Research for Development

A Policy Bulletin of the African Centre for Economic Growth (ACEG) No. 5/Jan 2003

ABOUT ACEG

African Centre for Economic Growth (ACEG) started its operations in 1993 as Africa regional office of the International Center for Economic Growth (ICEG) and was registered in Kenya in 1999 as a non-profit, non-partisan autonomus policy research organisation.

The mission of ACEG is to increase knowledge of the policies that work to accelerate economic growth and expand income opportunities for the people of Africa.

ABOUT THIS POLICY BULLETIN

This Policy Bulletin provides a channel through which to disseminate the results of research on policy issues affecting economic growth and development in Africa.

The objectives of the Policy Bulletin are to:

- disseminate research findings to key stakeholders in an effort to promote consensus on policies for sustaining economic growth and human development in Africa;
- provide informed policy advice to policymakers, intermediary origanisations, civic and opinion leaders in order to promote sound management of the development process in Africa.

ACEG gives special recognition to the United States Agency for International Development (USAID) for providing funding for the research study as well as the publication of this Policy Brief.

STEERING EAST AFRICA TOWARDS ENHANCED INTEGRATION

LESSONS FROM A MULTI-COUNTRY STUDY

This policy brief arises from a synthesis of research findings of a three-country study on costs and benefits of regional integration in Kenya, Uganda and Tanzania. The study was undertaken by the African Centre for Economic Growth (ACEG) in collaboration with partner institutes in Kenya, Uganda and Tanzania. 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 research activities in Uganda and Kenya respectively. The ACEG took overall responsibility for management, co-ordination and quality control of the study.

Background to the study

The history of regionalism in Africa is long but many integration schemes struggle and eventually flounder due to a myriad of factors such as restrictions in factor mobility, failure to agree on distribution of benefits, ineffectiveness of common external tariffs, inappropriateness of some of the policies pursued by member countries, inadequate political commitment, and macro-economic instability.

Regional groupings in East Africa have a similarly long history. For a long time, Kenya, Tanzania and Uganda have enjoyed close commercial, industrial, cultural and historic ties. Manifestations of integration were evident as early as 1919 and some of the 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. The original East African Community lasted only one decade before it floundered and was eventually dissolved in 1977. During its existence, there was 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. Twenty years after its dissolution, a 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,

BEST AVAILABLE COPY

and promote good governance. Furthermore, the strategy identified several areas in which regional co-operation was possible viz. 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 (EAC). This paved the way for the launching of the second East African Community Development Strategy in April 2001.

Reasons for conducting the study

Following the re-launch of the EAC, development experts are anxious that the mistakes that led to the collapse of the first EAC are avoided. For this reason, the study on which this policy brief is based aimed at identifying the economic, political and institutional issues likely to delay the realisation of successful regional integration scheme in East Africa. Such identification will not only sharpen the understanding of the challenges that East African countries face as they move towards regional integration but also guide the implementation of the appropriate treaties and protocols. The study aimed at determining the costs and benefits of regional integration in East Africa and suggesting appropriate mechanisms for sharing them equitably among the three member countries. The study also sought to deliberate on the economic, political and institutional precepts for successful implementation of the integration strategy.

How the study was conducted

The study was managed by the African Centre for Economic Growth (ACEG) utilising funds from the United States Agency for International Development (USAID. 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 a common methodology. This methodology workshop was hosted by the EAC secretariat in Arusha and allowed the incorporation of inputs by the secretariat into the study right at the design stage.

Thereafter, the study teams applied the common methodology to assemble information and prepare country reports that addressed country specific issues identified as critical for the success of the EAC. In each case, use was made of primary and secondary data, the latter serving to identify key sectors in terms of regional trade flows in order to determine the costs and benefits of integration. Regarding 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 to determine the revenue implications. Primary data was collected through the administration of common instruments to a wide cross-section of stakeholders who included manufacturers, traders, farmers, transporters, clearing and forwarding firms, revenue authorities and policy makers. The survey sought to generate perceptions on the social, political and economic factors that inhibit the implementation of EAC integration, and to identify solutions.

The country reports were discussed in national workshops under the auspices 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 the EAC Secretariat and relevant government ministries in the region as feedback on the formulation of strategies to push forward integration efforts in East Africa.

Research Findings

The evolution of tariff regimes

In the 1960s, external tariffs levied on goods originating from outside the East African Common Market were set on a common basis for Kenya, Tanzania and Uganda. 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 Kenya industries which took advantage of the position. 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 mechanism for quelling concerns about the negative 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 '80s. In Tanzania, other factors were put into consideration in accordance with socialist economic philosophy. The import substitution strategy depended on protection primarily from foreign firms. 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

BEST AVAILABLE COPY

self-reliance socialist era and meet the demands of different sections of society, the structures of the 1970s and 1980s in Tanzania could not be reconciled. Not only were the tariffs meant to protect domestic industries and raise government revenue, they were mechanisms for controlling consumption of luxury goods. The incidence of duty evasion 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 rate bands in existence in Uganda were reduced to four (viz. 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 luxury goods attracted maximum rates. Excise duties were reduced to a two-rate structure: 30 and 60% restricted to alcoholic drinks, cigarettes and all soap products except bar soap. The upper rate was further reduced to 50%. Export duty on all materials as well as import duty on all materials except those locally available was abolished. Duty exemptions were also extended for educational materials, newspapers, journals and periodicals in order 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. Tariff reductions approved by COMESA were implemented by Uganda, which also reached double taxation treaties with 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% to be altogether eliminated during the three-year period, reductions in duty rates on petroleum products, removal of exemptions, and the introduction of a progressive simplification and modernisation of the tax regime and its administration.

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 donor funding of development expenditure. This attracted import duty and tax exemptions 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; the higher the degree of processing, the higher the tariff rates. The main taxes include the general customs duty currently applied in five bands. Tariff preferences with 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. Suspended duty is applied on a discretionary basis to protect local producers at a flat and valorem rate of 20%. Tanzania also charges excise taxes on selected imports at specific rates and a flat 30% on other goods. The VAT on most imported goods stands at 20%.

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

Revenue implications of the customs union

Simulations based on different scenarios confirmed 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% 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 entail politically divisive re-distributions. These eventualities need to be avoided to pre-empt the collapse of the EAC. Considering the need to keep the CET as low as possible, and given that Kenya has potential for making up for losses of tariff revenue through alternative tax measures, revenue losses associated with a 20% CET are reasonable and the 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. Kenyan imports from East Africa are insignificant and duty revenues from the regions very small. A customs union would require complete elimination of intra-EAC tariffs. Estimates show that although there would some revenue loss in

Kenya following elimination of intra-EAC tariffs, such loss would be more than compensated for by the increase in exports arising from the dynamics of trade such as competition and efficiency improvements.

Tanzanian data and discussion with stakeholders reveal 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 the tariff reform policy. Additional analysis of Tanzania import data showed that close to 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 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 supply conditions in Kenya and Uganda allow an increase in products exported to Tanzania, there will be increased imports and consumption of partner imports in the medium- and long-terms. But other than the disappearance of the import tariff revenue, there will be other positive tax revenue adjustments that will accrue from increased import of 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/decrease if there is a net increase/decrease in imports. The specific impact will depend on the structure of domestic supply, demand elasticities and policy interventions.

A common external tariff

Using a mixture of scenarios, classifications and assumptions, the country reports showed that the establishment of a CET in the region will have differing revenue outcomes that put a premium on careful selection and negotiation of such a CET. Different levels of CETs have different revenue, among 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. 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..

Stakeholders perceptions

Opinions were sought from manufacturers, transporters, clearing and forwarding firms, agro-business firms, traders, tour operators and policy makers in each of the three countries. 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. Some of the concerns are, however, shared by different stakeholders, including the fact that they have not been adequately consulted in the development of proposals. 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 ill-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.

Compensation Mechanisms

Considering costs of integration schemes in the short run, compensation is important in minimising resistance to regional integration. Formal compensation is necessary but insufficient for effective regional integration. Compensation mechanisms should include a framework for reaching a consensus expeditiously. Such frameworks should be comprehensive and flexible. Compensation could be either direct fiscal compensation or through 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 use of re-distribution 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.

Indirect approach to compensation is also possible, including the option of a regional development equalisation fund. Removal of tariff and non-tariff barriers to trade will expose firms, businesses and industries to intensified 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 the development of frameworks that would force the development profiles of member countries to converge.

Two broad compensation mechanisms could be considered: one involving income transfers, and another effecting changes in the emergent patterns of resource allocation, trade and development. Further fiscal compensation would be through inter-governmental financial transfers, via budgets, to promote equity. 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 that represent 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 advanced 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.

Other compensation options include budgetary rebates using distribution of CET-generated revenue to partner states using a formula that is sensitive to differential impacts and pooling of regional tariff revenues for use on mutually agreed programmes. Although available compensation mechanisms are many, the specific compensation strategy chosen should be cost effective and sustainable, and the outcome of consultations and negotiation among member countries.

Conclusion

The 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 long term when the development outcomes of the regionalism have been 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.

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 long run. Others prefer a slow pace. A consensus regarding an appropriate pace is, therefore, desirable.

The compensation of losers will be critical in sustaining the process of integration, and consensus on how to handle compensation 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 the experiences of the 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 the 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 focal points in each of the three countries for the receipt and handling of stakeholders concerns related to the barriers that they encounter in their operations.

The adoption of a CET is essential but requires more work to guide the levels of tariffs 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, 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 bureaucracy and corruption, improving the reliability of utilities and paying attention to deficiencies

BEST AVAILABLE

in financing, transportation, customs clearance and the 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 region are important, political will remains a central factor in 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 the sub-sector level based on endowments of natural resources such as horticulture, mining and energy.

The way forward should also include knowledge integration, for example, 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 the convergence of national policy priorities and the co-ordination of policies to ensure permanency of such 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 ensure that the provisions made through protocols are more likely to take root.

A solution is needed on membership in dual regional blocks. Such memberships exhibit national priorities that may not converge, but may entail expensive policing of rules of origin, interference with the 'fast track' objective of the EAC, distort private sector's ability to make decisions by sending complex signals about regional preferences, and diverting 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 the 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. Differences in the rate of adherence are directly related to the relative efficacy of the private sector in each country.

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

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

There is also value in exploring possibilities for longer term integration of the EAC within 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.

Areas for further research

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 this pilot study.

Modelling the dynamic effects of regionalism, exploring the trade-off between revenue loss and industrial development under different CETs for intermediate goods would also be valuable. It is also necessary to keep track of the response of the private sector to deepening regionalism, since it is the private businesses that determine the success or failure of integration scheme.

There is also need to explore the most optimal position for the East African countries in respect of the many overlapping integration schemes to which these countries are potential members ⧗

For any inquiries, comments and/or clarifications, please contact:
African Centre for Economic Growth (ACEG)
P O Box 55237, Nairobi (KENYA)
Tel: 254 2 215295/241036; Fax: 254 2 223220
E-mail: aceg@aceg.org

Executive Director : Andrew K. Mullei
Design/Production : Nyokabi Nyanjui

BEST AVAILABLE