTA

The earliest FTA theory generally believed that any liberalisation of trade should be beneficial and welfare enhancing. It is believed that free trade maximises world welfare. A free trade agreement reduces/eradicate tariffs and is therefore it was believed that an FTA increases world welfare. However, this belief was challenged by Viner (1950) when he showed that the net impact of an FTA on welfare is uncertain and depends on a number of economic circumstances.

Viner (1950) demonstrated that An FTA can result in either trade creation or trade diversion. Trade creation on one hand is a shift from high-cost domestic production to lower-cost production in a partner country in the FTA. On other hand, trade diversion involves a shift from the low-cost non-FTA producer to a higher-cost partner of the FTA.

From the above discussion, it is obvious that the impact of an FTA on imports, exports, welfare and revenue is vague from a theoretical point of view. The various theoretical contributions point to potentially important effects and fundamental guidelines, but no general conclusions can be drawn from theory alone. This therefore implies that the question of whether an FTA is welfare-increasing or not is essentially an empirical question that must be settled by examining data specific of WTO MFN on Zimbabwe.

2.2 Empirical literature

Alfieri, Cirera and Rawlinson (2006) carried out a study on Mozambique WTO FTA. They assumed that Mozambique unilaterally liberalise its trade with the WTO framework, that is, the total elimination of tariffs and duty surcharges, while keeping existing VAT and excise taxes.

Alfieri, Cirera and Rawlinson (2006) shows that Mozambique will witness imports increasing by 4.68 percent if it liberalise its MFN rate. Mozambican consumers are expected to record a welfare gain of US$160 million. According to Alfieri, Cirera and Rawlinson (2006) this welfare gain is attributed by reductions in prices which are expected to tumble by 7.09 percent if the country adopts WTO FTA.

Alfieri, Cirera and Rawlinson (2006) also noted that Mozambique will witness significant loss of revenue if it implements WTO FTA. In addition, the research shows that US$49 million of trade will be diverted from the rest of the world to the WTO FTA.

The foregoing literature review demonstrates the range of empirical approaches that have been applied in analysing the trade, welfare and revenue effects of WTO FTA. It is evident that the results of the studies vary from case to case. The implications of a WTO FTA depend on a number of economic issues, the initial tariff structure of a country and its trade pattern among other things. For Zimbabwe, there was no study undertaken to evaluate the impact of a full liberalisation in the WTO context. It is therefore important that a research on the impact of a WTO FTA is undertaken so that policy makers will be equipped as they are negotiating the Doha Round.

3. RESEARCH METHODOLOGY

The study used partial equilibrium (PE) to evaluate the impact of WTO FTA on Zimbabwe with specific reference to exports, imports, trade creation and diversion, revenue and welfare effects at a given point in time. PE models assess policy reform impacts on sectors that are directly affected, commonly referred to as *first-round effects*. PE models require minimal data as only data on trade flows, tariffs, and elasticities are required.

For the purpose of this study, the Software for Market Analysis and Restrictions on Trade (SMART) was used. SMART is a partial equilibrium modelling tool included in the World Integrated Trade Solution (WITS), a database and software package developed by UNCTAD and the World Bank to allow analysis of market access conditions and different trade policy options available to countries. WITS gives access to four major trade and tariff databases namely TRAINS database maintained by UNCTAD, COMTRADE database maintained by the United Nations Statistics Division (UNSD) as well as the Integrated Data Base (IDB) and the Consolidated Tariff Schedule (CTS) databases both maintained by the World Trade Organization(WTO).

SMART contains in-built analytical models that support trade policy analysis such as effects of multilateral tariff cuts, preferential trade liberalisation and ad-hoc tariff changes. It uses applied tariffs and trade values found in the TRAINS database.

For this study a base year of 2007 and harmonised code 6 will be used.

A limitation of PE models is that they are static in nature, allowing only for a comparative static comparison of pre- and post-policy change when all other variables are held constant. Thus, they ignore the *second round effects* as the models do not consider impacts of policy reforms on the wider economy as well as inter-sectoral implications and exchange rate effects.

Despite its weakness as a PE model, WITS/SMART simulation model helps to estimate trade creation, trade diversion, imports, exports, welfare and revenue effects for those countries whose data is available.

4. RESEARCH FINDINGS

This section presents the empirical findings and analysis of the revenue and welfare implications of the WTO FTA on Zimbabwe.

4.1 SMART Model Simulation Results

This section presents the results of the SMART Model simulations in terms of trade creation and trade diversion, revenue and welfare effects.

(a) Trade Creation and Trade Diversion

Using simulations results from the WITS/SMART model, Table 1 shows the trade creation and trade diversion effects of the adoption of the WTO FTA by Zimbabwe.

Table 1: Trade Creation and Trade Diversion Effects of WTO FTA on Zimbabwe (US$ Millions)

HS Code	Product Description	Trade Creation
100640	Broken rice	2.615
310559	Mineral or chemical fertilizers	2.878
240120	Tobacco, partly or wholly stemmed/stripped	19.190
382450	Non-refractory mortars and concretes	2.347
740100	Copper mattes; cement copper (precipitated copper).	4.820
870421	Motor vehicle with gross vehicle mass not exceeding 5 tonnes:	3.136
560890	Mosquito net, fruit-tree and seed bed nets	3.116
670300	Human hair	5.668
Other		114.478
Total		**158.248**

Source: Author's Own Calculations

Table 1 show that Zimbabwe will have trade creation that will offset trade diversion resulting in net welfare gains for Zimbabwe if it goes for an FTA under the WTO arrangement. Zimbabwe expects trade expansion valued at US$158.248 million after WTO FTA.

Zimbabwe's major exports to the WTO FTA member states include Tobacco, partly or wholly stemmed/stripped which is expected to create additional trade of US$19.2 million. Other products include broken rice, chemical fertilisers and copper matters with export value of US$2.6 million, US$2.9 million and US$4.8 million, respectively.

Most member states heavily protect their industries from imports of these products to save employment and raise revenue for the government. The adoption of the WTO FTA will result in Zimbabwe's exports being competitive and therefore displace other member states products by exports shown in table 1.

For the importing country in this case Zimbabwe, trade diversion is neutral. It does not affect the overall imported quantity but reallocates market shares among exporting partners based on the new relative prices. The increase in imports from the WTO countries is balanced by a decrease in imports from the rest of the world which result in trade diversion being equal to zero. Thus, trade creation is the only influence on total social welfare. Although the trade creation effect of the WTO FTA on Zimbabwe is positive, its exact implications on the economy is difficult to ascertain in view of the fact that trade creation has some element of both positive and negative effects.

(b) Revenue Effect

The implication of the WTO FTA on member states' fiscal revenue is one of the contentious issues under discussion at the regional level. There are fears that the tariff cuts that have to be implemented by most WTO countries to conform to the FTA rates will result in tariff revenue shortfalls for most countries. In theory, there are two opposing forces that generate ambiguity as to how the reduction in tariffs affects revenue. First, the decrease in the tariff rate results in the decrease in tariff revenue. Secondly, as the prices of the goods decrease due to the decline in tariffs, there is a tendency for imports to increase, raising the tariff revenue.

Table 1: Revenue Effect of the WTO FTA on Zimbabwe (US$ Millions)

HS Code	Product Description	Revenue Loss
240120	Tobacco, partly or wholly stemmed/stripped	-13.129
330190	Aqueous distillates and aqueous solutions of essential oils	-1.305
480262	Paper sheets	-2.261
480419	Uncoated kraft paper and paperboard, in rolls or sheets	-3.035
730890	Steel structures for agricultural purposes	-1.232
732690	Transmission or conveyor belt fasteners	-1.464
740100	Copper mattes; cement copper (precipitated copper).	-4.970
852560	Transmission apparatus for radio-broadcasting or television	-2.499
870333	Motor vehicle of a cylinder capacity exceeding 2,500 cc:	-29.859
Other		-72.005
Total		**-131.759**

Source: Author's Own Calculations

Zimbabwe is among the countries that are supposed to undertake huge transformation of their national tariff structures in order to conform to the WTO FTA rates. Table 2 shows the revenue implications of the WTO FTA on Zimbabwe. The WITS/SMART simulations estimate that Zimbabwe will have a total fiscal revenue loss of US$131.759 million if the WTO FTA is implemented.

The total revenue collected in 2009 stood at US$988.5 million[1]. The revenue that will be lost by adopting the WTO FTA translates into 65.2 percent of the customs duty collected in 2009 and 3.9% of the total revenue collected in the same year. Although this value is a small proportion of government revenue, it is significant given the increasing importance of customs revenue to the country. Table 10 below shows the five products with the highest revenue losses.

Tobacco that is partly or wholly stemmed or stripped is currently attracting a duty rate of 100% in Zimbabwe. The adoption of WTO FTA implies that it has to be levied 0% duty. In Zimbabwe, motor vehicles currently attract duty rates ranging between 60 and 80%. The coming into effect of a WTO FTA will now mean that motor vehicle will attract a 0 percent tariff rate.

[1] ZIMRA Revenues Volume 9 First Quarter Issue, March 2010

(c) Consumer Welfare Effect

As shown in Table 3 below, SMART simulation results reveal that Zimbabwe will experience a gain in consumer welfare valued at US$21 million by implementing the WTO FTA.

Table 2: Welfare Effects of the WTO FTA on Zimbabwe (US$ Thousands)

HS Code	Product Description	Welfare Gains/ Loss
240120	Tobacco, partly or wholly stemmed/stripped	5.188
870210	Motor vehicles for the transport of ten or more persons, including the driver.	4.947
Other		10.884
Total		**21.019**

Source: Author's Own Calculations

The outcome is consistent with the findings of Alfieri, Cirera & Rawlinson (2006) who researched on the implication of a unilateral full liberalisation of trade between Mozambique and all WTO member states. Alfieri, Cirera & Rawlinson (2006) found that Mozambique stand to benefit consumer surplus valued at US$160 million if implemented WTO FTA.

As shown on table 3 tobacco and motor vehicles are major contributors of welfare gains in Zimbabwe. It is interesting to note that this result is consistent with the findings on revenue loss. The same products came out as major contributors of loss in government revenue. Technically, major losers in revenue should be seen in the basket of products contributing welfare gains for the simple reason that these commodities become cheaper to households thereby enhancing welfare.

The total gains in welfare represent less than 2.1 percent of 2009 GDP, which stood at US$ 988.5 million. It is however difficult to make firm conclusions on the basis of the above results alone as they capture only consumers' surplus and do not consider crowding out of inefficient domestic firms and reduction in business revenue (producers' loss). From the above analysis it is apparent that Zimbabwe will both lose and benefit by joining the WTO FTA. The country will experience an expansion in trade through trade creation and a gain in consumer welfare. However, government will lose revenue through the massive transformation of the current tariff structure. The results thus indicate that the implementation of the WTO FTA while being beneficial to the country's total trade and consumer welfare, it is detrimental to government revenue.

(d) Export View

Export view reveals how exports are affect by tariff reform (FTA in this case). Zimbabwe exports to the WTO group stood at US$2.675 billion before an FTA. After the implementation of the FTA the country exports increased by US$106.633 million to US$2.675 billion within the WTO group. One possible explanation to the increase in exports is increase in market access for Zimbabwe caused by an FTA and the rebound effect of reduction of cost for Zimbabwean producers who import raw materials at a low cost caused by tariff removal for production of export bound products.

Major commodities can boost Zimbabwe exports after joining WTO FTA include cathodes which are expected to net US$397.543 million, electrical energy with export value of US$170 million, cobalt with export receipts of US$145 million and central heating boilers which are expected to net US$111.135 million.

(e) Market view

Under market view the study explore changes in Zimbabwe imports caused by the unilateral adoption of the WTO FTA. The study estimate imports before and after WTO FTA. Zimbabwe's imports before WTO FTA totalled US$2.02 billion. Zimbabwe imports after the coming into effect the WTO FTA was US$2.179 billion. The WTO FTA will result is national imports increasing by US$158.248 million. The increase in imports is rationally as a result of improvements in economic agents' cashflows due to low cost of importing since tariffs would have been abolished. Zimbabwe major imports include electrical energy, motor vehicles, processed tobacco, copper products, paper and central boilers.

The outcome consistent with the findings of Alfieri, Cirera & Rawlinson (2006) who witnessed a dramatic increase in Mozambican imports after assuming a unilateral implementation of WTO FTA.

5.0 CONCLUSIONS AND POLICY OPTIONS

This section summaries the research findings relating to the revenue, trade creation and diversion, imports, exports and welfare implications of the WTO FTA on Zimbabwe. The last section will put forward policy options that the policy makers in Zimbabwe may wish to adopt.

5.1 Summary of Research Findings

The study used the WITS/SMART partial equilibrium model to analyse the impact of WTO FTA on Zimbabwe.

Zimbabwe will have trade creation of US$158.2 million that will offset trade diversion resulting in net welfare gains for Zimbabwe if it goes for an FTA under the WTO arrangement.

The WITS/SMART simulations estimate that Zimbabwe will have a total fiscal revenue loss of US$131.759 million if the WTO FTA is implemented. The revenue that will be lost by adopting the WTO FTA translates into 65.2 percent of the customs duty collected in 2009 and 3.9% of the total revenue collected in the same year.

SMART simulation results reveal that Zimbabwe will experience a gain in consumer welfare valued at US$21 million by implementing the WTO FTA.

On trade, Zimbabwe exports and imports are expected to increase by US$106.633 million and US$159 million, respectively.

Welfare gains are six times lower than loss in revenue in Zimbabwe. However, the wave of trade liberalisation is unstoppable. Hence, Zimbabwe must be ready to meet the consequences.

5.2 Policy Options for Zimbabwe

An ultimate free trade agreement is inescapable for Zimbabwe. A number of measures could be put in place to mitigate the negative impact and also enhance the benefits of the WTO FTA.

1. The country need to consider improving the collection of revenue from alternative sources such as personal and company taxes and excise duty in order to cushion itself against the revenue loss impact of the WTO FTA. The country could reconfigure the income tax bands so that they become more progressive thereby raising more revenue. government could also consider widening the tax base by taxing the informal sector, which has been growing rapidly in the past years. And, fiscal authorities need to consider VAT as an important trade policy instrument that can be used to mitigate loss of revenue due to trade liberalisation as suggested by Alfieri, Cirera and Rawlinson (2006).
2. The agreement by member states to have a basket of sensitive products will help to reduce the revenue loss for Zimbabwe. In this regard, Zimbabwe's negotiators should push for sensitive products that will not be subjected to tariff reduction for some time. This is crucial as it gives member states the needed policy space to develop their sensitive industries before opening up to

third countries' competition. For Zimbabwe the sensitive products basket should mainly be composed of finished products that are currently levied high duty rates.

3. Government needs to put in place capacity utilisation and re-tooling loan facility to encourage industries to increase their capacity utilisation and boost their efficiency and competitiveness in preparation for the reduction and removal of tariffs in some cases. An industrial bank mooted in the 2012 – 2016 industrial policy should come into reality. The industrial bank objectives inter-alia includes the provision of long term finance to industry at concessionary rates for re-tooling.
4. In addition to this, the industry needs to be sensitised and educated about the trade reforms and its implications so that they are well prepared.
5. Using the ongoing Doha Development Agenda, the government of Zimbabwe should call for smooth and flexible implementation of trade liberalisation that will take into account peculiar situation of developing countries like Zimbabwe.
6. On the ongoing Doha Round negotiations Zimbabwe should argue for adjustment facility which is designed to assist member states that will incur adjustment costs due to tariff reductions.

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