Steering East Africa Towards a Customs Union

Suggestions from a Pilot Study

EDITED BY ANDREW MULLEI

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Acknowledgements

This publication synthesises three country reports (Atingi-Ego et al 2002, Lyakurwa et al 2002, and Ng'eno et al 2002). These reports are outcomes of the pilot phase of a collaborative study on regional integration in Africa. The pilot phase covered countries that are in the East African Community (ACEG 2000), so that the reports from which the synthesis draws were specific to Kenya, Uganda and Tanzania. In Kenya, a team that was led by Nehemiah Ngeno included Eric Ronge, Hezron Nyangito, Justus Nyamunga and Moses Ikiara. The Tanzanian team was led by William Lyakurwa. Other members of his team included Longinus Rutasitara and G. D. Mjema. Michael Atingi-Ego led the Ugandan team that included Augustine Wandera, Charles Abuka and Marios Obwona.

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CHAPTER 1

Introduction

Many potential forms of regional economic schemes exist, ranging from simple preferential trade areas to political federations that characterise deep integration[1]. African countries have attempted different levels of inter-country co-operations. These attempts have received renewed impetus in recent years as countries continue to seek out configurations that can help to improve the welfare of their citizens.

Although many of the regional economic schemes in Africa came into existence in the 1970s, the history of regionalism in Africa is long, dating back to the pre-independence period. Indeed the world's oldest customs union was established in Southern Africa in 1910, so that the concept has a uniquely long application in Africa (Ngeno et al 2002). Africa's regional economic schemes have not been limited to narrowly defined regions as there have also been attempts to establish continental equivalents. An example is the African Economic Treaty, referred to as the Abuja Treaty that came into force in 1994. The Abuja Treaty initially sought to strengthen existing regional schemes and promote formation of new ones that would be the forerunners of a continental integration scheme. This eventual outcome was realised with the conversion of the Organisation for African Unity into a continental economic union in 2001.

Many of Africa's integration efforts proved difficult to sustain due to restrictions in factor mobility, failure to agree on distribution of benefits, ineffectiveness of common external tariffs due to repeated requests for exemptions to mitigate revenue losses, inappropriateness of import substitution policies pursued by member countries, inadequate political commitment and macroeconomic instability. For these reasons, many of the integration schemes in African have tended to struggle and eventually flounder.

Regional grouping in East Africa has a similarly long history. For a long time, Kenya, Tanzania and Uganda have enjoyed close commercial, industrial,

[1] For a summary of these forms of co-operation, see Appendix B.

cultural, and historic ties (Lyakurwa et al 2002). Initial manifestations of integration were evident as early as 1919 (Ngeno et al 2002). Prior to 1960, significant epochs in East African regionalism included the construction of the Kenya-Uganda railway in 1897-1901, the establishment of a Customs Collection Centre in 1900, and the formation of the East African Currency Board and Postal Union in 1905. Others include the Court of Appeal for Eastern Africa, established in 1909, a Customs Union in 1919, the East African Governors Conference in 1936, and the East African Tax Board and the Joint Economic Council in 1940. In the post 1960 period, such efforts included the East African Common Services Organisations Agreements that were in force over the 1961-1966 period. An East African Treaty was signed in 1967, establishing the East African High Commission, the East African Common Services Organisation, and the East African Community (Lyakurwa et al. 2002).

This original East African Community lasted only one decade during which period it begun floundering and was eventually officially dissolved in 1977. The dissolution was found necessary on account of limited participation by the private sector and civil societies in co-operation activities, inequitable sharing of community benefits, ideological differences and lack of political will to make necessary sacrifices for supporting community activities. After a period of uncertainty that followed the dissolution, the three countries eventually signed, in 1984, the East African Mediation Agreement for division of assets and liabilities of the defunct community. At the same time, the countries agreed to identify and explore areas for future co-operation. Ten years later, a Permanent Tripartite Commission for co-operation was established to co-ordinate economic, social, cultural, security and political issues in Kenya, Tanzania and Uganda.

A 1997 summit of heads of state from East Africa launched the first East African Co-operation Development Strategy which recognised the importance of market mechanisms, the private sector and civil society in any future co-operation. The strategy also stressed the need for governments to ensure peace and security, law and order, and to promote good governance. Furthermore, it identified a variety of areas in which regional co-operation was possible, including political, social, cultural, research and technology, defence, security, legal and judicial affairs, finance and trade. Two years later, the three heads of state signed a treaty for the re-establishment of the East African Community. This paved the way for the launching of the second East African Community Development Strategy in April 2001.

This new co-operation initiative has a wider scope as it covers not only the usual range of areas of mutual interest but its scope is expanded to include legal and judicial affairs. The objectives of the new Treaty are to be pursued with mutual trust and require political will and sovereign equality. Its cardinal principles include peaceful co-existence, good governance and egalitarianism. The renewed co-operation also embraces export orientation and free movement of goods and factors of production. In the medium and longer term, the community aims to establish an East African Customs Union and a Common Market that should open the way for a Monetary Union and Political Federation.

Although regionalism in the East African region has faced numerous challenges, progress has been made towards integrating the economies of Kenya, Uganda and Tanzania. The current co-operation is broad based and ambitious, with trade matters that are directed by appropriate trade protocols. A framework for the establishment of a customs union is also in place. The provisions for the trade protocols under customs union regime allow the application of principles that acknowledge the fact that the three partners are at different stages in their socio-economic development and preparedness for co-operation. As a consequence, trade measures are to be applied asymmetrically.

CHAPTER 2

Review of the Theoretical Attractions of Integration

Five stages define different degrees of integration. The shallowest of these is the Preferential Tariff Agreements through which tariffs on trade among member countries are reduced relative to those on trade with non-member countries, followed by a Free Trade Area defined by removal of tariffs and quotas on trade between members in goods originating within the FTA[2], a Customs Union by which members not only abolish restrictions on internal trade as in an FTA but in addition impose a common external tariff. The fourth integration level embodies the Common Market, which adds on to the Customs union by permitting free movement of factors of production. In a common market, common restrictions apply to movement of factors of production within non-member countries. The deepest level of integration is an Economic Union for which major economic policies are co-ordinated and the introduction of a monetary union made possible (Ngeno et al 2002).

In accordance with standard trade theory, integration, whatever its depth, improves welfare in respective countries provided such an arrangement creates trade, minimises trade diversion, or the trade so created exceeds any trade diversion that arises from integration. The effects of integration are either static or dynamic and arise from re-allocation of resources that follow changes in relative prices, specialisation, scale economies, efficiency changes that are driven by increased competition, and increased investment and growth. Integration also encourages growth by promoting stable national macroeconomic policies and rapid accumulation of human and physical capital.

Whether the static outcomes of integration are beneficial to member countries depends on the balance between trade creation or the shifting of the production of goods from less efficient to more efficient members, and trade diversion or the shifting of production from an efficient non-member to a less efficient member. Trade diversion and creation tend to follow tariff changes associated

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[2] Under a FTA, member countries retain restrictions on trade with non-member countries. Tariffs and other restrictions applying to external trade varied across countries, so that rules of origin are applied to implement preferential trade arrangement.

with a customs union. While trade creation represents a move towards freer trade and greater efficiency that improves welfare, trade diversion reduced efficiency and welfare. An assessment of whether integration is beneficial is essentially an assessment on whether the total trade creation that results from such integration outweighs the resultant total trade diversion. The circumstances under which welfare is improved during integration include those that enhance trade creation such as extensive overlap in activities protected by tariff across member countries, and large cross country differences in the costs of producing commodities that are subject to protection. Conditions that minimise trade diversion include a large customs union membership, situations where pre-union trade is only a small proportion of members' production, where a high pre-union trade is with member countries, and a low common external tariff compared to members' pre-union tariff (Ngeno et al, 2002).

The dynamic effects of integration are gradual and longer lasting and include greater opportunities for the realisation of scale economies, increased efficiency enhancing intra-union competition, capital formation through reduction in trade barriers, technology transfers and diffusion, increased marginal product of capital, the side effects of export growth, and the higher likelihood of influencing terms of trade faced by union members through group actions. These dynamic effects are more efficacious in their impact on economic growth and welfare, and offer stronger arguments for regional integration (Ngeno et al 2002).

We can summarise the benefits of regional integration in terms of scale effects and competition, improved terms of trade and its effects on foreign direct investment, location and trade effects. The scale effects and competition arguments are as follows: many countries on their own have insufficient quantities of specialised inputs and product markets that are too small to generate adequate sales to cover production costs. In the circumstance, regional integration opens opportunities for shifting an economy to a threshold where attraction of investment and technology transfers become more probable. Integration also generates competitive pressure that improves internal efficiencies and productivity in domestic markets. Increased openness in the trading blocks reduces price cost margins as sectoral competition increases[3].

Intense competition within a block has the potential of inducing non-member countries to reduce prices of exports to the bloc, improving the terms of trade within the block. Furthermore, increased competition within the bloc also

[3] It has been argued (Atingi-Ego et al. 2002) that some of these benefits can be reaped through unilateral trade liberation.

increases the inflow of foreign direct investments following improvement in the terms of trade. Lumpy investments requiring minimum sales guarantees become more probable, contributing to further inflow of foreign direct investment.

Integration also generates positive trade and location effects. This is an outcome of changing relative prices that follow a lowering of tariffs and /or imposition of a common external tariff within member countries. Imports from member countries become cheaper. When these price changes are accompanied by shifts in patterns of demand and output levels, the outcome is trade creation/ diversion. Regional integration among developing countries has greater potential of generating trade diversion rather than creation. Imports from non-member countries tend to fall without any compensating increase from intra-bloc sources.

Because integration leads to reallocation of economic activity, industrial activity increases in some countries as it falls in others. This changes intra-bloc income levels and generates losers and winners both of whom have to be handled carefully. It also raises concern about convergence.

Regional integration makes political sense in that it enhances security against non-members and reduces intra-regional conflicts. This is because interlocking of economies through regional integration facilitates building of trust and permits other forms of cross-border co-operation. Often, the impetus for regional integration may be generated by a felt regional need to face a common external threat as a unified entity, so that economic co-operation serves as a precursor to military co-operation. The bargaining power of regional blocs is more efficacious than that of individual countries, provided member countries are able to strike a common understanding on mutually relevant issues. Preparation of joint projects and co-operation can also be useful in dealing with cross boarder problems such as pollution and transport bottlenecks. Commitment mechanisms help member governments to implement domestic political agenda, reducing the costs and possibilities for domestic policy reversals and loss of credibility. Regional integration therefore has lock-in policy reform effects that are politically beneficial.

There are of course costs associated with regional integration such as loss of national sovereignty, creation of internal tensions and resentments where unfair distribution of integration benefits and costs results. Whether regional integration improves or worsens intra-regional security depends on the characteristics of the member countries and the design and style of the integration scheme.

CHAPTER 3

Study Objectives

The broad objective of the study on which this synthesis is based aimed at identifying economic, political and institutional issues likely to delay the realisation of successful regional integration schemes in Africa (ACEG 2000). Such identification was meant not only to sharpen understanding on the challenges that African countries will face as they move towards regional integration but also guide implementation of the appropriate treaties and protocols. It was assumed that unless economic political and institutional issues are well understood, addressed and resolved, they would continue to be impediments to successful regional integration efforts in Africa.

The pilot stage of the study aimed at determining the costs and benefits of regional integration in East Africa and designing appropriate mechanisms for sharing these costs and benefits equitably among the three East African countries. The study also sought to deliberate on the economic, political and institutional precepts for successful implementation of the integration strategy.

More specifically, the study sought to:

- Determine and quantify the benefits and costs and identify losers and beneficiaries
- Identify mutually acceptable mechanisms for compensating losers and sharing benefits
- Establish the most suitable institutional framework for handling matters of compensation and sharing of benefits within the Community
- Highlight social and political aspects that may hold back the pace towards regional integration
- Identify priority policy areas that each member country, the EAC Secretariat and other key stakeholders needs to address for the process to move forward.

It was hoped that the findings of the pilot stage of the study would form the basis for the design and implementation of other phases of the study to cover other regional integration groupings in Africa.

Policy questions

What specific groups/industries in each country are likely to gain or lose with the implementation of the current EAC treaty? Other than quantifiable economic costs and benefits, are there other positive or negative effects that are likely to arise from the process of regional integration whose distribution may require consideration as plans for moving forwards are made? What are the most appropriate ways of compensating losers and what mechanisms are available for sharing equitably the benefits of regional integration? What options are available for educating those who gain from regional integration to establish an effect lobby to counter-balance the pressures likely to be exerted by potential losers? What are some of the measures that countries can take in order to reduce over dependence on trade taxes?

Is there existing potential for unidirectional movement of capital and labour and the relocation of industries to one of the regions? If so, what policies or incentives are available for addressing this problem? What are some of the mechanisms for ensuring smooth implementation of the East African Community? Should the EAC be given supra national authority to enforce common decisions? To what extend does the EAC Treaty recognise reciprocal rather than unilateral trade liberalisation as an engine of growth for the sub region? Are there potential conflicts posed by the overlapping memberships and if so how should these be resolved?

Study methodology

The EAC pilot study was undertaken as a collaborative research project between the African Centre for Economic Growth (ACEG) and three partner institutes in East Africa. In Tanzania, the research activities were co-ordinated by the department of Economics in the University of Dar es Salaam. The research department of the Bank of Uganda and the Kenya Institute of Public Policy Research and Analysis in Nairobi co-ordinated the research activities in Uganda and Kenya, respectively. The ACEG took overall responsibility for management, co-ordination and quality control of the collaborative study.

The project adopted a country case study approach so that each country in the regional integration scheme was studied under a common methodology. Before commencement of the country studies, a two-day methodology workshop brought together the three country teams to jointly develop and agree on the common methodology. The methodology workshop was hosted by the EAC secretariat in Arusha and allowed the incorporation of inputs of the secretariat in to the study right at the design stage.

Thereafter, each of the study teams applied the common methodology to prepare country reports that addressed country specific issues identified as critical for the success of the EAC. In each case, use was made of secondary and primary data, the former to identify key sectors in terms of regional trade flows and tracking the costs and benefits of integration. In the tracking of costs and benefits, simulation models were used in conjunction with internationally determined import price elasticities of demand for important commodities. Different scenarios of the Common External Tariffs (CET) for imports of primary, intermediate and final goods were explored in simulations to determine the revenue implications. Primary data were collected through the administration of common instruments on a wide range of stakeholders. Included among these were manufacturers, traders, farmers, transporters, clearing and forwarding firms, revenue authorities and policy makers. The survey sought to generate perceptions on social, political and economic factors that inhibit the implementation of EAC integration, and identify solutions.

The country reports that were outcomes of this methodology were discussed in national workshops under the aegis of the respective ministries of regional co-operation in each country. In the end, a regional dissemination workshop was organised under the EAC Secretariat and attended by key stakeholders from the three member countries. The output from the regional workshop was submitted to EAC Secretariat and relevant government ministries in the region as feedstock in the formulation of strategies to push forward integration efforts in East Africa.

CHAPTER 4

Evolution of Trade Regimes

In spite of ideological differences marked by the socialist experiment in Tanzania, the three East African countries embraced trade regimes that were very similar. All the countries adopted import substitution development strategy that had its roots in the colonial era. This strategy was pursued through a combination of tariffs and import quotas supplemented by foreign exchange allocations. Over-valued currencies, low interest rates and credit policies that subsidised producers of manufacturing products were all supportive of the import substitution. Each of the three countries introduced pervasive controls that were particularly extensive in the 1970s. These strategies generated excess capacities and inefficient production that could not compete in the external market. In Tanzania, stringent controls fuelled parallel market activities. Thereafter, trade policies increasingly relied on market incentives.

Trade liberalisation was the epitome of this reliance on market incentives and was part of the structural adjustment programmes negotiated with the international development institutions and implemented during the 1980s. Liberalisation entailed reduction in the level and dispersion of tariffs, converting non-tariff barriers to tariffs, facilitation of exports/imports, and easing of foreign currency controls in respect of current and capital transactions. In Uganda, the main objective of the reforms was to weaken the effects of factors that discriminated against productive efficiency and export development. In Kenya, export promotion has been a government policy since independence and although nothing was done by way of application of this policy until the 1970s, many export promotion measures were put in place in Kenya in the 1980s[4].

Import liberalisation in Tanzania entailed reduction and compression of tariffs, reduction of quantitative restrictions and easing of foreign exchange controls. There was also easing up of administrative rigidities that complicated and delayed application of import procedures and created

[4] The export promotion plat forms mentioned in Ngeno et al (2002), included manufacturing under bond, general import duty and VAT exemption schemes, regulatory reforms, green channel system to hasten administrative approvals, and export processing zones.

avenues for corruption. Tanzania also mounted an active export liberalisation programme. Exporters were allowed to keep a progressively high proportion of export earnings until 1993, when the surrender requirements on non-traditional exports were abolished. These import and export trade liberalisation efforts were complementary[5].

Trade liberalisation in East Africa was a progressive pain staking process as the Uganda case demonstrates. Before adopting the Economic Recovery Programme (ERP) in 1987, Uganda's trade regime was characterised by foreign exchange controls, administratively determined allocations and control of interest rates by the administration. The year following adoption of the ERP, the Ugandan government established an Open General Licence through which foreign exchange was made available to selected manufacturing establishments for acquisition of raw materials and spare parts needed for industrial development. This was followed by the introduction of a Dual Licences Scheme that permitted exporters of non-traditional commodities to retain all their earnings for the importation of commodities of their choice[6]. A Retention Account Scheme followed, by which exporters were allowed to maintain foreign exchange accounts. Importers without foreign exchange were allowed import goods without recourse to official foreign exchange channels. The greatest liberalisation boost was the outcome of the authorisation of full retention of export proceeds for all non-coffee exports. The legalisation of foreign exchange bureaux was also a major policy shift with a bearing on liberalisation. A foreign exchange auction system was also put in place to inject transparency into foreign exchange allocations. An inter-bank foreign exchange market was initiated simultaneously with the elimination of restrictions on payments and transfers for international transactions. In 1997, the current account was also fully liberalised with the abolishment of surrender requirements and foreign exchange borrowing restrictions.

Similar reforms were put in Kenya that progressively liberalised trade during the 1990. As an example, between 1991-93, the Foreign Exchange Allocations and Import Management Committees, and foreign exchange allocation licences were abolished and foreign exchange bearer certificates introduced. In 1993, the shilling was floated, foreign exchange retention accounts for exporters of traditional exports and services were re-introduced, the inter-bank market was expanded and tea and coffee marketing systems liberalised.

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[5] It is argued in Lyakurwa et al (2002) that import liberalisation, duty drawbacks and taming of parallel market exports all contributed to the recovery of exports in Tanzania.

[6] The only requirement was that such imports should not be in the government's negative list (Atingi-Ego et al 2002).

In the same year, administrative controls hampering international trade were abolished, and tariff rates and bands reduced[7]. All domestic price and foreign exchange controls had been lifted by 1995. In the same year, domestic trade had been fully liberalised, the Foreign Exchange Act repealed and foreign exchange bureaux legalised. By the end of 1995, the imposition of countervailing duties to control subsidised exports was the only remaining barrier to international trade.

A similar chronology of events is traceable in Tanzania. During 1987-92, tariffs were liberalised and the rates and categories compressed. Foreign exchange bureaux were introduced. During 1993-94, exchange rates were unified and foreign exchange licensing abolished, an inter-bank foreign exchange market introduced and parallel exchange rate premium disappeared. Over the same period, exporters were no longer required to register with the Bank of Tanzania or even have export licences. The exchange rate was also tied to a weighted average of bureaux rates. Foreign exchange surrender requirements on non-traditional exports were abolished. Those for traditional exports were also rescinded in 1994. Export taxes on all products were abolished. There were only 5 tariff bands and the maximum tariff rate was a mere 25% by 1998/1999. In 2001/2, a maximum dutiable value that was introduced the previous financial year was replaced by an Agreement on Customs Valuation[8].

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[7] As mentioned in Ngeno et al (2002), reforms implemented in Kenya since the 1980s resulted in considerable simplification of the country's tariff regimes. In 1987/88, there were 24 tariff bands, a maximum rate of 170% and a weighted average tariff rate of 39.9%, the corresponding figures for 1997/98 were 4, 25% and 12.3% respectively.

[8] The exception here was sugar which was governed by special agreement. To curb tax evasion, Minimum Dutiable Value was applied on imports that were prone to under-valuation (Lyakurwa et al 2002).

CHAPTER 5

Evolution of Tariff Regimes

Tariff reforms in East African have been driven by the need to increase revenue to meet budget obligations, enhance equity, increase compliance, minimise tax evasion and improve tax administration. There was also attempt to avoid taxes and tariffs that reduce export competitiveness (Atingi-Ego et al (2002). In the 1960s, external tariffs levied on goods originating from outside of the East African Common Market were set on a common basis for Kenya, Tanzania and Uganda (Lyakurwa et al. 2002). These tariffs, inadvertently, favoured Kenya which was relatively more industrialised than its neighbours. The structure of protection that emerged from East Africa's external tariff encouraged the flow of resources towards protected Kenyan industries that took advantage of the protection. Inter-community tariffs (transfer taxes) were then introduced in 1967 on selected products originating from partner states as an incentive for promoting new industries especially in Tanzania and Uganda. As a device for quelling concerns about the mal-distributive consequences of participating in the common market, the inter-community tariffs were inadequate. Perceptions about such inadequacy partly accounted for the collapse of the first EAC in 1977.

For East African countries, the import substitution strategy and the need to generate revenue and widen the tax base shaped the evolution of the tariff structure up to the mid 1980s. In Tanzania, other factors were put into consideration such as the socialist economic philosophy. The import substitution strategy depended on protection primarily from foreign firms[9]. As a result, external tariffs were high for final consumer goods but low for imports of intermediate and capital goods used for domestic production. Over-valuation of local currencies was a further mechanism for the protection of local industries. To pursue multiple objectives of the self-reliance socialist era and meet demands from different segments of society, the structures of 1970s and 1980s in Tanzania were uncoordinated. Not only were the tariffs

[9] Lyakurwa et al (2002) argue that in Tanzania, where the state was directly involved in production, the import substitution strategy also relied on protection from domestic competition. Protection from domestic competition included price controls and preferential access to domestic credit and foreign exchange.

meant to protect domestic industries and raise government revenue, they were mechanisms for controlling consumption of luxury goods. The incidence of duty evasions and exemption was high.

Since the 1980s, there has been progressive reduction in tariff rate bands, better remuneration of revenue collectors and training of personnel. There has also been some emphasis on the simplification of tax implementation and provision of adequate facilities for effective tax collection.

During 1990/91 numerous rate bands in Uganda were reduced to four (namely 10% , 30%, 70% and 150%). These were to apply to locally produced and imported goods. Raw materials were taxed at the lower end of the scale while luxuries attracted the maximum rates. Excise duties were reduced to a two-rate structure: 30 and 60 percent restricted to alcoholic drinks, cigarettes and all soap products except bar soap. The upper rate was further reduced to 50 percent.

Export duty on all materials as well as import duty on all materials except those locally available were abolished. Duty exemptions were also extended for educational materials, newspapers, journals and periodicals to promote literacy. Protection tariffs were imposed for sugar, cement, leather footwear and rice.

Uganda made further tariff adjustments during 1993-2000. Tariffs were used to protect bicycle manufacture. Special import surcharges introduced on Kenyan imports in 1993 were widened to cover final goods from COMESA to further protect local industries and compensate for revenue losses. Most agricultural inputs, pharmaceuticals and medical equipment were duty exempt. However, import bans were imposed on beer, sodas and cigarettes[10]. Tariff reductions approved by COMESA were implemented by Uganda, which also reached double taxation treaties with the Kenya, South Africa, Tanzania and the United Kingdom. Import licence commission was removed for all raw materials and capital equipment in June 2000. But it was the 1998/ 99 budget that initiated a three-year tariff reform programme. This led to the harmonisation of all import excise charges at 10 percent to be altogether eliminated during the three year period, reductions in duty rates on petroleum products, removal of exemptions, and introduced a progressive simplification and modernisation of the tax regime and its administration.

Owing to a narrow domestic tax base, revenue needs and the quest for domestic industry protection in Tanzania meant frequent use of non-tariff taxes on imports (Lyakurwa et al 2002). A high proportion of government

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[10] VAT was introduced in Uganda in 1994. VAT was perceived to be more buoyant (Atingi-Ego et al. 2002)

revenue is generated through international trade taxes. Tariff rate reductions are therefore critically predicated on the ability of the Tanzanian government to find alternative domestic revenue sources to offset loses occasioned by tariff reductions. Since there is an upper limit on the permissible domestic tax rates, offsetting strategies include widening of the tax net, improved efficiency in tax administration, reduction in discretionary exemptions and increased reliance on non-tax revenue sources.

Kenya and Uganda have lower external tariff and VAT rates than Tanzania. Duty charges on Kenya and Uganda imports contribute only 7% of Tanzania's duty collection. Duty exemptions increased considerably in the 1990s due to increased role of donor funding of development expenditure that attracted import duty and tax exemptions, and for religious educational and charitable purposes. There is therefore a high incidence of foregone revenue through these exemptions.

Import commodities in Tanzania are classified into five main bands depending on the 'degree of processing' (Lyakurwa et al 2002: 34). The higher the degree of processing, the higher the tariff rates. The main taxes include the general customs duty rate currently applied in five bands[11]. Tariff preferences in respect to any regional trade arrangements are anchored on these rates. There is also the COMESA rate, 80% of the general rate, initially extended to COMESA members and currently applied on East Africa's imports to Tanzania. It is therefore effectively the EAC rate. Suspended duty is applied on a discretionary basis to protect local producers at a flat ad valorem rate of 20 percent. Tanzania also charges excise taxes on selected imports at specific rates and a flat 30 percent on other goods. The VAT on most imported goods stands at 20 percent.

Kenya generates tax revenues through four channels namely, income tax, customs and excise taxes, value added tax and traffic fees. While the contribution of customs and excise taxes has been declining in recent years, that for VAT has been increasing[12]. There has also been a general movement away from direct taxation to consumption taxation. While income tax revenues in Kenya have shown considerable instability, VAT revenues have been resilient during times of changes in economic fortunes. Still, tariff revenues are important in Kenya and the country is reluctant to adopt a low

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[11] It is also referred to as the most favoured nation rate. The bands are 0, 5, 10, 20 and 25 percent graduated in accordance with the degree of processing.

[12] Between 1996 and 2001, tax revenues in Kenya grew by 9 % annually. Most of this growth came from growth in VAT. VAT on imported and domestic goods and services accounted for 48% of the annual tax revenues growth experienced in the last 6 years (Ngeno et al 2002).

common external tariff.

All the three members of the EAC have undertaken major tax reforms in the recent past. Nevertheless, tariff revenues remain important in the region. if regional integration process stays on course and leads to a lower, perhaps zero intra-regional tariff, mechanisms have to be found for offsetting the revenue losses in all the member countries.

CHAPTER 6

Revenue Implications of the Customs Union

The importance of tariff revenues in the three countries implies that the replacement of all tariffs for the region's internal trade with a common external tariff will have major revenue implications.

Simulations based on different scenarios confirm that the more drastic the reduction in tariffs, the higher the revenue loss. On the basis of revenue implications alone, maintaining tariffs of 7.5, 15 and 20 percent for primary, intermediate and final goods respectively in Kenya would be most optimal. This is because this scenario represents potential revenue gains amounting to 8% of Kenya's 1998/1999 tax revenues and 12% of the 1999/2000 tax revenues. However, a high CET would increase the likelihood of costly trade diversion, raise the cost of agglomeration or clustering of economic activity and make necessary politically divisive re-distributions. These eventualities need to be avoided to obviate collapse of the EAC. Considering that the CET needs to be kept as low as possible, that Kenya has potential for making up for losses of tariff revenue through alternative tax measures, that the revenue losses associated with a 20% CET are reasonable and that there is need to encourage manufacturing through easier access to cheaper raw materials and intermediate goods, a CET embodying 0% for primary goods, 5-10% for intermediate goods and 20% for final goods is recommended for Kenya(Ngeno et al 2002). Kenyan imports from East Africa are insignificant and duty revenues from the region very small. A customs union would require complete elimination of intra-EAC tariffs. Estimates show that although there would be some revenue loss in Kenya following elimination of intra-EAC tariffs, such loss would be more than compensated by the increase in exports arising from the dynamics of trade such as competition and efficiency improvements.

Simulations on Tanzanian data and discussions with stakeholders revealed that the preferred tariff bands are 0, 10-15, and 15-20% for basic raw materials, intermediate goods and finished commodities, respectively. An important consideration in deciding on these rates is the need to avoid reversals which would result in un-predictability of tariff reform policy (Lyakurwa et al 2002).

Additional analysis of Tanzania import data showed that close to a half of the imports from Kenya are final manufactured goods. Although imports from Uganda are lower than those from Kenya, most of them are also finished goods. Imports from Kenya and Uganda into Tanzania fall within the high tariff band. Further analysis revealed that the implicit tariffs on these imports do not always match the statutory rates due to erroneous charging, poor recording, tax evasions and discretionary and statutory exemptions.

Given the structure of intra-EAC trade, Tanzania will forego a higher tariff revenue than any of its neighbours. This revenue loss would be the most direct cost to Tanzania in the short run following complete elimination of intra-regional tariffs. A gradual reduction of tariff toward 0 will permit better absorption of the losses over an extended period. Assuming trade creation and reasonably high elasticities of demand for imports, and that the supply conditions in Kenya and Uganda allow increased production of commondities exported to Tanzania, there will be increased imports and consumption of partner imports in the medium and long terms. The supply response is taken for granted since this is what justifies a larger tariff-free market[13]. But other than the disappearance of the import tariff revenue, there will be other positive tax revenue adjustments that will accrue from increased imports from the region. There will, for example, be a revenue impact due to VAT and revenue from excise and suspended duty and other fiscal devices will increase/fall if there is a net increase/fall in imports. The specific impacts will depend on the structure of domestic supply, demand elasticities and policy interventions.

An increase in net imports from partner states also increases welfare by increasing consumer surplus. It also generates a positive 'production effect' in savings as the real cost of goods previously produced domestically were produced at higher costs. The converse is true if trade diversion occurs: it is possible that Tanzania could end up importing from higher cost partners instead of lower cost external sources. With the imposition of a zero tariff in the EAC, more expensive goods from Kenya and Uganda could displace some of the goods currently imported by Tanzania from the rest of the world, so that the net effect is negative welfare. Over time, Tanzania also foregoes the tariff revenue collected from these other imports.

Using a mixture of scenarios, classifications and assumptions, the Tanzanian data showed that the establishment of a CET in the region will have differing revenue outcomes that put a premium on careful selection and negotiation

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[13] As pointed out in Lyakurwa et al (2002), actual quantities imported into Tanzania will depend on the amounts of similar products that Tanzania itself plans to produce.

of such a CET[14]. Different levels of CETs have different revenue and other implications. Specifically, a high CET would perpetuate high cost firms, erode competitiveness and encourage rent seeking behaviour and divert trade. A low CET would expose domestic firms to considerable competitive pressure. Where initial conditions in partner countries are unequal, a well thought out compromise is needed[15]. After negotiations have been made on the specifics of the CET, time will be needed to allow partner countries to factor the effects, especially the losses, into future plans.

The analysis assumes away the cost implications of participating in parallel regional integration schemes. These schemes focus on the same resources and volumes of trade, so that multiple memberships are consequential (Lyakurwa et al. 2002).

Final goods in Uganda have the highest import value, followed by intermediate and primary goods in that order, reflecting Uganda's small industrial sector. Tariffs on primary goods are higher than those on intermediate and final foods: the import values are higher for the later. Analysis of the revenue implications of a CET showed that changes in revenue are associated with changes in volume related to price elasticity of demand and changes in price resulting from tariff adjustments[16]. Simulations were based on the three commodity groupings, three possible demand elasticities, and a proposed CET of 7.5, 15 and 20% for primary, intermediate and final goods respectively. The simulations showed positive potential revenue changes for all commodity groups. This is despite the fact that the proposed CET represents a 32 percent reduction on current primary commodity tariffs. However, the CET represents a 50 percent increase in the tariff of intermediate goods and 167 percent increase in the tariff of final goods. Total elimination of tariffs in Uganda results in revenue losses for both primary and intermediate goods. Uganda would, however, register net revenue gains under different elasticity assumptions (Atingi-Ego et al 2002).

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[14] In simulating the revenue outcomes of a CET, the Tanzanian team used 6 possible scenarios that are based on different assumptions about the tariff bands, initial conditions, demand elasticities, and classifications of imports (Lyakurwa et al. 2002)

[15] It was not possible to make firm recommendations on the CET using Tanzanian data since the classification of imports does not conform to customs classifications that are more representative of the local situations.

[16] The Ugandan team employed a Tariff Item Procedure and applied a model that tracks changes in potential revenue through import price elasticities of demand, the CIF value of imports and tariff rates before and after introduction of a CET.

CHAPTER 7

Stakeholders Perceptions

This section summarises opinions expressed by manufacturers, transporters, clearing and forwarding firms, agro-business firms, traders, tour operators and policy makers in each of the three countries[17].

Some of the Kenyan manufacturing firms interviewed have branches in Tanzania and Uganda. These manufacturing firms complain about high tariffs and non-availability of raw materials. They are also concerned about the cost of utilities and problems with infrastructure in general. Manufacturing firms in Tanzania also are concerned about infrastructure and services, supply of raw materials and financing. Like Kenyan firms, Ugandan manufacturers are concerned about high tariffs and non-availability of materials as well as uncertain government regulations.

Ugandan manufacturers expect integration to lead to free movement of goods and services, capital and labour, and lower tariffs on goods from the region. They perceive Kenyan manufacturers as having an advantage over those from Uganda and Tanzania. This advantage was because Kenyan manufacturers enjoyed lower transport costs, larger scale economies and lower domestic taxes. Many of the Ugandan manufacturers source materials from Kenya because of competitive tariffs and availability of products. Kenyan suppliers also extend supplier credit to Ugandan customers. There was, however, preference for American dollars in these transactions by both suppliers from Kenya and Tanzania as well as by Ugandan importers (Atingi-Ego et al 2002). Manufacturers in Uganda are confident that removal of intra-country tariffs within the region would impact positively on their performance. Many view such removals as having potential for increasing profits, expanding production, increasing capacity utilisation and creating space for upgrading of technology. Half of the Ugandan manufacturing firms also saw possibilities of relocating their production operations to either Kenya or Tanzania following removal of intra-country tariffs.

Tanzanian manufacturers are positive about the future prospects for intra-regional trade. They perceive intra-regional trade as fair, but raise concern

[17] The Kenyan and Ugandan teams also included revenue authority officials. In addition, the Kenyan team also included representatives of consumer organisations.

about potential input subsidies by governments in the region that may give unfair advantage to competitors from member countries. Most Tanzanian manufacturers also raised concern about customs clearance delays, bureaucracy, police roadblocks and licensing delays as potential bottlenecks (Lyakurwa et al 2002). Kenyan manufacturers perceive most of their competition as domestic rather than regional. Nevertheless, they perceived Tanzanian and Ugandan manufacturers as more competitive due to preferential input tariffs, lower costs and reliable utilities, more government subsidies and support. Furthermore, Kenyan firms viewed themselves as having competitive advantage on account of better quality products, scale of production, higher labour productivity and lower transport costs.

Kenyan manufacturers source raw materials either domestically or from outside of East Africa. Inputs from outside of East Africa are preferred due to quality, availability and price advantage. Those available domestically are preferred on account of shorter delivery time, lower transport costs and availability. A majority of Kenyan manufacturers are beneficiaries of duty remissions, export compensation, trade promotions and exhibitions, tax holidays and export processing zones. Removal of these incentives would, according to Kenyan manufacturers, impact negatively on firm operations.

More than a half of these firms view regional integration to mean free movement of goods, capital and labour. Some also view integration to mean zero tariff on goods traded in the region. They expect removal of tariffs to impact positively on production, capacity utilisation, exports, domestic sales and employment.

How do traders perceive these changes? Those based in Uganda argued that most of their competitors were in Kenya and Tanzania. This is perhaps because traders in the region generally deal in similar products. Most of them pointed at bureaucracy, customs clearance delays, licensing and police roadblocks as important non-tariff trade barriers. Ugandan traders are confident that the removal of intra-EAC tariffs would increase availability of trading commodities, expand markets, improve prices and increase profits. Tariff adjustments would therefore have all round positive effects.

Two thirds of products handled by Kenyan traders were from East Africa and more than three quarters sold in the region. Only a quarter of the traders faced competition from Tanzania and Uganda, and many viewed such competition as healthy because it lowers consumer prices, helps standardise costs, and puts pressure for quality improvements. Nonetheless, their trading operations are hampered by high customs and import duties, differential tariffs in the region, double taxation, bureaucracy, customs clearance delays, licensing and police roadblocks. They perceive removal of intra-EAC trade tariffs as likely to expand the market, lead to an improvement in prices, and increase availability of trading commodities and profits.

Tanzanian traders have trading partners in South African, Kenya and the rest of the world. They perceive other firms supplying from these regions as also posing the greatest competition. Unlike Kenyan and Ugandan traders, Tanzanian trading firms perceive competition as having a negative effect: it reduces market and profit shares. These traders consider themselves ill equipped for competition. Many view import duty as a major roadblock to intra-regional trade. Other impediments include bureaucracy, custom clearance delays, licensing procedures and police roadblocks. Elimination of tariffs will expand the regional market for traded goods, improve availability of price margins and profitability, facilitate clearance of goods across the boarder and reduce freight and handling charges. Some are of the opinion that removal of tariffs may depress market prices, increase competition, and reduce business and profits. Others perceived the pace of the implementation of regional integration as reasonably slow giving adequate time for reflections before formalisation of co-operation protocols.

Business persons operating in Kenya's agricultural sector understood the EA community to lead to lower tariffs on intra-EAC trade, increase free movement of goods, services and people, and to some extent the movement of capital[18]. They expect regional integration to increase availability of inputs, generate more processing and create forward linkages. On the negative side, they expected the EAC to increase competition, depress prices and domestic agricultural production. Three quarters were however confident that the benefits would outweigh the costs. For this reason, operators in Kenya's agricultural sector proposed a number of measures that can assist in maximising benefits accruing from integration, namely, removal of domestic production constraints, setting of a common external tariff, accelerating the pace of integration and gunning for higher levels of integration.

A majority of Kenyan business persons operating in the agricultural sector viewed CET as important in the integration process and as being potentially beneficial to Kenya's agricultural sector. The benefits accruing from the establishment of a CET, in their view, include expansion of investment, production and trade. However, a CET is also likely to provoke retaliation from affected countries outside the community, precipitate a re-location of industries, put pressure on consumer prices, and probably lead to a

[18] Business persons in Kenya's agricultural sector sampled for this part of the analysis were involved in marketing, production, provision of advisory services, regulation and in storage and warehousing.

deterioration of product quality. To further improve competitiveness in the EAC market, respondents from Kenya's agricultural sector suggested that governments in East Africa should support the sector through training, research and extension services, extend subsidies to farmers, improve access roads, and reduce tariffs on agricultural inputs.

Agricultural sector firms in Uganda were clear that the community would entail free movement of goods, services and people. They saw the formation of the EA community as leading to lower tariffs on goods originating from member states. Nearly all the firms intimated that they had never been involved in the process of establishing the community. Even then, they were confident that the implementation of the EAC Treaty coincided with their wishes. The majority felt that the community would positively affect Uganda's agricultural sector by expanding the market for products, increasing supply and availability of inputs, and improving prices of agricultural products. Some felt that the community would increase competition and that in some cases, this could lead to the collapse of local production of some of the agricultural products.

Still, a majority of Ugandan agricultural firms were of the opinion that a higher level of economic integration is important in optimising the benefits of regionalism because it would lead to the removal of domestic production and supply constraints and impose an acceptable and binding CET. Most of the firms proffered that the benefits of integration far outweigh its costs. They also felt that the adoption of a common external tariff would increase production, trade and investment. Retaliation from other regions and relocation of processing industries and deterioration in the quality of goods were feared to be potential costs of the CET. Like manufacturing firms, many agricultural firms in Uganda perceived bureaucracy and customs licensing delays as important non-tariff barriers to intra-regional trade in East Africa. In their view, complete removal of tariffs would increase the availability of trading commodities, expand the regional markets and improve prices and profits.

Tour operators have also their own perceptions on integration. Those sampled from Tanzania perceived the EAC as entailing free movement of goods, capital and labour, and lower tariffs for goods traded within the community. They however were concerned about excessive documentation, poor roads and high road charges. Although their opinions were not solicited in the establishment of the EAC, some have benefited from increased business, reduced documentation, faster clearing of goods and services and a reduction in freight and handling costs, since the establishment of the EAC protocols. These benefits can be increased, according to the tour operators, by eliminating tariffs on intra-EAC trade, greater participation of the private sector, removal of cross border restrictions, and improvement of transport network.

These sentiments are shared by the Uganda-based tour firms, which are especially concerned about insecurity in Uganda, delays in customs clearance in the Kenya, poor roads in Uganda and excessive documentation and corruption in Kenya. They are also concerned about inefficient port services in both Kenya and Uganda and poor rail services in the region. Most of the Ugandan tour operators understood the EAC as involving lower tariffs, free movement of goods, capital and labour. Although most were not involved in the process of establishing the EAC, they were in agreement with the concept. Many also perceive the community to be beneficial because it increases business, reduces documentation and permits faster clearance of goods across the boarder. Easing up of border crossing restrictions, elimination of tariffs and improvement of the transport network in the region will, in the opinion of Ugandan tour operators, increase the benefits of integration. Such integration would, on other hand, increase competition[19]. These tour operators were also unanimous that removal of intra-EAC tariffs would improve production, boost exports and create employment[20].

The Kenyan and Ugandan samples included opinions from revenues authorities. In addition to collecting revenue, the Kenya Revenue Authority (KRA) administers exemptions and drawbacks from regime management, processing of rules of origin application, supervises export platforms such as manufacturing under bond, export promotion zones and export promotion programmes, processes application of Restrictions and Prohibition provisions of the treaty and collects statistics for economic planning and decision making.

The KRA has witnessed successes since the inception of the EAC, including harmonisation of the Tariff Codes, simplification and harmonisation of trade documents and procedures, establishment of the East African Bill of Entry, development of the Rules of Origin and sharing information among partner states. KRA also perceives major outstanding challenges in establishing a CET, harmonising rates and exemptions, elimination of non-tariff barriers, and application of principles of Asymmetry.

In KRA's assessment, the elimination of tariff on intra-EAC trade will not significantly affect Kenya's revenue base. Compensation for revenue loss will

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[19] Some of the Ugandan tour operators were already experiencing such integration-related competition.

[20] Two thirds of the Ugandan tour operators would relocate to Tanzania if they got an opportunity.

be done through identification of additional sectors with revenue potential, upward adjustment of domestic tax rates, and enhancing tax administration capacity to improve compliance and reduce evasion. While manufacturing, transport, banking and insurance sectors in Kenya are likely to benefit from elimination of EAC tariff, food processing is likely to suffer due to competition from food processing firms in partner states. Besides loss of revenue, other costs of the EAC perceived by the KRA include potential increase in crime and collapse of some Kenyan industries. To mitigate the losses, East African countries could hasten the integration process and reduce membership in multiple regional groupings. According to KRA, revenue loss from tariff elimination should only be addressed once revenue leakage due to evasion and corruption has been ruled out.

The Uganda Revenue Authority (URA) ensures that the East African Treaty and its protocols are implemented appropriately by creating public awareness, training its staff and by monitoring progress. The training syllabi contain modules for addressing issues related to EAC. URA revenue officials indicated that if either a CET of at most 10% was adopted or intra-EAC tariffs altogether eliminated, tariff revenue would fall. However, a CET of 15% would preserve current tariff revenues. A CET of 25% or more would, on the other hand, increase tariff revenues but generate other undesirable consequences. To counter revenue shortfalls occasioned by tariff elimination, URA suggests a lowering of VAT registered tax payers, improving income tax and VAT administration and strengthening anti-smuggling measures. To minimise the overall effect of integration, a slower pace of integration, reducing memberships in multiple regional groupings and compensation to losers are desirable. Such compensation, according to URA officials, can be financed through a surcharge on imports affecting the losers.

Opinions were also sought from policy makers. Those from Uganda were satisfied with progress made so far with the implementation of Article 75 (7) on the customs union, monetary policy harmonisation, increased convergence of trade policies, investment procedures, institutionalisation of EAC activities and harmonisation of standards. Protocols had opened the Kenyan market for Ugandan products. Policy makers perceived integration as inherently beneficial as it leads to trade expansion, creates employment, increases investment and productivity, improves product quality, make free movement of people possible and lowers prices. These benefits could be maximised by introducing a CET and removing tariffs completely, eliminating domestic production constraints and transport problems, promoting more private sector participation, improving border clearance and pursuing integration beyond a customs union.

Policy makers in Uganda appreciate that integration does not happen costlessly, and perceive some of the costs of integration to include possible collapse of some industries and consequent loss of employment, conflicts with other regional schemes, and loss of sovereignty. Smaller Ugandan manufacturing firms are also likely to be exposed to greater competition especially from Kenya firms. A majority of the policy makers were convinced that the benefits of integration far outweigh its cost. A CET was considered important in increasing the benefits of integration as it would expand markets and encourage domestic firms to be more efficient and competitive. These policy makers were concerned about lack of enthusiasm by Uganda's business community, absence of an integrated regional financial market, and problems with movement and settlement of labour.

Although Kenyan policy markers are happy with progress made towards integration, they sited difficulties in reaching agreement on a CET, mistrust, mutual suspicion, indecision on tariffs, endless introduction of additional documents, multiple membership in integration schemes and perceived or real differences in levels of development as bottlenecks in the integration process. Nevertheless, the policy makers pointed out that there were many benefits accruing from integration including trade expansion, increased investment, and easier movement of goods and people. Other benefits include increased employment and productivity. Such benefits, according to Kenyan policy makers, could be maximised by accelerating elimination of intra-EAC trade tariffs, removal of non-tariff barriers, removal of domestic production constraints, establishment of a CET, greater participation of the private sector, and injecting efficiency into border clearing.

Tanzanian policy makers pointed out the importance of private business support organisations such as the East African Business Council, better national co-ordination of implementation of protocols and pro-action in shaping protocol and improved implementation mechanisms. They suggested that the competitiveness of Tanzanian products in the regional markets could be enhanced by putting in place properly functioning duty drawback schemes, export processing zones, adherence to the degree of processing principles in taxation, trade promotions and exhibitions, mounting of Export Credit Guarantees and Insurance Schemes, accelerated capital allowance and protection of property rights, regulated electric power and energy tariffs, business-encouraging taxes and trade incentives.

Policy makers in Tanzania consider some deadlines unrealistic and that bureaucratic delays, over-reliance on donor funding, management problems, multiple membership to integration schemes and national sluggishness in approving key steps all affected the speed of implementation. On multiple regional schemes, policy makers in Tanzania were of the opinion that this stymied the implementation of the EAC protocols because it reduced resources (financial and human) and complicated the trade harmonisation agenda. Multiple membership creates conflicts that have to be resolved to facilitate speedy implementation of the EAC treaty and protocols. These conflicts include difficulties in negotiating partnerships with the European Union under the Cotonou Agreement.[21] It is also perceived that the EAC trading block once fully developed will be very different from the other block, raising possibilities of conflicts between the EAC and other blocks.

Different stake holders from the three countries of East Africa are optimistic that the net benefits of integration are positive but raise concerns that are shaped by country-specific peculiarities, types of responsibilities they hold and the interest they represent. There are however concerns that are shared by different stakeholders, including the fact that they have been adequately consulted. Opinions about the impact of competition generated by reduction of tariffs are mixed with firms based in Tanzania and Uganda being more worried that they are equipped to cope with such competition. These differences are likely to shape opinions about the usefulness of deeper integration and should form the basis for further consultations.

[21] It is not clear whether countries should go alone or as a block and if as a block, which one, given multiple memberships.

CHAPTER 8

Compensation Mechanisms

Considering the short run costs of integration schemes, compensation is important in minimising resistance to regional integration. According to the Ugandan team, formal compensation is necessary but insufficient for effective regional integration. Skilful and innovative political management of compensation is of essence. Compensation mechanisms should include a framework for reaching a consensus expeditiously. Such frameworks should be comprehensive and yet flexible. Ugandan policy makers underscored the importance of compensation in making the EAC attractive. Such compensation could be in the form of either direct fiscal compensation or a regional development equalisation fund. Two avenues for direct fiscal compensation are proposed: through a legal provision in the East African Treaty that allows transitional compensation for the first 5-10 years, with the provision permitting re-distribution of customs revenue to address losses, or through external assistance. For the latter, international financial organisations would co-sponsor compensation initiatives for cushioning member countries against revenue losses during the transitional period.

Ugandan policy makers also identified an indirect approach to compensation such as the regional development equalisation fund. Removal of tariff and non-tariff barriers to trade will expose firms, businesses and industries to intensify competition, with more efficient firms such as those located in Kenya capturing a large share of the additional market and income. A transitional fund can help balance development in the region and allay fears that integration will concentrate industries in one country and widen inter-country differences. For this reason, a well designed transitional programme should include development of frameworks that would force the development profiles of member countries to converge.

A number of compensation strategies are available for consideration. The Tanzanian team observed that there are two broad compensation mechanisms, one involving income transfers and another effecting changes in the emergent patterns of resource allocation, trade and development. Compensation could be fiscal, such as with intergovernmental financial transfers through budgets to promote equity[22]. Another common fiscal compensation mechanism is the net tariff revenue foregone as a result of buying products in member states. This loss often corresponds to higher import prices which represents a static loss of national income suffered by an importing country due to membership in an integration scheme. The less developed member countries can also be permitted to adopt a slower pace towards full trade liberalisation than the more advance partners. Industrial development can also be influenced to compensate potential losers through provision of incentives and adoption of planned industrial specialisation agreements supported by legislative and administrative sanctions. National fiscal incentives can also be harmonised in a way that influences the distribution of industrial activity. Less developed partners, for example, can be allowed to provide more generous investment incentives to attract foreign investment.

The Kenyan study team stressed that the benefits arising from regionalism in East Africa should be distributed equitably to obviate collapse of the regional scheme. Although the dynamic gains from trade may more than compensate for losses in Kenya, the situation may be different in other partner states. Compensation is therefore of utmost importance. The team proposed several compensation options, such as budgetary rebates using distribution of CET-generated revenue to partner states following a formula that is sensitive to differential impacts and pooling of regional tariff revenues for use on mutually agreed programmes[23]. There is however more preference for use of surcharges on imports for industries that are most vulnerable. In place of compensation, weaker economies can be allowed to adjust gradually.

These country reports suggest the existence of many compensation options. The specific compensation strategy chosen should cost effect and sustainable, and also be the outcome of consultations and negotiation among member countries.

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[22] Under the defunct EAC, a transfer tax was introduced in 1967 to address widening trade imbalances between Kenya and its partners (Lyakurwa et al 2002).

[23] Kenyan respondents were of the opinion that this compensation mechanism is not feasible since revenue from a CET is important in national budgets.

CHAPTER 9

The Way Forward

This pilot study has identified clear benefits and costs of regional integration in East Africa. The three countries stand to gain from integration especially in the longer term when the development outcomes of such regionalism have fully played out. In the short term, the net outcome should be beneficial to partner states, although the extent of these net benefits will vary from partner to partner. Methodologically, a more precise quantification of benefits and costs is best handled in a general equilibrium model capable of isolating short term and long term trade and development effects. General equilibrium analysis requires finer data that could not be collected under the pilot study. Because of this information limitation, the study focused on short term or trade effects, with a specific quantification focus on tariff revenue effects. Some of the other effects were identified through the survey of a wide range of stakeholders, but these were generally subjective and do not lend themselves to generalisation because of the thinness of the survey.

Nevertheless, the balance of the finding is that even the short term revenue losses should not be a deterrent to the pursuit of economic integration in East Africa. Although the dynamic long terms gains have yet to be quantified, these can be assumed to be powerful enough to push integration towards a common market and beyond. Some stakeholders in Kenya prefer an expeditious deepening of integration because of anticipation of huge net benefits of such integration in the longer run. Others prefer a slow pace because a consensus regarding an appropriate pace is desirable.

The compensation of losers will be critical in sustaining the process of integration, such that consensus on how to handle compensation remains imperative. There are a number of possible strategies out of which a cost effective and sustainable choice has to be made. Specific considerations for compensation include modest surcharge, establishment of a development fund and a gradual adjustment process. A decision on the best compensation strategy is central to any further progress along the integration path.

The revival of regional integration in East Africa is founded on renewed conviction about the potential benefits related to long-term prosperity of the peoples of the region. The new EAC will allow co-operation in the use of the region's natural resources as identified in the East African Development Strategy. Further co-operation is anticipated in fiscal and monetary policies, trade, legal and judicial matters, and private sector development. Considering experiences from previous EAC and lessons from elsewhere, parties need to consider all potential pitfalls and proceed cautiously. Initial disparities should be taken into account. Non-tariff barriers such as administrative delays, pre-shipment requirements, technical and standardisation requirements, and border point delays, pose serious bottlenecks to successful implementation of the Treaty and will need to be addressed to allow further progress in this direction. To deal with such barriers sustainably, member states may have to establish points in each of the three countries for receipt and handling of stakeholders' concerns related to the barriers that they encounter in their business.

Simulation exercises have shown that it is possible to adopt a CET that balances the need to make up for lost tariff revenue, potential dynamic gains from improved trade, the need for cheap but quality raw materials and intermediate goods for industrialisation, infant industry concerns, and the tendency for high CETs to divert trade and lead to agglomeration of economic activity. Suggested CETs for each country generally converge but need to be fined tuned through negotiations.

The adoption of a CET is essential but requires more work to guide the height of such a tariff that partner states can apply on imports from the rest of the world. Simulations carried out as part of this pilot study generated some suggestions for each country. These should form the basis for further negotiations, giving time for each partner state to move from the current tariff rates to the preferred ones. A long adjustment period is invaluable in terms of creating an opportunity for partner states to absorb the implied costs including seeking out alternative sources of revenue.

Local firms in some of the countries need assistance to acquire technological capabilities critical for process and engineering design, standardisation, quality control, and technological adaptation and innovation so that these firms can serve the markets sustainably. Reducing the costs of doing business is imperative, and must include reduction of red tape and corruption, improving the reliability of utilities and paying attention to deficiencies in financing, transportation, customs clearance, and specific concerns of specific sectors.

Although legal, regulatory and policy reforms are needed to remove elements that are not business oriented, and developing infrastructure and efficient capital markets in the region are important, political will remains a central plank of any further economic integration. The manifestation of that will must be extended to include support from key stakeholders such as the private sector in designing strategies for deepening regional co-operation. Without such support, progress will remain painfully slow and prospects for reversal high. Partner states also need to identify areas of complementarity in production and exchange at sub-sector level based on endowments of natural resources such as horticulture, minerals and energy.

The way forward should also include knowledge integration such as through joint investments in research and development (R&D), seeking out economies in resource use, sharing the outcomes of R&D, agricultural extension, and exchange of trained manpower and expertise in finance, banking and insurance. Joint training institutions will also be desirable as will be the convergence of national policy priorities and the co-ordination of policies to ensure permanency of policy convergence.

Consultation has so far been limited and the objectives of the EAC Treaty not clearly understood by important stakeholders. Such stakeholders feel left out of discussions on most aspects of the process of creating a customs union. Future deliberations should seek to engage these stakeholders to spread ownership of the union and make the provisions in protocols more likely to take root.

A solution is needed on membership in dual regional blocks. Such membership exhibits national priorities that may not converge, but may entail expensive policing of rules of origin, interference with the 'fast track' objective of the EAC, distortion of private sector's ability to make decisions by sending complex signals about regional preferences, and divert attention from deepening integration in East Africa. Participation in each block entails costs that are difficult to share. A possible way out is to make EAC protocols compatible with those in other countries and let EAC set the pace in future deepening of these trading blocks. For this to happen, member states will have to assess the weight they attach to the EAC relative to other blocks.

Since it is often beneficial when countries exploit opportunities available from multilateral trading systems as a block, East African countries need to develop a common strategy as they face the challenges posed by globalisation. Difference in the speed of tagging relate to the relative efficacy of the private sector in each country.

To confer certainty and stability to policies meant to attract foreign exchange, it is necessary to harmonise monetary, fiscal, commercial, income, labour and investment policies. This is challenging because of differences in spending priorities that can only be harmonised in time. There are also differences in national tax systems and tariff structures which can be harmonised gradually and in step with investment policies.

A framework is needed for the exchange of information on current and forthcoming national policies, developing mechanisms for minimising conflicts and co-ordinating actions to ensure consistency.

Security of property and human capital is important for meaningful integration[24]. There is also value in exploring possibilities for longer term integration of the EAC with larger industrialised blocks to exploit resource diversities and broader comparative advantages. Harmonisation of policies with WTO regulations such as those pertaining to cross border trade, consumption abroad, commercial presence and free movement of people is also important for regional integration in East Africa. Well considered positions on these issues would strengthen EAC's voice during negotiations.

Finally, there are some issues that invite further research including modelling the dynamic effects of regionalism, exploring the trade-off between revenue loss and industrial development under different CETs for intermediate goods, tracking the response of the private sector to deepening regionalism, and updating elasticities of demand for different intra-EAC imports using more recent data.

[24] It was pointed out, for example, that nationalisation of industries in Tanzania and expulsion of Indians from Uganda in the past had made these two countries very unfriendly to international capital.

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APPENDIX A

Major Epochs in East African Co-operation

Date	Event
1895-1903	Construction of the Kenya-Uganda railway.
1905	Establishment of East African Currency Board for Kenya and Uganda.
1917	Formation of Customs Union and Common External Tariff.
1922	Tanganyika's adoption of the common External Tariff.
1940	Creation of East African Income Tax Board and Joint Economic Council.
1948	Establishment of the East African High Commission and the East African Legislative Council.
1961	Formation of the East African Common Services Organisation.
1963	Declaration for Political Federation among Kenya, Tanzania and Uganda in Nairobi.
1964	Signing of the Kampala Agreement on matters pertaining to the re-distribution of industries in East Africa. Agreement not ratified by Kenya.
1965	Tanzania announces the establishment of its own Central Bank and introduces its own currency to replace the common East African shilling. Other member states follow suit. Tanzania imposes quotas on Kenyan goods.
1966	The formation of the Phillip Commission to try and contain the crisis in East Africa. Its recommendations form the basis for East African Community.
1967	Signing of the Treaty for the East Africa Community. Arusha becomes the Headquarters of the East Africa Community.
1971	Idi Amin topples Milton Obote and becomes president of Uganda.
1975	The Establishment of the DemasCommission to save the community.

1977	The East African Community becomes defunct.
1978	Kenya, Uganda and Tanzania appoint Walter Umbritch to propose the division of assets and liabilities of the defunct community.
1981	The Umbritch report is produced and former partners are apportioned shares of the defunct community assets. Kenya gets 42%, Tanzania 32% and Uganda 26% respectively.
1984	Signing of the EAC Mediation Agreement on the division of assets and liabilities of the defunct EAC. Agreement also seeks new areas of co-operation in EA.
1993	Presidents Mwinyi, Moi and Museveni of Tanzania, Kenya and Uganda respectively sign an agreement for the establishment of a tripartite commission for the East African co-operation in Arusha.
1996	A secretariat of the East African Co-operation is launched in Arusha.
1997	The East African heads of state instruct the Tripartite Commission to negotiate up-grading of the agreement into a treaty, launch the first East African Community Development Strategy (1997-2000), the East African passport and the East African flag.
1999	A treaty for the establishment of the second East African Community is signed.
2000	The treaty establishing the EAC enters into force after depository of the instruments of ratification by all partner states to the Secretary General.
2001	Launching of the second EAC Development Strategy, 2001-2005.
2001	Inauguration of the East African Assembly and Court of Appeal.

Source: Adopted from Lyakurwa et al (2002). Table 2.1

APPENDIX B

Cooperation between two or more countries can be based on either of the following arrangements:

- o preferential trade area (PTA)
- o free trade area (FTA)
- o customs union (CU)
- o common market (CM)
- o economic community (EC
- o monetary union (MU)
- o economic union (EU)
- o political confederation (PC)
- o political federation (PF)

<u>Preferential trade area</u> requires partner states to:

- reduce tariffs on all or selected products
- reduce other obstacles to trade
- ease movement of persons

A <u>free trade area</u> requires partner states to:

- guarantee free movement of goods and services produced within the FTA
- remove all tariffs on internally traded goods
- abolish non-tariff barriers
- maintain indirect domestic taxes
- enhance movement of persons
- maintain independent trade policy against non-members

A <u>customs union</u> requires partner states to:

- eliminate all intra-state tariffs and other charges of equivalent effect
- abolish all non-tariff barriers (NTBs)
- harmonise commodity description and coding systems
- adopt a uniform tariff classification of goods - Common Tariff Nomenclature (CTN)
- adopt a common external tariff (CET) and a standard system of valuation

- harmonise customs services and procedures
- establish uniform national customs legislation
- simplify and harmonise trade documentation and procedures
- establish common requirements for transit of goods within the customs territory and re-exportation of goods from third countries
- establish rules of origin with respect to products originating in the partner states
- adopt uniform standards/requirements for anti-dumping practices, subsidies, counter veiling measures, duty exemption, duty drawback, and other export promotion schemes i.e. refund and remission of duties
- further enhance movement of persons
- effect collection of all import duty at the first points of entry into the customs territory
- set up mechanism for sharing out common customs revenue as collected in entry points

A <u>common market</u> requires partner states to:
- form a customs union
- harmonize monetary and fiscal policies
- establish common market institutions
  e.g. tribunal and regional court

<u>Economic community</u> requires partner states to:
- put in place a common market
- allow free movement of labour and capital
- establish a regional parliament

<u>Monetary union</u> requires partner states to have in place:
- common currency
- common monetary authority

<u>Economic union</u> requires partner states to have already established:
- economic community
- monetary union

<u>Confederation</u> requires partner states to:
- establish an economic union, as well as
- common defense and common foreign affairs

<u>Political federation</u> requires the establishment of:
- economic union
- common defense and common foreign affairs
- common planning
- single federal government
- common budget

Regional integration efforts between Kenya, Uganda and Tanzania have received renewed impetus in recent years. Some of the laudable accomplishments made to increase the level of regional integration among the three countries include establishment of a secretariat of East African Cooperation in 1996; signing of the Treaty establishing the East African Community (EAC) in November 1999 (subsequently ratified on July 7, 2000); launching of the second EAC Development Strategy (2001-2005) in April 2001; and inauguration of the East African Assembly and Court of Appeal in December 2001.

Despite the accomplishments so far made, the pace of liberalising the trade regimes in the sub-region has been slower than perhaps, would be desirable for faster development in the region. One reason for the this slow pace is the perception of inequality in the distribution of costs and benefits accruing from the trade integration process among partner states. The second reason is the fear that the process of trade integration might lead to the marginalisation of the relatively less developed industries in member states.

This book generates incremental knowledge on costs and benefits to Kenya, Uganda and Tanzania of the on-going integration efforts. Without knowledge of the costs and benefits accruing to each member state and a sober understanding of available mechanisms for compensating losers, fears for skewed distribution of benefits and costs among partner states will continue to hamper the pace at which integration efforts in the sub-region move forward.

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