Regional Integration Study of East Africa: The Case of Kenya

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ABBREVIATIONS

AGOA	African Growth and Opportunity Act
CBI	Cross-Border Initiative
CET	Common External Tariff
COMESA	Common Market for East and Southern Africa
EAC	East African Community
EALA	East African Legislative Assembly
EPPO	Export Promotion Programs Office
EPZs	Export Processing Zones
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Area
IGAD	Inter-Governmental Authority on Development
IGADD	Inter-Governmental Authority on Drought and Development
KRA	Kenya Revenue Authority
MUB	Manufacturing Under Bond
NIC	Newly Industrialised Country
NTB	Non-Trade Barriers
PTA	Preferential Trade Area
QR	Quantitative Restrictions
RI	Regional Integration
ROW	Rest of the World
SADC	Southern Africa Development Community
SAPs	Structural Adjustment Programs
SSA	Sub-Saharan Africa
WTO	World Trade Organisation

EXECUTIVE SUMMARY

This study evaluates the costs and benefits of the East African Community Customs Union to Kenya. In particular, the study assesses the potential impact (to Kenya) of removing tariffs on intra-EAC trade and establishing a common external tariff for the Community. This assessment is restricted to simulation of the government tariff revenue implications of the implementation of the customs unions agreement. However, the study also analyses views of stakeholders on the current or expected impacts of the EAC customs union.

Past efforts to form regional integration schemes in Africa failed because of political and economic factors, which did not favour sustainability of the schemes. However, in recent years, a new momentum of integration has emerged in the continent with the revival of the EAC in 1993 being indicative of that momentum. A number of factors explain this new emphasis on integration including: greater political will, globalisation and the attendant need to strengthen small economies and expand markets to avoid marginalisation, and the desire to achieve economic development.

Literature on Regional Integration Agreements (RIAs) indicates that RIAs can generate benefits through (i) trade creation and growth, (ii) reallocation of resources in response to changing relative prices, (iii) specialisation, (iv) economies of scale, (v) changes in efficiency owing to increased competition, (vi) increased levels of investment and growth, and (vii) through achievement of political objectives such as enhanced security, enhanced bargaining power, and provision of a "commitment mechanism" for trade and other policy reforms. However, regional integration schemes are also associated with costs that include revenue loss from elimination of trade taxes, trade diversion and concentration of industries in well-suited locations, which can lead to increased transport costs for markets in the periphery. Other costs of RIAs may include divergence of the income levels of the countries involved, potential political conflicts as a result of such divergences and loss of national sovereignty especially if integration is deep.

It is generally agreed, however, that overall integration schemes are beneficial because trade creation, welfare improvement and industrial development arising from the schemes generate spillover effects which can compensate for the costs.

Kenya has undertaken substantial trade liberalisation and has made commitments towards trade integration schemes not only with the EAC partner states but also with other countries under COMESA, CBI and IGAD. All these efforts are aimed at expanding the country's trade. Currently, agricultural products (54%) and industrial supplies and consumer goods (33.3%) dominate Kenya's export trade. The major imports are industrial supplies (34.5%), machinery and capital equipment (32.4%) and fuel and lubricants (15.5%). The major destinations for Kenya's exports are Europe (33% of total exports) and East Africa (28%). Trade with COMESA countries excluding East African states constitutes about 14% and shows an increasing trend. Semi-manufactured products, processed agricultural products and minerals dominate exports to EAC and COMESA. The European union is the major source of imports for Kenya (32.8% of the total) followed by the Middle East (18%). Kenya's imports from EAC are about 1% of the total imports and comprise mainly of agricultural products. The data indicates that there is potential to expand trade within the East African states.

A major concern with respect to integration schemes is loss of trade tax revenues. For Kenya, however, the tax revenue base is broad enough to offset some of the revenue losses. In the year 1999/2000 for instance, the country collected a total of Ksh 167 billion in taxes from the following sources: import duties (17.1% of the total), excise duties (16.9%), income tax (31.1%), value added tax (27.5%), and others (9.4%). There has been a general tendency to shift towards consumption-based tax revenues. Despite this, however, tariff-based revenues still form an important component of government revenues. This partly explains the country's reluctance to adopt a low common external tariff under the revived East African Community (EAC).

The Kenyan perspective on an EAC customs union is favourable. The removal of internal EAC trade tariffs will cost the country about US$ 58.7 million per year in potential revenue and about US$ 613,400 in actual revenue (about 0.03% of total tax revenue collections). Therefore, the removal of internal tariffs for EAC may not be a serious problem for Kenya. The major concern for the country is the level of the common external tariff (CET). Simulation results indicate that the lower the levels of CET the higher the revenue loss for the country. However, revenue loss should not be the only consideration when setting a CET, as welfare gains or losses and impact on industrial development of members of the union are also important. In fact, the level of CET is an important determinant of the likelihood and cost of trade diversion, and the likelihood of agglomeration of economic activity, with higher CETs increasing such likelihood and costs. A maximum CET close to the current average of 20% seems to be a reasonable compromise for revenue and welfare implications, and for protection of domestic industries for Kenya. Consequently, we recommend the following CET: 0% for primary goods, 5-10% for intermediate goods and 20% for final goods. This would lead to an annual loss of potential revenue of about US$ 25-50 million (or about 10-20% of annual tax revenue collections). Determination of the actual CET rate for intermediate goods requires a careful balance between revenue considerations and technology transfer, and therefore industrial development, which requires more research.

Despite the revenue implications, the government and various stakeholders in the country are in favour of quick and deep integration because they expect overall benefits from such integration to outweigh the costs in the long run. With exception of the agricultural sector, other sectors of the Kenyan economy are expected to gain from the implementation of the EAC customs union according to the stakeholders interviewed.

Important policy concerns emerge from this research, including:

(i) **Information regarding EAC integration and its objectives**: The

objectives of the EAC Treaty and in particular the creation of a customs union are not well known to all stakeholders. There is need to disseminate information regarding the objectives of the Treaty and what it entails to all stakeholders.

(ii) **Speed of integration**: Most stakeholders consider the speed of integration to be slow and many would like to see the removal of internal tariffs effected as soon as possible.

(iii) **Implementation of those aspects of the Treaty that have been agreed upon:** Stakeholders are dissatisfied with the implementation of those elements of the Treaty which have been agreed upon such as lower import tariffs (80% by Uganda and Tanzania for Kenyan products and 100% by Kenya for Ugandan and Tanzanian products). Other matters of concern include the removal of travel barriers, and reduction and harmonisation of documentation. Stakeholders complain that these have not been implemented effectively and would like them to be.

(iv) **Consultations with stakeholders on major aspects concerning creation of a customs union**: Most stakeholders feel left out on discussions regarding some aspects of the customs union such as the level of the common external tariff. Stakeholders should be consulted on such matters for their opinion.

(v) **Revenue implications from a customs union**: The loss in revenue from removal of EAC trade internal tariffs is insignificant for Kenya and should not pose a problem. However, the level of a CET has significant revenue and other implications. The established CET should be a compromise for revenue gain or loss, welfare gain or loss, appropriate protection of domestic industries for the country, and in general socio-political implications.

(vi) **Losses from EAC integration other than revenues**: These include conflicts with other integration schemes such as COMESA and SADC, loss of sovereignty and employment in sectors likely to

lose (such as agriculture). The position of these schemes with respect to the EAC need to be clarified to stakeholders and harmonised. Fear of loss of sovereignty and employment also needs to be addressed.

(vii) **Compensation mechanisms for revenue loss**: Revenue implications and distribution of benefits from the EAC customs union are major concerns for government and stakeholders in the economy. For stakeholders, increased competition and therefore lower profits is the main concern. This can be dealt with through improvement of infrastructure to reduce the cost of doing business. Therefore, creation of a development fund to support development of common services for the region is a useful mechanism to consider for compensation of losers from the EAC customs union. In some cases, use of surcharges and rules of origin to protect infant industries are mechanisms that can be considered.

(viii) **EAC integration strategy**: Considering that the old East African Community collapsed partly because of ideological and other political differences between the heads of state, it is imperative that institutions of the current EAC deal effectively with such vulnerability. Even the current EAC treaty, however, grants excessive power to the heads of state. For instance, Article 63 empowers the heads of state to assent to or reject Bills of the East African Legislative Assembly, weakening it substantially. There is need therefore to review parts of the treaty and to secure as much political will as possible even as economic integration proceeds.

After consideration of a number of factors, EAC integration is viable but the following political, social, and economic challenges have to be addressed. First, in the economic sphere, the three countries are low-income countries although Kenya is slightly better off. Yet, we are informed by experience that RI between low-income countries tends to result in divergence rather

than convergence in incomes, trade diversion rather than trade creation, and to attract "tariff jumping" foreign direct investment–factors that reduce the economic and political viability of such RIAs. Second, even though political will does not seem to be a problem for the moment, the immense power that heads of state continue to hold over the destiny of the Community is potentially disastrous. Third, lack of adequate involvement of stakeholders could also affect successful implementation of the EAC. Fourth, non-tariff barriers (such as administrative delays, lack of information at border points or delays in getting it, pre-shipment requirements, technical and standardisation requirements, and bureaucratic administration of rules of origin) are a serious bottleneck to the successful implementation of the EAC Treaty. Finally, membership to multiple RI schemes is likely to adversely affect implementation of EAC Treaty through contradictory obligations, increase in complexity that may adversely affect decision-making by the private sector and therefore affect investment, and through diversion of the energy and commitment that is required to pursue depth and width of EAC integration.

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1. INTRODUCTION

Regional integration efforts in Africa have a long history dating back to the colonial period and an equally long history of floundering due to lack of political commitment and disagreements over compensation and distribution of benefits. Despite the evidence of failure, African countries are once again calling for enhanced regional cooperation in relevant areas of economic activity such as trade, tourism, immigration, cross-border investments and infrastructure. The East African countries in particular have made a commitment to integrate their economies through the East African Community (EAC). Given past failures of integration efforts, there is need to identify issues affecting integration not only for a clearer understanding of the challenges faced, but also to guide the ongoing efforts. The aim of this study is therefore to analyse the cost and benefits of EAC integration for Kenya and to propose mechanisms for their distribution.

This study is organised into eight parts. The first part presents the background to the study covering the research problem and the objective and justification of the study. The second part reviews literature on regional integration, focusing on the theoretical framework and integration experiences generally and the specific experience of East Africa. The third part reviews trade liberalisation regimes in Kenya while part four discusses the sources of tax revenue and tariff regimes for Kenya. The fifth part presents an empirical analysis focusing on simulation of the revenue implications of EAC integration for Kenya. The sixth section presents the views of stakeholders on the implications and progress of EAC integration. The seventh part presents mechanisms for compensation of losers and sharing of integration benefits. The way forward is discussed in the final part of this study.

1.1 Background

Regional integration (RI) has along history in Africa and is still a subject of interest both within and outside the continent. The world's oldest custom union is the South Africa Customs Union (SACU), having been formed in 1910 (Alemayehu and Kibret, 2000; Jenkins, 2000). Moreover, a regional grouping for the three East African countries was formed in 1919. It developed into a customs union in 1967 under East African Community (EAC). However, the majority of the regional economic schemes in Africa started in the 1970s. There have also been attempts to establish continental integration schemes. The African Economic Community Treaty (Abuja Treaty) that came into force in 1994, in particular, seeks to strengthen existing Regional Integration schemes and to encourage the formation of new ones with the eventual aim of establishing a continental integration unit. The Sirte and Lome Declarations (made in 1999 and 2000, respectively) called for a speedy implementation of the Abuja Treaty.

Despite these early efforts, the record of sustaining regional integration schemes in Africa has been poor. The failure of most RI schemes in sub-Saharan Africa (SSA) is attributed to a number of factors, including:[1]

- Restrictions on factor mobility;
- Ineffectiveness of industrial planning, and especially failure to agree on the distribution of industries;
- Ineffectiveness of common external tariffs (CETs) arising from requests for exemption to avoid revenue losses;
- General failure of import substitution policies;
- Lack of strong and sustainable political commitment; and
- Macroeconomic instability.

[1] See Lyakurwa *et al* (1997) for details.

In spite of the unsatisfactory performance of RI schemes in Africa, there seems to be a new momentum to invigorate the process. The revival of the EAC, which started in 1992 and culminated in the formal launch of the Community in 2001, is one of such efforts. The current motivation for RI schemes in African countries may be somewhat different from that of the past initiatives. A number of analysts (Alemayehu and Kibret, 2000 and Jenkins, 2000) cite the following as reasons for the new interest in RI schemes:

- Political will expressed in the Abuja Treaty of 1991;
- Formation and strengthening of various regional blocks outside Africa (in Europe, Asia, and the Americas), thereby setting a global trend;
- Small national markets and fear of marginalisation in a world dominated by powerful trading blocs;
- Liberalisation initiatives which have created a conducive environment for out-ward looking economic policy while RI is seen as an alternative to unilateral trade liberalisation; and
- Donor concern for small markets and lack of progress in economic development and poverty reduction.

Broadly, SSA countries see regional cooperation as a means of promoting intra-regional trade and exploiting economies of scale by pooling small and fragmented domestic markets to support industrialisation strategies (Kasekende and Ng'eno, 2000).

The challenges facing East African countries were instrumental in creating demand for the new EAC. Ndung'u (2000) elaborates on these challenges which include the need for (i) high output growth, (ii) industrialisation, (iii) reduction of unemployment which has become politically threatening, (iv) increase in export trade, (v) reduction of external and domestic indebtedness to sustainable levels, (vi) raising of social and human capital

development, and (vii) reduction in poverty. Indeed, the EAC Treaty (Article 5.1) emphasises that the broad goal of EAC is to widen and deepen cooperation among partner states in political, economic, social and cultural fields, research and technology, defense, security, and legal affairs for their mutual benefits. The vision is to create wealth in the region and enhance competitiveness through increased production, trade and investment. Increasing industrial production is advocated to address the economic challenges faced by the East African countries, partly because of pressure from economic globalisation and from relatively successful regional integration schemes such as the Southern Africa Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA). Besides, economic reforms and liberalisation have shown that there are regional spillover effects beneficial to the neighbouring countries.

Therefore, a more coordinated regional group with competitive production structures and policies that support a competitive production process is required to increase domestic production of goods and services. Furthermore, harmonised policies within a RI schemes can maximise the benefits arising from regional trade and the comparative advantages of participating countries.

1.2 Objectives

The main objective of this study is to determine the cost and benefits of the EAC customs union to Kenya. In particular, the study seeks to identify and, where possible, estimate potential revenue and other implications of (i) elimination of intra-EAC trade tariffs; and (ii) adoption of a common external tariff (CET), both targets of the EAC Treaty. The ultimate goal is to provide information that will help resolve political, economic and institutional issues that may hamper successful EAC integration.

Moreover, the study seeks to identify an appropriate and mutually acceptable mechanism for equitable sharing of benefits and costs of

integration in East Africa and a formula for compensating losers, including a suitable institutional framework for handling matters of compensation and benefit sharing within the Community.

The study also aims to highlight social, political, and institutional factors that are likely to delay the achievement of successful integration of the East African countries.

Finally, the study seeks to identify priority areas of policy for Kenya, the EAC Secretariat and other key stakeholder groups that need to be addressed for integration to move forward.

1.3 Methodology

The study uses both secondary and primary data. Besides reviewing the existing literature, secondary data are used to identify the key sectors of the country in terms of EAC trade. The data are also used to analyse the cost and benefits (proxied by revenue implications) for Kenya in the event that intra-EAC tariffs are eliminated and a CET adopted.

The benefits and costs are analysed using a simulation model and internationally determined import price elasticity of demand for various commodities. Policy options in the form of different scenarios of CETs for primary, intermediate and final goods imports are examined in the simulation model to determine their revenue implications.

Primary data was collected using structured questionnaires from stakeholders in key sectors including manufacturers, traders, farmers, transporters, clearing and forwarding firms, revenue authorities, and policy makers. The purpose of the survey was to identify social, political and economic factors that affect the implementation of the EAC integration and possible solutions to these challenges. The survey was also intended to identify other costs and benefits, actual and perceived, associated with the EAC integration (besides revenue implications).

2. REGIONAL INTEGRATION: THEORY AND EXPERIENCES

This section reviews theoretical and empirical literature on the economic, social, and political costs and benefits of regional integration. It also reviews regional integration experiences with a special focus on East Africa, and Kenya's policy on regional integration.

2.1 Theory of Regional Integration

The theory of regional integration draws heavily from the standard trade theory which states that free trade is superior to all other trade regimes. From this basic principle it is assumed that integration among two or more countries will improve the welfare of the member countries provided the arrangement leads to trade creation, minimal trade diversion, and/or trade creation that exceeds trade diversion.

The term *integration* covers a wide variety of possible schemes. Lyakurwa *et al* (1997) classifies the schemes into five levels on the basis of the degree of integration, as proposed by Balassa (1961) and Jovanovic (1992):

(1) Preferential Trade Agreements (PTAs): Tariffs on trade among member countries are reduced relative to those on trade with non-member countries.

(2) Free Trade Area (FTA): Member countries remove tariffs and quotas on trade between members in goods originating within the FTA, but retain control over their own restrictions on trade with non-member countries. The tariffs and other restrictions applying to external trade will vary from one country to another. For this reason, a FTA normally applies rules of origin to implement the preferential trade arrangement.

(3) Customs Union: Members not only abolish restrictions on internal trade as in a FTA, but they also impose a common external tariff (CET) on trade with non-member countries. Rules of origin are no longer required which is a major advantage because implementation of rules of origin is very costly administratively.

(4) Common Market: This is a customs union, which in addition has free movement of factors of production. Common restrictions apply to movements of factors with non-member countries.

(5) Economic Union: This goes further than a common market in that major economic policies (e.g. fiscal, monetary, industrial) are coordinated and a monetary union may be introduced.

The above classification of schemes is hierarchical with each level embracing the one before it. In the formation of the new EAC, creation of a Customs Union was considered as the entry point followed by a Common Market, a Monetary Union, and ultimately a Political Federation of East Africa States. The establishment of the Customs Union is mandated in the EAC Treaty under Article 75(7), which provides for the removal of internal tariffs and establishment of a CET.

Assessing the benefits of regional integration

The customs union theory is concerned with associated welfare gains and losses. The effects can be both static and dynamic and they arise from (i) reallocation of resources in response to changing relative prices, (ii) specialisation, (iii) economies of scale, (iv) changes in efficiency owing to increased competition, and (iv) levels of investment and growth (Lipsey, 1987[2] and Lyakurwa *et al*, 1997). Most of the theoretical literature relates to

[2] Cited by Alemayehu and Kibret (2000).

static effects (changes in terms of trade) while the dynamic effects (specialisation, economies of scale and efficiency changes) are rarely dealt with, as they are difficult to model. This is despite the development of new models such as Krugman's (1991) economic geography model which attempts to explain the determinants of regional concentration of economic activity. These models have yet to be put into empirical test particularly in Africa (Alemayehu and Kibret, 2000). Therefore, while the basic principles of trade theories provide us with some general insights, they fall short of serving as practical guides in the African context.

Due to the shortcomings of the standard trade theories and observed lack of progress in the integration process, some authors (e.g. Fine and Yeo, 1997) suggest that the focus of regional integration in Africa should re-orient itself to the enhancement of economic growth through stable and sound national macroeconomic policies and rapid accumulation of human and physical capital. In addition, others (e.g. Robinson, 1996) argue in favour of focusing on cooperation in infrastructure and natural resources development. This is because the requirements for making reasonably complete forms of regional integration work are more demanding. For example, the distribution of gains has to be carefully enumerated and compensation mechanisms designed. In contrast, regional cooperation in infrastructure and natural resources is far less demanding and there are clear gains for all countries involved irrespective of their size and level of economic development.

The biggest challenge in understanding the successes and/or failures of RI in Africa perhaps is the analysis of benefits and costs. The empirical evidence is scanty and is based mostly on simple descriptive intra-regional trade statistics. Available evidence (e.g. World Bank, 1991; Lyakurwa *et al*, 1997; Yeats, 1999; and Longo and Sekkat, 2000) indicate that there have been no noticeable changes in the composition of trade that would suggest that integration has led to any significant structural changes in the economies of the countries involved.

Static effects of RI

Most studies on customs union are based on the pioneering study by Viner (1950)[3], which focused on production effects and resultant changes in trade structure. According to Viner, the formation of a customs union would lead to increased trade between union members. However, the desirability of this (from the point of view of union members or of the world as a whole) would depend on the balance between two effects:

(i) Trade creation: the shifting of production of some goods from a less efficient member to a more efficient member; and

(ii) Trade diversion: the shifting of production from an efficient non-member to a less efficient member.

Both effects are likely to occur as a result of tariff changes associated with the formation of a customs union. Trade creation represents a move towards freer trade and greater efficiency in the union and so is welfare improving. Trade diversion, however, leads to reduced efficiency and to an adverse effect on the welfare of the union members. The overall impact of the customs union will therefore depend on the balance between trade creation and trade diversion, with prospective unions being assessed on whether or not total trade creation outweighs total trade diversion.

Some authors (e.g. McMillan, 1993) argue that it is possible for a RI arrangement, formed among an arbitrary group of countries, to structure itself in such a way as to make each member country better off without making any member worse off. This is possible by setting an optimal CET. However, given the likely difficulty in calculating the optimal tariff, this proposition may seem to be only of theoretical interest. In the case of the EAC, for example, determination of a CET is currently one of the outstanding issues (McCarthy, 2001).

[3] Cited by Lyakurwa et al (1997).

In general, it is argued that integration schemes characterised by factors which are likely to enhance trade creation and those likely to minimise trade diversion are the most likely to be welfare-improving. Following Hazelwood (1987), the factors that are welfare improving include:

(1) Factors enhancing trade creation. These include:

  (a) extensive overlap among union members in activities protected by the tariff; and

  (b) large differences between member countries in the cost of producing commodities subject to protection.

(2) Factors tending to minimise trade diversion. These are:

  (a) many union members;

  (b) pre-union trade being a small proportion of members' production;

  (c) a high pre-union trade being with members; and

  (d) a low common external tariff compared with members' pre-union tariff.

Therefore, benefits and costs considered under static analysis mostly deal with changes in relative prices as a result of the changing pattern of tariffs. In addition to these static effects, however, there are also a variety of potential dynamic effects.

Dynamic effects of RI

Dynamic effects are felt more gradually, but are longer lasting and in some cases continued. The effects include:

(1) greater possibilities of exploitation of economies of scale;

(2) increased competition within the union, with consequent efficiency benefits;

(3) capital formation through several channels such as reduction on trade barriers to diffusion, technology transfer, externalities from export growth and increased marginal product of capital; and

(4) ability to influence terms of trade faced by union members through group actions.

When these effects apply, they have potential positive effects on growth. They provide stronger arguments for regional integration than the static arguments based on resource re-allocation. The dynamic effects also present some of the issues to be considered in assessing the relative desirability of non-preferential tariff reduction versus regional integration. However, it should also be noted that some of the dynamic effects could result from non-preferential tariff reduction.

Discussions on the likely influences of dynamic effects requires different models from those used in addressing the static issues, which typically do not incorporate the time dimension and are based, implicitly or explicitly, on assumptions of perfect competition and constant or decreasing returns to scale. However, although the importance of dynamic factors is appreciated, there is no consensus as to a single adequate model to analyse them.

Benefits and costs of RI

Benefits and costs from RI arise from static and dynamic effects. As indicated above, analysis of the static effects is much easier than is the case for dynamic effects. This section gives an overview of the empirical evidence of the benefits and costs associated with static and dynamic effects from RI schemes.

Trade creation and growth

One of the straightforward tests of the welfare effects of RI proposed by McMillan (1993) is to examine what happens to exports and imports for countries in the union. If in each commodity category the volume of imports and exports increases after entry into the integration scheme then the scheme is welfare improving relative to the pre-integration situation. Although this is a straightforward test, it is subject to objection because changes in trade volumes may have other causes besides the entry into an integration arrangement–there remains a problem of counterfactuals (Bhagwati, 1993).

Regarding terms of trade, if RI leaves all prices unchanged when internal tariffs are eliminated, and if goods are sufficiently strong substitutes, the demand for goods imported from third parties will be reduced and regional trade will increase. However, empirical evidence is not categorical about this. An analysis by Sloaga and Winters (1999) of nine regional blocs (NAFTA, Latin America and European regional trade areas), for instance, does not offer evidence of a positive effect on intra-regional trade after the signing of regional agreements. As a matter of fact, empirical evidence shows that trade diversion occurs to some extent, with intra-RIA imports as a ratio of extra-RIA imports increasing after implementation of RIA in many RIAs (World Bank, 2000). For EU's common agricultural policy alone, Messerlin (1998) conservatively estimates that trade diversion costs 12 per cent of total EU farm income. Vamvakidis (1998), analysing EU, ASEAN, Andean Pact, CACM and UDEAC blocs using a growth regression technique found that only the EU had a positive effect on the growth rates of its members, while for the rest, the impacts in terms of growth were not statistically significant. Infact, regional integration might lead to negative growth if trade diversion occurs with respect to the intermediate goods (World Bank, 2000). However, Chang and Winters (1999) found a positive effect on terms of trade in the case of Brazilian membership in Mercosur. There was a substantial fall in the price of US goods in the Brazilian market relative to the prices of the Argentinean ones.

De Rosa (1997) reviews literature which seeks to assess the effects of RI on welfare of member countries using general equilibrium models (CGE). The approach, containing a great deal of microeconomic details, is used to predict income gains associated with the RI. Lewis *et al* (1999), for example, in assessing the impact of free trade areas in the South African area found that trade creation dominates trade diversion under all areas concerned. In the EU, static gains from "competition and scale" effects have been estimated at up to 5 per cent of GDP (World Bank, 2000). Flores (1997) in the study on Mercusor found that the potential gains that might be expected from competition and scale effects are 1.8 per cent, 1.1 per cent and 2.3 per cent for Argentina, Brazil and Uruguay, respectively. The larger economies gain less because they are already larger and reaping economies of scale. This model would be the most appropriate to use for analysing the EAC RI but its complexity, the detailed data requirements, and time constraints do not allow for its use in this study. Overall, evidence from CGE studies show that there are gains from regional integration even though the gains are small (World Bank, 2000).

Revenue gains and losses

The net gain/loss from integration is a major issue in developing countries because in a customs union, internal tariffs are removed for member states and a CET for non-member states is established. Both of these have a direct effect on reduction in government revenues because these countries rely substantially on trade taxes. In most cases, custom duties and other forms of import taxes and excise and sales taxes generate the bulk of the revenue. Therefore, if members of a RI differ in respect of the importance they attach to trade taxes as a source of revenue, loss of revenue becomes one of the thorniest issues to deal with. Rajaram *et al*. (1999) indicate that the EAC members depend on import and excise duties as a major source of revenue in varying degrees (Kenya 32%; Uganda 51% and Tanzania 30%). The removal of internal tariffs and establishment of a CET with integration will affect this.

However, if RI leads to trade creation, consumer welfare improvement and industrial development, then these spillover effects can compensate for the loss in direct revenue. Loss of revenue from integration for COMESA member states, for instance, is insignificant and may be compensated for by dynamic gains from growth (Alemayehu and Kibret, 2000). This may be true also for the EAC since all the three member countries were in COMESA until Tanzania's recent withdrawal.

It is also argued that revenue losses arising from RI schemes in developing countries can be compensated for by growth of manufacturing encouraged by integration. Unlike Latin American integration during the 1950s and 1960s and the Lagos Plan for Action for regional integration in Africa, modern integration initiatives aim at using integration as an instrument for export-oriented development rather than import substitution. This stimulates importation of capital goods, which in turn induce increases in domestic investment (Rodrick, 1995). However, growth of manufacturing may not occur in all the countries involved in the RIA, especially in the case of developing low-income countries where regional integration is more likely to lead to divergence (of income levels) rather than convergence (World Bank, 2000; Venables, 1999).

Although access to markets is a major consideration under export-oriented growth, it is argued that protection is a major prerequisite for it to occur. For example, Shafaeddin (1998) indicates that all countries that have been successful in export-oriented growth including developed countries and the newly industrialising countries (NICs), first laid their foundation of industrial capability before venturing into foreign markets. This can justify protection as a strategy for targeted industrialisation but cannot justify continuous protection (McCarthy, 2001). Therefore, in the world of non-reciprocal trade liberalisation that EAC member states face as developing countries, modest protection and unrestricted access to markets of the developed countries can create favourable circumstances for industrial growth. This will allow the benefits from industrial growth to compensate the costs that the consumer

must bear because of protection arising from a CET. Trade diversion that may arise will also be compensated for by industrial growth. The challenge that arises, however, is determination of an appropriate CET to allow for the benefits of modest protection that can favour industrial growth to compensate for the loss in revenue.

Economies of scale and location effects

Economies of scale from a RI scheme are expected to arise from enlargement of the market. The gains from economies of scale are based on the argument that the domestic market of a small country may not support a large number of firms, especially industries in which scale economies are important. This can cause problems since small numbers of firms tend to collude and exploit consumers by raising prices. Competition from imports is an important means of restraining the monopoly power of domestic firms. Therefore, since RI facilitates a larger market, it provides the incentives for investment in the region. This means that creating trade barriers within a region can make it considerably less attractive to foreign investment and therefore deprive it of the dynamic advantages accruing from the flow of foreign direct investment (FDI).

Baldwin (1997) argues that creation of a RI scheme removes the barriers and the risks of marginalising the region. This argument was put forward in favour of integration between eastern European countries as a complement to their free trade with the European Union. Further, Elbadawi (1997: 213) argues that:

> economic integration could generate the threshold scales necessary to trigger the much needed strategic complementarily, and to attract adequate levels of investment (especially FDI) necessary for the development of modern manufacturing cores and the transfer of technology within the region.

It can therefore be concluded that the integration of the East African countries can act as a catalyst for FDI flows into the region as a result of the economies of scale that may arise to investors.

The gains from economies of scale can be analysed building on the theoretical works of Krugman (1991). The theory states that factors determining location are production costs, the size of the market and access costs (insurance, customs, tariffs, etc). The decision to locate a firm in a particular area is the result of a trade-off between the advantages in terms of production costs in that area, the size of the market accessible from the location and the cost of getting access to that market. Krugman (1991) further argues that concentration of manufacturing, for example, in one region which is better suited to this activity than the other has the following advantages:

(i) the ability to exploit economies of scale;

(ii) existence of demand externalities from other firms (e.g. suppliers of inputs); and

(iii) concentration of production which constitute increased local demand.

There is a disadvantage however in that there will be increased transport costs involved in serving the markets in the periphery. Therefore, the concentration of manufacturing firms will depend on the balance of the different factors. For example, manufacturing activities which are not tied to a particular locality for reasons of natural resource that necessitate concentration for extraction purposes, and have low transport costs, are more likely to concentrate in a single or smaller number of localities. Manufacturing activities, and activities with large economies, are more likely to concentrate, other things being equal.

Lyakurwa *et al* (1997) indicates that many manufacturing activities involve significant fixed costs, and consequently have significant economies of scale. However, many developing countries are too small in terms of population

and effective demand to be able to exploit fully the economies of scale. Regional integration may allow this to be achieved through increased concentration of manufacturing activities. Therefore, a group of countries may benefit from concentrating their manufacturing activities if economies of scale are large enough relative to intra-regional transport costs. The location in which the concentration takes place might not necessarily be the same for each sector, though the extent to which it would be desirable to have different centres of concentration for different sectors would depend on the extent of the demand externalities between the sectors.

The argument above raises the problem with integration for member states with respect to economies of scale. Regional integration enlarges the unprotected market but to exploit the benefits of economies of scale, it will be necessary to allow increased concentration between countries to exploit the possibilities offered by regional integration. This means, however, that the benefits of regional integration are unlikely to accrue equally to participating countries although the union as a whole may gain. The likelihood that some members will lose calls for an appropriate compensation mechanism within the union to allow all members to benefit from the integration scheme.

This study does not offer a comprehensive analysis of the likely concentration of economic activities in the EAC member states, but the analysis of the structure of economic activities in each country will indicate the likely gains and losses with respect to concentration.

Political implications of regional integration

Regional integration has both political costs and benefits. In fact, the main arguments for membership in RIA are political although socio-economic benefits offer the façade. World Bank (2000) discusses the politics of regional integration. There are a number of political benefits associated with regional integration, namely:

(i) Enhancement of security against non-members and reduction of the work of intra-regional conflicts. The arguments are that since countries interlock their economies through regional integration, conflict between them becomes more expensive and that, through regular political contact, the regional integration facilitates building of trust and initiation of other forms of cross-border co-operation. Polachek (1992, 1997) found that doubling of trade between two countries reduces the risk of conflict between them by 17 per cent. At times, the impetus for regional integration is moreover provided by the need to face a common external threat as a unified entity. For example, SADC emerged from SADCC that was formed in 1980 to provide a unified front against the apartheid regime of South Africa. In ECOWAS, economic cooperation served as a precursor to military cooperation.

(ii) Strengthening of bargaining power as a regional bloc can be more effective than individual countries in negotiations. This benefit, however, depends upon the ability of RIA members to strike common positions on relevant issues, which is often an elusive goal. There is some evidence that one factor that stimulated the formation of EEC in 1957 was the desire to increase bargaining power relative to the United States (World Bank, 2000).

(iii) Facilitation of project cooperation (such as sharing of such resources as rivers, lakes, fishing grounds, hydro-electric power, rail connections) and cooperation to deal with trans-border problems such as pollution and transport bottlenecks. Such cooperation saves money and is facilitated by RIAs through collaborative ties and frequent policy-level contact that builds trust.

(iv) Provision of a "commitment mechanism" for trade and other policy reforms, which helps governments to implement domestic political agendas. By raising the cost and therefore reducing the likelihood of domestic policy reversal, regional integration is associated with political benefit of policy reform "lock-in". World Bank (2000) cites examples where RIAs have reinforced democracy in member states. MERCOSER, for instance has additional membership to democracy.

(v) Greater political feasibility in relation to unilateral or multilateral trade liberalisation. Allowing reciprocal-free internal trade, RIAs are more acceptable to lobbies (mainly producer lobbies) than the two alternative forms of trade liberalisation.

There are also political costs associated with regional integration. The most important is that the deeper regional integration is the greater the loss of national sovereignty. Another political cost, especially with respect to RIAs driven by economic rather than political motivations, is that RIAs create internal tensions and resentment (economic insecurity) if unfair distribution of regional integration benefits and costs is perceived and industries are concentrated in a single location (World Bank, 2000). Therefore, whether regional integration improves or worsens intra-regional security is a function of the economic characteristics of the member countries and the design and style of the integration scheme (World Bank, 2000).

Compensation mechanisms

Successful regional integration is based on trade creation and effective trade promotion. It is argued that a regional integration should lead to a win-win situation for the participating members. However, the theory of and experience with regional integration demonstrate that the outcome of integration will be influenced substantially by the nature of the participating economies. McCarthy (2001) argues that many regional integration

arrangements, including the former East African Community, which was dissolved in 1977, can trace their failure to the skewed distribution of benefits associated with integration. The skewness can be ascribed to the substantial differences in the economic size and levels of development of participating states. Size differences lead to agglomeration and polarised development with the largest and most developed members being perceived to gain more than the others.

For the new EAC integration, compensation is a thorny issue since Kenya dominates intra-regional trade because of its larger and more diversified manufacturing sector (Rajaram, et al. 1999). However, Ndung'u (2000) argues that the fears for Kenya's dominance in the new EAC are historical and not real and that the other members, particularly Tanzania, face a similar problem within SADC where South Africa dominates intra-regional trade. Despite this, the issue of compensation is of major concern and it is argued that EAC integration cannot work without appropriate safeguards to address trade imbalances.

Mechanisms for compensation pose a challenge. The options include: (i) payment of compensation by the advantaged member country; (ii) establishment of a development fund; (iii) investment in common services such as infrastructure; and (iv) built in safeguard measures such as rules of origin and support of infant industries to protect the disadvantaged members.[4] These measures are used differently by various RI schemes. For example, SACU uses a compensatory factor in revenue distribution in favour of the smaller members, EU uses the principles of common investment and a development fund[5] while COMESA countries use safeguard measures. Use of particular measures depends on the unique circumstances applicable to members in each RI scheme. A compensation mechanism for the EAC

[4] The principle of asymmetry in which the members benefitting most make larger contributions to the fund and to the costs of regional projects relative to other RI members is often applied and is being considered in the EAC.

[5] The EU uses compensatory budgetary rebates and gradual adjustment process (for some members) also (World Bank, 2000).

will have to consider the unique economic circumstances prevailing in each of the members to avoid the past pitfalls that led to the collapse of the original EAC.

2.2 Review of Regional Integration Efforts in East Africa

The three East African countries have had close economic ties since the First World War, with the first formal arrangement between them being the customs union formed between Kenya and Uganda in 1917 and joined by Tanzania in 1927 (ESRF, *et al*., 2001). Other arrangements followed:

- East African High Commission (1948-1961);
- East African Common Services Organisation (1961-1967); and
- East African Community (EAC) (1967-1977).

After the collapse of the EAC in 1977[6], the three countries did not have any economic arrangement exclusive to them until 1993 when fresh attempts at the restoration of the EAC were initiated. In the meantime, however, the three countries, among other neighbouring countries, belonged to the Preferential Trade Area of Eastern and Southern Africa (PTA) (formed in 1981 and transformed into COMESA in 1994) and the Cross-Border Initiative (CBI) formed in 1992. Currently, Kenya and Uganda are members of the EAC, CBI, COMESA and IGAD while Tanzania has membership to the EAC, CBI and SADC. In the following paragraphs each of these regional groupings is briefly discussed.

[6] For the reason(s) of the collapse, see a later section on social, political and institutional factors likely to affect successful integration in East Africa.

East African Community (EAC) and cross-border initiative

CBI[7] was started in 1992 to foster regional integration and provided the impetus for restoring EA Cooperation. The members of the Cross-Border Initiative are Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe.

Efforts began in 1993 to restore cooperation among EA countries with the formation of a Permanent Tripartite Commission, which culminated in the establishment of the secretariat for EAC in March 1996. Subsequently, the Treaty establishing the Community was signed on 30 November 1999 and the Community was officially launched in January 2001.

The long-term objective of the EAC is progressive deepening of integration with the establishment of a customs union as the entry point, followed by the establishment of a common market, a monetary union, and finally a political federation.

One of the fairly immediate objectives[8] of the EAC is the possibility of forming a customs union. Such a union would require a common external tariff (CET) and a zero internal tariff. The aim of the EAC is a faster reduction of intra-EAC tariffs relative to the requirements of other regional integration schemes that the three countries belong to, principally COMESA and SADC. Towards the achievement of this objective, the EAC adopted the trade liberalisation programme agreed upon within the CBI framework in 1993. The programme involved:

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[7] Now known as the regional Integration Facilitation Forum (McCarthy, 2001)
[8] In broad terms, the objectives of the EAC are cooperation in agreed fields, promotion of sustainable utilization of natural resources and protection of the environment, enhancement of the role of women in development, and promotion of peace, security, and good neighborliness. Five areas were picked for cooperation over the 1997-2000 period. These are economic cooperation in trade and industry, transport and communications, energy, agriculture and animal husbandry, promotion and investment, environment and natural resources, tourism and wildlife, social and cultural activities, and harmonization of fiscal and monetary policies; immigration; political cooperation; legal and judicial cooperation; and security matters.

(i) removal of all NTBs on all imports from participating countries (except for a list of few imports set aside for health and security reasons),

(ii) timetable for intra-regional tariff reduction requiring 60 per cent reduction by October 1993, 70 per cent reduction by October 1994, 80 per cent by October 1996, 90 per cent by October 1999, and 100 per cent by October 2000,

(iii) movement towards a CET by adopting the import duties on third countries of the members with the lowest rates,

(iv) harmonisation of tariff rates (3-4 tariff bands including zero, average trade weighted tariff of at most 15%, and a maximum tariff of not more than 20-25%),

(v) harmonisation of customs procedures, and

(vi) possibility of forming a customs union.

The East African countries have already implemented some of these policies under the COMESA framework. Therefore, Kenya has already reduced tariffs by 100 per cent while Uganda and Tanzania have reduced them by 80 per cent (ESRF *et al*., 2001). This reduction of intra-regional protection has already provoked the use of import surcharges against Kenyan commodities by Uganda and re-introduction of non-tariff barriers in Tanzania, indicating the need for a slower speed towards zero tariffs than that planned under the EAC (Rajaram *et al*. 1999).[9] McCarthy also recommends sensitivity and care in the management of the movement to intra-EAC free trade.

[9] The superiority of Kenya over her EAC partners in terms of level of industrial development, industrial diversification and trade is clear from the following data (reported in McCarthy, 2001). In 1997, Kenya's regional exports amounted to 2.6% of the combined EAC GDP compared to 0.23% for Tanzania and 0.05% for Uganda. Kenya's manufacturing sector is also larger and more diversified than that of Tanzania and Uganda.

A CET has substantial long-term benefits. These include increase in efficiency and growth due to improved investments, reduction of anti-export bias in the current tariff structures, improvement in welfare arising from reduced tariffs, and increase in commercial activity associated with easing of trade barriers (Rajaram *et al*, 1999). The CET could however have substantial revenue opportunity costs. Due to these revenue implications and differences in tariff bands and rates, consensus on the level of CET has not been reached, with Uganda favouring a maximum rate of 15 per cent while Kenya and Tanzania prefer a higher rate of 25 per cent as the maximum. Analyses of trade and revenue data show that a low CET has larger revenue implications for Kenya and Tanzania relative to Uganda (Rajaram et al., 1999; Maasdrop, 1999). It is also associated with higher consumer welfare while a higher one may lead to more trade diversion especially in developing countries that tend to have low levels of intra-regional trade (McCarthy, 2001). The WTO requires that the CET level should not exceed the weighted average of nominal tariffs obtaining in the member states, which is higher than Uganda's three-band (0-7-15%) tariff structure favoured by Maasdrop and Rajaram *et al* (McCarthy, 2001). Taking into consideration this WTO requirement, consumer welfare, revenue and modest industrial protection, McCarthy (2001) recommends a CET of 0 per cent for raw materials and capital goods, 10 per cent for intermediate goods and 20 per cent for final goods for the EAC.

In the area of trade, the EAC also provides for joint promotion of trade and investment and establishment of EA standards for locally-manufactured products. Significant progress has been made with respect to the latter, with 91 EA standards already agreed upon and notified to the WTO (ESRF *et al*, 2001). Other policies being implemented or considered include:

- harmonisation of competition policies with a workshop on the issue having been held in May 2000;

- facilitation of the free movement of people, with people now seeking employment across borders; and
- harmonisation of tax policies. Kenya, for instance, has increased its VAT and reduced excise duty rates in an effort to match those prevailing in the other two countries.

Besides these, Kenya is keen to have investment rules and incentives, as well as tax exemptions, harmonised within the EAC so as to promote the region as a common investment area (Republic of Kenya, 1999).

Common Market for Eastern and Southern Africa (COMESA)

COMESA was formed as the Preferential Trade Area (PTA) for Eastern and Southern Africa in 1981 and reverted to its new status in 1994. It has 20 members, among them Kenya and Uganda. Designed to deal with the structural and institutional weaknesses of its member countries by pooling resources, COMESA Heads of State and Government selected (in 1994) the following as priority areas of focus for 5-10 years:

- increasing productivity in industry, manufacturing, processing and agro-industries;
- increasing agricultural production;
- promoting, expanding and facilitating trade;
- developing transport and communications infrastructure and services; and
- developing comprehensive, reliable and up-to-date information data bases.

As mentioned in the section on the EAC, the East African countries have already implemented significant tariff reductions within the COMESA framework, with Kenya having already reduced tariffs by 100 per cent and

Uganda and Tanzania by 80 per cent. Kenya has provided the agreed preferential tariff discount to its COMESA trading partners, at 80 per cent of the tariff applied to third countries. Therefore, in 1997/98 the mean tariff rate on imports from COMESA was 13 per cent compared with 15 per cent for all imports. The three East African countries, though committed to these COMESA tariff preferences, have acted in contrast. Therefore, in July 1996 Uganda introduced a 10 per cent excise duty on many imports from Kenya, Tanzania suspended the preference during the 1997/98 fiscal year (although it withdrew its membership in 2000), and Kenya increased the rate of suspended duties on agricultural products that could be imported from the region (Rajaram *et al*, 1999). In addition, non-tariff barriers are still used to control regional trade. Administrative weaknesses, difficulties in enforcing rules of origin, influence of domestic protectionist lobbies, and concerns about protection and revenue loss are factors explaining the selective application of tariff preferences (Rajaram *et al*, 1999).

Because of these problems, intra-COMESA trade remains very low as a percentage of total trade flows for the member countries. This percentage grew from 5.74 per cent in 1980 to 6.81 per cent only in 1996. Moreover, trade is dominated by a few members, notably Kenya, Zimbabwe and Tanzania. In the 1990s, however, Mauritius and Zambia have increased their share of trade substantially. Another characteristic of the intra-COMESA trade is that member countries are, in general, exporters of similar primary commodities and importers of similar manufactured goods, which is indicative of the non-complementary nature of intra-COMESA trade.

Inter-Governmental Authority on Development (IGAD)

The Inter-governmental Authority on Drought and Development (IGADD) by Djibouti, Ethiopia, Kenya, Somalia, Sudan and Uganda was created in 1977 to tackle the problems of drought and desertification regionally. Eritrea became the seventh member of IGADD in 1993. Soon after, the mandate of IGADD and its name were changed so that IGAD now concentrates on economic, political and security cooperation in general and regional

integration for food security, environmental protection, natural resource management, economic cooperation and promotion of peace and security in particular.

IGAD Secretariat, based in the city of Djibouti, is headed by an Executive Secretary and has three divisions: one dealing with Economic Cooperation, another with Agriculture and Environment and the last with Political and Humanitarian issues. The main preoccupation of IGAD at the moment is conflict resolution in Southern Sudan and in Somalia. Egypt is expected to join IGAD later. Sudan has drafted a trade protocol, which the Secretariat is studying. The 8th summit of the Heads of States and Government held in 2000 encouraged facilitation and expansion of inter-state trade among IGAD members.

Southern Africa Development Community (SADC)

SADC was incepted in 1992 and has 14 member countries. Tanzania is the only East African member country. SADC is a regional market of 199 million people and a combined GDP of US$ 176 billion.[10] The vision of SADC is the creation of a single economic region, that is, deep economic integration that provides for cross-border investment and trade, free movement of factors of production, common set of social values, democracy, and popular participation in the fight against poverty (SADC, 2000). Its primary role is to help define regional priorities, facilitate integration, assist in mobilising resources, and maximise the regional impact of projects.

Each of the member states is allocated a sector to coordinate by proposing policies, strategies and priorities for it; processing projects for the sector; monitoring the progress, and reporting to the Council of Ministers (SADC, 2000). The Council of Ministers approves sectoral projects and programmes before they are included in the SADC Programme of Action.

[10] South Africa accounts for 73% of this GDP and 22% of the population.

Industry and Trade is just one of SADC's 22 sectors, currently being coordinated by Tanzania. SADC Trade Protocol is yet to be ratified but there is general consensus in favour of a Free Trade Area, with restriction of only few sensitive products, and the need for measures to ensure equitable distribution of the benefits of trade integration. Notwithstanding the non-ratification of the Trade Protocol, intra-SADC trade increased from 22 per cent in 1995 to 28 per cent in 1997 and only 30-40 per cent of the goods (value) traded within SADC have tariff rates above 10 per cent (SADC, 2000). Negotiations on tariff reductions are almost complete.

2.3 Performance of and Constraints facing Regional Integration Arrangements

Performance of regional integration schemes in Africa has been dismal. Therefore, empirical literature reviewed by Alemayehu and Kibret (2000) reach the general conclusion that regional integration in the continent has failed to achieve its objective of expanding intra-regional trade and policy coordination. None of the regional groupings has achieved the eventual objective–formation of a common market–or even the formation of well functioning customs unions. Even though tariff rates within COMESA have been lowered to some extent, non-tariff barriers have emerged to replace them. Such non-tariff barriers include administrative delays, lack of or delays at getting information at border points, pre-shipment requirements, technical and standardisation requirements, and bureaucratic administration of rules of origin, among others. Moreover, many member countries joined regional integration schemes while still pursuing inward-looking import-substitution growth strategies that conflict with the objectives of the schemes.

Potential revenue losses have played a significant part in delaying the progress of regional integration schemes. In the case of COMESA, for instance, static estimation shows that if tariffs were eliminated in 1998, Uganda and Tanzania would have lost 9.12 per cent and 8.6 per cent respectively of their total revenue associated with international trade,

compared with 4.65 per cent in the case of Kenya (Alemayehu and Kibret, 2000). Besides revenue loss, the relatively weaker economies within COMESA are seriously concerned about competition from the more industrialised economies, principally Kenya, Mauritius, Zimbabwe, Egypt and South Africa.

Membership to multiple integration schemes is also a major characteristic for East African countries. Therefore, Tanzania was a member of EAC, CBI, COMESA and SADC until recently before quitting COMESA. Both Kenya and Uganda are members of CBI, EAC, IGAD and COMESA. Membership to multiple schemes hinders integration because of duplication of effort, human and financial costs,[11] lack of harmony in such policies as rules of origin and customs procedures, information gaps, and changing political positions (Alemayehu, 1998; Aryeetey and Oduro, 1996). The almost certain establishment of free trade within SADC creates potential problems for industries in Kenya and Uganda, as South African goods will find their way into the EAC through Tanzania (McCarthy, 2001). This will require excessively expensive policing of rules of origin by Kenya and Uganda. In addition, a customs union cannot "fast-track" the way EAC is intended if its members belong to separate free trade arrangements (McCarthy, 2001). The complexity engendered in membership to multiple RIAs may also affect private sector decision-making and dampen investment while such membership may also divert official attention from crucial and difficult issues of depth and width of integration (World Bank, 2000).

2.4 Kenya's Policy on Regional Integration

In the current industrialisation strategy, aimed at turning Kenya into a newly industrialising country (NIC) by year 2020, pursuance of regional trade arrangements is a key element of trade policy alongside export subsidisation

[11] In the case of EFTA – European community trade, for instance, it was estimated (in 1986) that the cost of implementing rules of origin amounted to 3–5% of the FOB prices (World Bank, 2000).

and promotion and further trade liberalisation. Regional integration is also seen as a vehicle for achieving poverty alleviation and employment generation (Republic of Kenya, 1999). Regional integration is expected to facilitate exploitation of economies of scale, attract local and foreign investment, and improve resource allocation and technology transfer. Within the broad regional integration strategy, the Government of Kenya has the objectives of:

- Pushing for the rationalisation of the regional arrangements or groupings;
- Supporting trade relations with other trading blocs such as South-East Asia;
- Encouraging the domestic manufacturing sector to exploit regional industrial support services; and
- Improving the negotiation skills and capability of Kenyans to maximise the benefits the country receives from multilateral negotiations.

As a reflection of Kenya's commitment to these policies, the country is not only a member of the WTO, but is also a member of numerous regional groupings as indicated earlier. The country is committed to the principle of free trade through multilateral negotiations, under the World Trade Organisation (WTO) framework. Even though Kenya is committed to this principle one aspect of its industrialisation strategy is to raise tariffs for a period up to around 2007 to protect intermediate and capital goods industries (Republic of Kenya, 1997). Nevertheless, the country remains committed to tariff elimination and a common external tariff (CET) both for EAC and COMESA (Republic of Kenya, 1999). However, the current policy of the Government is to adjust COMESA preferential rates on a reciprocal basis and apply the rules of origin stringently (Republic of Kenya, 2000a).

3. REVIEW OF TRADE DEVELOPMENTS IN KENYA

Kenya's trade policy like that of the rest of developing countries has evolved from inward looking which emphasised restrictions on imports to open trade policies which emphasise free trade. This section reviews trade policy developments in Kenya and the consequences on the trade regime.

3.1 Trade Liberalisation and its Impact

As part of an import substitution strategy that was initiated during the colonial era[12] and continued in the first two decades following independence, Kenya introduced pervasive controls, especially in the 1970s. Controls included quantitative restrictions (QRs), high tariffs on competing imports, and overvalued exchange rates. There were also controls on importation and licensing, domestic prices and wages. Exports were also taxed. Even though the need for export markets was expressed, beginning early after independence and in the following years, nothing serious was done to secure them until the mid-1980s.

By the second half of the 1970s, the small size of the domestic market was seriously holding back growth and the country was facing a serious balance of payments crisis towards the end of that decade (Ikiara and Ndung'u, 1999; Ronge and Nyangito, 2000). Kenya was forced to seek financial assistance from the World Bank and the International Monetary Fund. The conditions that accompanied this assistance initiated trade liberalisation in particular and the switch towards outward-looking industrialisation policies in general.

[12] Price controls can be traced back to the Price Control Ordinance of 1956. Prices of staple food commodities were controlled with the aim of protecting low-income earners while those of manufactures were controlled to prevent monopolistic pricing.

Trade liberalisation in the 1980s

The first Structural Adjustment Loan (SAL) that Kenya signed with the World Bank in March 1980 and the first stand-by agreement signed with IMF in October of the same year marked the beginning of the era of Structural Adjustment Programmes (SAPs) in the country, and with it trade liberalisation.[13] The two came on condition that Kenya committed to adopt a more outward-oriented industrial strategy, initiate trade liberalisation, reform its interest rate regime, and reduce deficit financing (Ikiara and Ndung'u, 1999). These liberalisation measures had, however, been spelt out in the 1979-1984 Development Plan. The Plan announced the intention of the Government to remove QRs, reduce tariffs, promote exports, and establish a flexible exchange rate regime. In 1982, the country signed the second SAL and stand-by agreement subject to similar conditions of fiscal discipline, import liberalisation and trade liberalisation in general, further devaluation of the shilling, interest rate reforms and sectoral reforms (liberalisation of maize marketing and energy sectors). Improved price and marketing incentives and increased export promotion were added on the other conditions in the 1985 stand-by facility. In 1990, a sectoral adjustment programme for export development was designed for Kenya but, like others before and after it, it was not properly implemented due to lack of commitment. Most of the other conditions imposed in the 1980s related to fiscal discipline and sound macroeconomic management.

The Government failed to implement some of these conditions — particularly the liberalisation of the maize and cereals markets — leading to substantial deterioration of relations between the country and the donors (Ikiara and Ndung'u, 1999). By 1984, however, removal of QRs and reduction of tariffs had been implemented to a fairly large extent. Therefore, the proportion of restriction-free import items doubled between 1980 and 1985

[13] It should be noted, however, that the export compensation scheme was started in 1974.

to reach 48 per cent while the average tariff rate reduced by about 8 per cent over the same period (Swamy, 1994). There were periodic reversals, however, involving increases in tariff rates especially when balance of payments deteriorated. This also happened in 1993-94. There was also limited devaluation of the shilling and increased export compensation. Import licensing was also progressively improved so that by July 1991 only a few imports were on the restricted schedule on account of health, security or environmental grounds (Ikiara and Ndung'u, 1999). Particularly between 1985 and 1991, harmonisation of tariffs was implemented as a central component of trade liberalisation while tariffication of quotas was adopted over the 1989-90 period.

Export promotion has been a consistent policy of the government since independence, although this was hardly implemented before 1974 when an export compensation scheme was put in place. Since then, other notable export promotion measures adopted by the Kenyan government in the 1980s were:

- Manufacturing under bond (MUB), in which import duty and other taxes on imports used for production of export goods were waived. This scheme was introduced in 1988 and is still in place, albeit with progressive adjustments.
- General import duty and VAT exemption scheme.
- Regulatory reforms.
- Green Channel system to hasten administrative approvals.
- Improvement and simplification of investment procedures.
- Introduction of Export Processing Zones (EPZs) in 1990 that offered to exporting firms 10 years of tax holiday, unrestricted foreign ownership and employment, and freedom to repatriate any amount of earnings.

Even though there was lack of seriousness in the implementation of these policies and lack of fiscal discipline that led to macroeconomic imbalances, there was an increase in non-traditional exports and a small overall export supply response between 1985 and 1990 (Swamy, 1994).

Trade liberalisation in the 1990s

In spite of reluctance, reform reversals,[14] and the poor relationship between the Kenyan government and the Bretton Woods institutions, the 1990s (particularly 1993 and the following two or so years) marked the period of sustained economic and political reforms. With respect to trade liberalisation, the following measures were taken:

(i) Between July 1991 and 1993, the Foreign Exchange Allocation Committee, the Import Management Committee and the foreign exchange allocation licence were abolished and foreign exchange bearer certificates introduced.

(ii) In February 1993, the shilling was floated, foreign exchange retention accounts for exporters of traditional exports and services were reintroduced, the inter-bank market expanded and coffee and tea marketing systems liberalised.

(iii) In April-May 1993, the export pre-shipment discount facility was abolished.

(iv) By November 1993, all administrative controls hampering international trade had been abolished, tariff rates gradually reduced, and tariff bands reduced. The tariff reforms carried out in Kenya since the 1980s have resulted in tremendous simplification of the country's tariff regime (Swamy, 1994;

[14] In March 1993, for example, unhappy with donors the Government abolished retention accounts, abandoned floatation of the shilling and let the market for foreign exchange bearer certificates collapse, reforms that had been introduced only a few months earlier.

Rajaram et al., 1999). While in 1987/88 the country had 24 tariff bands (including zero), a maximum rate of 170 per cent and a weighted average tariff rate of 39.9 per cent, the corresponding figures had changed to 5, 35 per cent, 14 per cent and 4, 25 per cent and 12.3 per cent by 1996/97 and July 1997/98, respectively (Rajaram *et al*, 1999).

(v) By the beginning of 1995, domestic price decontrols that had been started in 1983 had been virtually completed.

(vi) By the end of 1995, the Government had removed virtually all price and foreign exchange controls, liberalised domestic trade, liberalised imports and the exchange rate market, repealed the Foreign Exchange Act, and legalised foreign exchange bureaux.

(vii) Export promotion in the 1990s centred on the creation of an enabling environment for export growth through institutional reforms, reduction and restructuring of tariffs especially on raw materials and capital goods, abolition of export duties, improvement of capital allowances, introduction of export earnings retention schemes, provision of short-term export finance, and improvement of foreign exchange and insurance regulations including the establishment of the private sector National Export Credit Guarantee Corporation, and stationing of commercial attaches in major trading partner countries and organising trade missions to emerging markets. Even these, however, have not had any major impact on export performance. Therefore, the country's exports of goods declined from 16.5 per cent of GDP in 1998 to 15.4 per cent in 1999 (Republic of Kenya, 2000a).

By the end of 1995, imposition of countervailing duties[15] to curb subsidised exports was the only barrier to international trade remaining. The use of "suspended duties" in Kenya for revenue or protective purposes renders the country's tariff structure less transparent, with more than 459 items attracting such duties in 1996/97 alone (Rajaram *et al*, 1999)[16]. Requirement for observance of minimum quality standards for imports, as determined by the Kenya Bureau of Standards (KBS), also remains. Other current trade policies include (Republic of Kenya, 1999, 2000a, 2000b):

- measures to avoid diversion of transit goods;
- duties on imports of locally-available agricultural products[17];
- harmonisation of trade policies;
- minimisation of trade licensing requirements;
- introduction of Electronic Data Interchange on inward international trade;
- improvement in revenue collection;
- minimisation of duty exemptions;
- removal of minor import inspection fees so as to reduce production cost for firms;
- establishment of a Tribunal for resolution of customs value disputes, as required by WTO rules;

[15] Anti-dumping legislation is also in place and the Government is keen to enforce it aggressively in order to ensure fair competition for Kenyan products.

[16] Suspended duties on all products except oil products were abolished in the 2000/2001 Budget.

[17] From time to time, these duties are lowered to alleviate domestic shortages. These are also to be applied for the protection of those sectors with potential for high domestic value added and employment generation (Republic of Kenya, 2000a).

- harmonisation and coordination of the marketing efforts of both private and public sectors agencies;
- improvement of port efficiency through privatisation, simplification of customs procedures, reduction of corruption, and other measures in order to reduce the cost of trading;
- exploitation of all new trade opportunities such as those presented by the US African Growth and Opportunity Act (AGOA) and the new EU-Lomé Agreement; and
- involvement of the private sector in global trade negotiations and letting it play an overseeing role with respect to public sector institutions.

Impact of trade liberalisation

The impact of the trade liberalisation measures that Kenya has adopted since the 1980s is discernible from trade flow changes. The openness index (value of exports and imports as a proportion of GDP) for the country increased from about 55 per cent between 1990 and 1992 to an average of 72 per cent over the 1993-1996 period, following tremendous liberalisation in 1993. Besides trade flow changes, trade liberalisation has affected domestic production and employment, as well as consumer welfare. While no comprehensive studies have been carried out to assess the magnitude of these impacts, casual empiricism suggests that the impacts have been quite substantial in some sectors of the Kenyan economy. Import liberalisation has led to massive imports of some products and the closure of the domestic firms that used to produce these products. The textile and leather industries were particularly hit by the importation of cheap new and used clothes and shoes. The negative employment effects of import liberalisation, however, were partly compensated for by the positive impact of export promotion. For example, EPZs had created 5,000 new jobs between 1990 and 1995 (Ikiara and Ndung'u, 1999). In addition, competitive industries at the time of

liberalisation experienced expansion (leading to more employment) from foreign exchange reforms.

In the short-run, trade liberalisation leads to increase in unemployment since it is accompanied by an outflow of resources from production to commerce. Therefore, trade liberalisation has had positive consumption effects. In contrast to the impact of this external trade liberalisation, decontrol of domestic prices favoured producers, but had a negative impact on consumption and is strongly opposed by the labour movement.

The preceding sub-sections have shown that unilateral trade liberalisation in the country under SAPs has been characterised by reluctance, policy reversals and lack of serious commitment largely because of political reasons. An interesting question is whether trade liberalisation in the contest of EAC would have been more credible than such unilateral liberalisation.

Trade liberalisation under the EAC framework would have been credible for a number of reasons. First, because regional integration offers an opportunity for reciprocal trade liberalisation, it is more politically feasible than unilateral trade liberalisation (World Bank, 2000). Domestic lobby groups (especially producer lobby groups) may prefer regional integration to unilateral trade liberalisation as it limits international competition to home country producers and offers opportunity for reciprocal granting of market access (World Bank, 2000). Empirical studies reviewed in World Bank (2000) show that RIAs that tend to be politically sustainable are those that maintain high external protection, deliver minimal benefits to consumers, and raise returns to producers. This implies that, politically, it is easier to liberalise trade on a regional basis than unilaterally or through the multilateral process. Second, regional integration has political benefits as discussed in an earlier section, which unilateral trade liberalisation lacks. Finally, on account of the comparative advantage of Kenya relative to her East African partners and on account of relatively better agglomeration (clustering) factors, Kenya would not have lost as much as it has lost through unilateral liberalisation if trade had been liberalised under the EAC context.

3.2 Kenya's Trade Patterns with Emphasis on EAC Trade

Kenya has a relatively open economy with an openness index greater than 50 per cent between 1972 and 1999. This openness has, however, varied over time. For the decade 1972-81 the ratio was 63.3 per cent while it was 52.5 per cent for the decade 1982-1991. Following intensification of the structural adjustment programme in 1993 and the resultant trade liberalisation, the index shot up to an average of 72 per cent between 1993 and 1996. Subsequently, trade was constrained by poor economic performance and fiscal stringency so that the openness index averaged only 58.7 per cent over the 1997-1999 period.

Composition of trade

The structure of Kenya's trade represents that of a typical developing country. Therefore, exports are predominantly primary goods and imports are principally capital equipment. For instance, between 1993 and 1999, the era of serious liberalisation, agricultural products constituted over 54 per cent of the country's total exports. Industrial supplies and consumer goods are also significant export items for Kenya, averaging about 33.3 per cent of total Kenyan exports over the same period. However, industrial supplies exports have been on a general decline over the period. As Table 1 shows, the share of exports of these supplies in total exports dropped from the high of 26.9 per cent in 1995 to 17.9 per cent in 1999.

Kenya's imports are predominantly intermediate goods and capital equipment, comprising machinery and capital equipment, and fuel and lubricants. These two categories account for about 32 per cent and 17.6 per cent of the country's total imports, respectively (Table 1).

Kenya trades with both developed and developing countries, the latter especially because of the country's strategic position as a regional industrial giant with access to sea. The geographical distribution of her trade shows

that the EU has been the dominant market for Kenyan exports followed closely by the EAC (Table 2).

Exports

Table 2 show that the share of Kenya's exports to the EAC (Tanzania and Uganda) has increased from 7.4 per cent in 1990 to 26.2 per cent in 2000, representing an impressive rate of growth of 12.2 per cent per annum over the period. The significant increase in exports to the EAC began in 1993, the year when Kenya made significant liberalisation of her trade regime under the structural adjustment programme. Over the same period (1990-2000), the share of the exports going to the EU declined by about 4.0 per cent annually. Nevertheless, the EU is still the largest market for Kenyan exports. The share of exports to the rest of COMESA (excluding the EAC) has shown an increasing trend[1] over time while the share of exports to the rest of Africa has been more or less constant.

In the financial year 1999/2000, 31 per cent of Kenya's exports to Tanzania were finished and semi-finished manufactured products. In addition, processed agricultural products constituted about 10.4 per cent of the total exports to Tanzania in that year. Exports to Uganda in the same year comprised mainly manufactured goods and minerals, accounting for about 33.2 per cent of total Kenyan exports to Uganda. It is evident therefore that Kenya's exports to EAC are mainly composed of manufactured and mineral products.

Table 1: Commodity composition of Kenya's trade, 1990-2000

Type of Commodity		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Food and Beverages	Exports [a]	60.4	53.3	54.4	54.8	51.5	51.1	52.9	53.7	57.4	55.9	56.3
	Imports[b]	7.1	4.5	7.6	6.2	10.0	4.5	7.7	6.6	8.6	7.8	7.7
Industrial supplies	Exports	19.9	20.9	21.8	24.2	26.4	26.9	26.1	22.4	18.2	17.9	19.1
	Imports	31.9	37.6	37.6	38.0	39.4	39.2	36.6	39.8	33.8	34.5	27.4
Fuel and Lubricants	Exports	12.2	17.4	14.4	9.8	6.5	5.3	6.6	9.0	9.1	8.2	8.6
	Imports	19.2	18.7	21.2	24.8	16.2	13.0	16.1	15.5	16.1	15.5	25.6
Machinery and Capital Equipment	Exports	0.6	0.7	0.8	0.7	0.9	1.4	0.9	0.6	0.9	1.3	0.5
	Imports	24.9	23.0	20.3	14.6	15.4	19.3	18.2	16.9	17.6	17.3	15.8
Transport Equipment	Exports	0.2	0.3	0.5	0.8	1.1	0.5	0.5	0.4	0.6	0.9	0.5
	Imports	12.4	11.1	8.1	9.1	12.3	17.0	14.4	14.4	15.7	15.1	16.7
Consumer Goods	Exports	6.7	7.4	8.1	9.8	13.6	14.8	13.1	13.9	13.7	15.9	15.1
	Imports	4.3	5.0	5.1	7.1	6.7	6.9	6.8	6.4	7.9	9.2	6.4

[a] As a share of total exports [b] as a share of total imports
Source: Republic of Kenya, *Economic Surveys*.

Table 2: Direction of Kenya's exports and origin of its imports, 1990-2000

Geographical area and country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
European Union											
Exports[a]	46.8	41.5	44.0	39.1	34.8	33.7	35.3	34.3	31.7	31.3	29.8
Imports[b]	48.8	44.3	36.2	36.6	35.4	40.4	37.7	32.2	32.6	32.8	30.5
Rest of western Europe											
Exports	1.0	5.4	4.6	1.0	0.7	1.3	1.2	1.3	0.8	0.8	0.9
Imports	1.6	2.0	2.0	1.4	2.0	1.4	2.3	1.7	1.8	1.8	1.4
Eastern Europe											
Exports	1.6	0.1	0.1	0.2	0.2	0.1	0.3	0.4	0.3	0.5	0.5
Imports	0.6	0.9	0.7	0.8	0.5	0.5	1.1	0.8	0.7	0.9	2.1
America											
Exports	4.4	4.3	4.2	4.7	4.3	3.6	3.5	3.5	3.3	2.7	2.7
Imports	7.1	6.9	10.9	7.8	8.0	6.9	7.4	9.5	13.0	9.7	6.0
Tanzania											
Exports	**2.4**	**3.2**	**4.2**	**7.0**	**10.2**	**11.8**	**12.0**	**12.2**	**12.0**	**11.2**	**8.2**
Imports	**0.5**	**0.4**	**0.5**	**0.5**	**0.9**	**0.4**	**0.6**	**0.5**	**0.3**	**0.2**	**0.4**
Uganda											
Exports	**5.0**	**6.4**	**6.7**	**9.0**	**12.2**	**15.1**	**15.4**	**14.3**	**15.2**	**17.3**	**18.0**
Imports	**0.1**	**0.1**	**0.3**	**0.3**	**0.2**	**0.1**	**0.0**	**0.2**	**0.0**	**0.2**	**0.2**
Rest of COMESA											
Exports	11.6	11.1	10.9	14.0	16.6	13.9	12.5	13.3	14.2	15.3	15.9
Imports	2.2	2.1	2.1	1.6	1.5	0.7	0.7	2.9	0.9	1.4	1.5
Rest of Africa											
Exports	2.2	2.3	4.0	4.1	4.5	6.1	5.4	4.3	3.9	2.9	3.9
Imports	0.2	0.4	0.3	0.1	11.2	7.5	8.3	11.6	7.5	9.0	7.1
Middle East											
Exports	3.9	2.9	2.9	2.9	1.8	2.5	3.5	3.4	4.2	4.5	4.9
Imports	20.6	20.0	21.9	22.8	15.4	14.5	16.1	17.2	18.2	5.5	29.7
Far East and Australasia											
Exports	12.7	10.9	13.4	12.9	11.7	11.4	10.8	11.0	12.9	13.1	12.1
Imports	18.2	22.6	22.9	18.8	24.4	26.5	25.6	22.9	24.3	5.5	20.9

Source: Kenya Economic Surveys
[a]As a share of total exports
[b]As a share of total imports

Imports

The European Union is the leading source of imports for Kenya, although the Union's share of total imports to Kenya has declined over time from 48.8 per cent in 1990 to 30.5 per cent in 2000. Other major sources of imports for Kenya include the Middle East and Far East and, more recently, the rest of Africa (primarily South Africa). The EAC is a relatively insignificant source of imports for Kenya. Imports from Tanzania and Uganda combined have been relatively stable since 1990, never exceeding 1.0 per cent of total imports. The rest of COMESA is also an insignificant source of imports for Kenya.

Agricultural products accounted for about 35 per cent of total imports into Kenya from Tanzania (compared with 57 per cent in the case of Uganda) in the fiscal year 1999/2000. Manufactured and mineral products accounted for another 19 per cent of total imports from Tanzania (and 26 per cent in the case of Uganda) in the same year. Therefore, it is clear that there is a predominance of agricultural imports from the EAC.

4. SOURCES OF REVENUE AND EVOLUTION OF TARIFF REGIMES

A major concern in integration, as mentioned severally, is loss of revenues from tariffs and various duties and taxes on trade. This section reviews the major sources of revenue for Kenya and the evolution of tariff regimes to help understand the revenue implications of integration.

4.1 Sources of Revenue

Revenue collection in Kenya has become increasingly effective. Therefore, total revenue collection rose from Ksh 122.2 billion in the 1995/96 fiscal year to KShs 167.9 billion in 1999/2000 and is expected to reach 183.6 billion in the 2000/2001 fiscal year (Table 3). Collection performance has tended to exceed target levels. Moreover, tax to GDP ratio has averaged about 25 per cent over the last eight years. The ratio rose from 22 per cent in the 1992/93 fiscal years to an all-time high of 27.9 in 1995/96 but fell again to 21 per cent by 1999/2000 (Table 4). This tax performance is much better than in the neighbouring countries.[18]

The Kenyan Government, through Kenya Revenue Authority (KRA), administers various tax laws, which are the source of the legal mandate for tax collection. The following taxes are administered in Kenya:

- Income tax, which includes PAYE, Withholding tax, Corporation tax, Individual tax and Advance tax. Widows and Children Pensions and the Members of Parliament Pensions Fund are also collected.
- Customs and Excise taxes, which include Import duty, Excise duty both on domestic goods and imports, Air Passenger Service Charge and other agency revenue such as Road Maintenance Levy, Foreign Motor Vehicles inspection fees, Import Declaration and

[18] IMF estimates show that the current tax/GDP ratio for Uganda and Tanzania is 11% while that for Rwanda in 1998/99 was 10.4%.

Pre-Shipment fees, Road Transit Toll and Petroleum Development Levy.

- Value Added Tax both on domestic and imported goods and services. The VAT department of KRA also administers Betting and Casino taxes as well as Kenya Bureau of Standard Levy.
- Traffic fees.

The proportion of revenue from import and excise duties in the GDP has declined from 7.9 per cent in 1996/97 to 7.5 per cent in 2000/2001, while that of income tax revenue has declined by 1.1 percentage points over the same period. On the other hand, VAT revenue gained relative significance as a share of GDP rising from 5.1 per cent to 6.4 per cent over the period. This is consistent with government policy of increasing reliance on VAT for revenue. This trend is clearer in the tables that follow. Therefore, while VAT accounted for 23.2 per cent of total revenue in 1995/96, the share had increased to 24.4 per cent by 1999/2000 and is expected to reach 27.5 per cent in 2000/2001 (Table 5). Over the same period, the share of import duty revenue is expected to drop from 17.4 per cent to 16.3 per cent while that of excise duty is expected to fall to 15.6 per cent from 18.5 per cent in 1995/96 (Table 5).

The relative contribution of income tax has declined from about 40 per cent in 1995/96 to the 31 per cent level expected during 2000/2001. This decline is largely attributable to corporate tax, which declined by 50 per cent over the period. Other taxes (which include Roads Maintenance Levy, Petroleum Development Fund, Air Passenger Service Charge, Import Declaration and Pre-Shipment fees and Traffic revenue) have registered significant increase in their relative share contribution to total tax revenue, rising from about 1 per cent in 1995/96 to about 10 per cent in 2000/01. The introduction of the Petroleum Development Fund and the Road Maintenance Levy have been part of a deliberate Government policy aimed at reducing reliance on excise duty.

Table 3: Total tax revenue collection in Kenya: 1995/96-2000/01 (Ksh million)

	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01*
TOTAL REVENUE	**122,208**	**133,364**	**154,884**	**165,407**	**167,902**	**183,646**
A. Import Duty	**21,310**	**22,726**	**24,506**	**28,602**	**28,755**	**29,873**
(i) Import Duty Ordinary	16,652	16,932	17,596	19,891	19,878	20,868
(ii) Import Duty Oil	4,658	5,794	6,910	8,711	8,877	9,005
B. Excise Duty	**22,611**	**24,661**	**27,715**	**28,789**	**28,403**	**28,738**
(i) Excise Duty Oil	9,190	10,502	13,311	13,917	13,926	13,887
(ii) Excise Duty Domestic	12,831	13,321	13,588	13,720	13,605	13,801
(iii)Excise Duty Import	590	838	816	1,152	872	1,050
C. Air Passenger Serv. Charge	**1,000**	**1,024**	**990**	**916**	**1,834**	**2,523**
D. Others	**17**	**6,447**	**8,434**	**11,168**	**13,261**	**13,629**
E. Income Tax	**48,259**	**48,470**	**56,173**	**55,682**	**53,556**	**57,096**
(i) PAYE	14,893	17,926	22,264	24,789	26,688	28,683
(ii) Corporate Taxes	26,754	21,089	23,024	20,870	18,518	20,383
(iii) Withholding Taxes	3,684	6,666	8,079	7,510	6,059	5,945
(iv) Individual Taxes	2,659	2,610	2,688	2,403	2,169	1,945
(v) Others	269	179	118	110	122	140
F. VAT Local and Import	**28,398**	**29,136**	**36,079**	**39,263**	**41,020**	**50,503**
(i) VAT Local	14,750	14,845	19,250	21,075	22,404	27,478
(ii) VAT Ordinary Import	12,726	13,261	14,912	15,970	15,822	20,040
(iii) VAT Oil Import	922	1,030	1,917	2,218	2,794	2,985
G Traffic Revenue	**613**	**900**	**987**	**987**	**1,073**	**1,284**

Source: Republic of Kenya, *Economic Surveys* and *Printed Estimates*.

Even though the revenue data demonstrate reform of the tax administration involving movement away from direct taxation towards consumption based taxation, it is apparent that tariff revenue is still very important in the Kenyan economy. This explains to a great extent Kenya's reluctance to adopt a low CET rate within the EAC framework.

Table 4: Kenya: revenue collection effort, 1996/97–2000/01 (% of GDP)

	1996/97	1997/98	1998/99	99/00	2000/01
Income Tax	8.3	8.5	7.7	7.1	7.2
PAYE	3.1	3.4	3.5	3.6	3.5
Other	5.3	5.1	4.3	3.5	3.7
Import Duty	3.8	3.8	4.0	3.8	3.8
Non Oil			2.8	2.6	2.6
Oil			1.2	1.2	1.2
Excise Duty	4.1	4.4	4.0	3.7	3.7
Non Oil			2.1	1.9	1.9
Oil			1.9	1.8	1.8
VAT	5.1	5.3	5.5	5.4	6.4
Domestic	2.5	2.7	2.9	3.0	3.5
Import	2.6	2.6	2.5	2.4	2.9
Other/2	2.8	3.6	3.3	1.4	1.6
Total	24.2	25.4	24.5	21.4	22.7

Source: Calculated from Republic of Kenya, *Economic Surveys* and *Printed Estimates*.

1/ Estimated total revenue from Printed Estimates of Revenue.

2/ Includes income from Central Bank of Kenya dividends and Agency Fees.

4.2 Relative Growth of Tax Heads and their contribution to Overall Growth of Tax Revenue

Between 1996/97 and 2000/01 fiscal years, tax revenue in Kenya grew by almost 9 per cent annually on average (Table 6). This growth came mainly from growth in VAT (12.6%), import and excise duty (12.1%), Air Passenger Service Charge (26%) and agency charges under Customs and Excise department (17%). VAT on imported and domestic goods and services accounted for about 48 per cent of the annual tax revenue growth experienced over the 1996/97 – 2000/01 period (Table 7). The corresponding contributions by import duty, excise duty, air passenger service charge, income tax and traffic revenue were 15.1 per cent, 2.8 per cent, 10.1 per cent, -7.9 per cent and 1.3 per cent, respectively (Table 7).

Table 5: Relative share of tax heads in Kenya (% of total), 1995/96-2000/01

	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01*
TOTAL REVENUE	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
A. Import Duty	**17.4**	**17.0**	**15.8**	**17.3**	**17.1**	**16.3**
(i) Import Duty Ordinary	13.6	12.7	11.4	12.0	11.8	11.4
(ii) Import Duty Oil	3.8	4.3	4.5	5.3	5.3	4.9
B. Excise Duty	**18.5**	**18.5**	**17.9**	**17.4**	**16.9**	**15.6**
(i) Excise Duty Oil	7.5	7.9	8.6	8.4	8.3	7.6
(ii) Excise Duty Domestic	10.5	10.0	8.8	8.3	8.1	7.5
(iii) Excise Duty Import	0.5	0.6	0.5	0.7	0.5	0.6
C. Air Passenger Serv. Charge	**0.8**	**0.8**	**0.6**	**0.6**	**1.1**	**1.4**
D. Others	**0.0**	**4.8**	**5.4**	**6.8**	**7.9**	**7.4**
E. Income Tax	**39.5**	**36.3**	**36.3**	**33.7**	**31.9**	**31.1**
(i) PAYE	12.2	13.4	14.4	15.0	15.9	15.6
(ii) Corporate Taxes	21.9	15.8	14.9	12.6	11.0	11.1
(iii) Withholding Taxes	3.0	5.0	5.2	4.5	3.6	3.2
(iv) Individual Taxes	2.2	2.0	1.7	1.5	1.3	1.1
(v) Others	0.2	0.1	0.1	0.1	0.1	0.1
F. VAT Local and Import	**23.2**	**21.8**	**23.3**	**23.7**	**24.4**	**27.5**
(i) VAT Local	12.1	11.1	12.4	12.7	13.3	15.0
(ii) VAT Ordinary Import	10.4	9.9	9.6	9.7	9.4	10.9
(iii) VAT Oil Import	0.8	0.8	1.2	1.3	1.7	1.6
G Traffic Revenue	**0.5**	**0.7**	**0.6**	**0.6**	**0.6**	**0.7**

Source: Calculated from Republic of Kenya, *Economic Surveys* and *Printed Estimates*.
* Estimates for the current year

4.3 Potential for Tax Revenue Growth

The foregoing analysis, and Tables 6 and 7 in particular, show the declining reliance on import and excise duties and increasing reliance on VAT as sources of revenue. Income tax revenue has demonstrated substantial instability, indicating its unsuitability as a pillar of tax revenue. In contrast, VAT revenue has demonstrated remarkable resilience to changes in economic situation, and the Government is right to focus on it as the key source of tax revenue. The sources of revenue growth[19] in Kenya over the 1995/96-2000/2001 period have been shown to be, in order of declining

[19] See Appendix A for a formular to calculate growth of tax heads.

Table 6: Growth of various tax heads (%), 1996/97-2000/01

	1996/97	1997/98	1998/99	1999/00	2000/01*	AVE
TOTAL REVENUE	**9.1**	**16.1**	**6.8**	**1.5**	**9.4**	**8.6**
A. Import Duty	**6.6**	**7.8**	**16.7**	**0.5**	**3.9**	**7.1**
(i) Import Duty Ordinary	1.7	3.9	13.0	-0.1	5.0	4.7
(ii) Import Duty Oil	24.4	19.3	26.1	1.9	1.4	14.6
B. Excise Duty	**9.1**	**12.4**	**3.9**	**-1.3**	**1.2**	**5.0**
(i) Excise Duty Oil	14.3	26.7	4.6	0.1	-0.3	9.1
(ii) Excise Duty Domestic	3.8	2.0	1.0	-0.8	1.4	1.5
(iii) Excise Duty Import	42.0	-2.6	41.2	-24.3	20.4	15.3
C. Air Passenger Serv. Charge	**2.4**	**-3.3**	**-7.5**	**100.2**	**37.6**	**25.9**
D. Others	**0.0**	**30.8**	**32.4**	**18.7**	**2.8**	**17.0**
E. Income Tax	**0.4**	**15.9**	**-0.9**	**-3.8**	**6.6**	**3.6**
(i) PAYE	20.4	24.2	11.3	7.7	7.5	14.2
(ii) Corporate Taxes	-21.2	9.2	-9.4	-11.3	10.1	-4.5
(iii) Withholding Taxes	80.9	21.2	-7.0	-19.3	-1.9	14.8
(iv) Individual Taxes	-1.8	3.0	-10.6	-9.7	-10.3	-5.9
(v) Others	-33.5	-34.1	-6.8	10.9	14.8	-9.7
F. VAT Local and Import	**2.6**	**23.8**	**8.8**	**4.5**	**23.1**	**12.6**
(i) VAT Local	0.6	29.7	9.5	6.3	22.6	13.8
(ii) VAT Ordinary Import	4.2	12.5	7.1	-0.9	26.7	9.9
(iii) VAT Oil Import	11.7	86.1	15.7	26.0	6.8	29.3
G **Traffic Revenue**	**46.8**	**9.7**	**0.0**	**8.7**	**19.7**	**17.0**

Source: Calculated from Republic of Kenya, *Economic Surveys* and *Printed Estimates*.
* Estimates for the current fiscal year

significance: VAT, agency revenue (other), import duty, air passenger service charge, and lastly excise duty. Although income tax in broad terms adversely affected the overall tax revenue growth, PAYE contributed positively to the growth.

It can be concluded then that the potential for tax revenue growth in Kenya lies in VAT (especially on local goods and services), PAYE, air passenger service charge, levies like Petroleum Development Fund and the Roads Maintenance Levy, and on import duties. In addition, there is potential for growth in income revenue, particularly with respect to enhanced audits of

Table 7: Relative contribution to tax revenue growth in Kenya (%), 1996/97-2000/01

	1996/97	1997/98	1998/99	1999/2000	2000/01*	AVE**
TOTAL REVENUE	42.4	100.0	100.0	100.0	100.0	100.0
A. Import Duty	**12.7**	**8.3**	**38.9**	**6.1**	**7.1**	**15.1**
(i) Import Duty Ordinary	2.5	3.1	21.8	-0.5	6.3	7.7
(ii) Import Duty Oil	10.2	5.2	17.1	6.7	0.8	7.4
B. Excise Duty	**18.4**	**14.2**	**10.2**	**-15.5**	**2.1**	**2.8**
(i) Excise Duty Oil	11.8	13.1	5.8	0.4	-0.2	4.7
(ii) Excise Duty Domestic	4.4	1.2	1.3	-4.6	1.2	-0.2
(iii) Excise Duty Import	2.2	-0.1	3.2	-11.2	1.1	-1.8
C. Air Passenger Serv. Charge	**0.2**	**-0.2**	**-0.7**	**36.8**	**4.4**	**10.1**
D. Others	**0.0**	**9.2**	**26.0**	**83.9**	**2.3**	**30.4**
E. Income Tax	**1.9**	**35.8**	**-4.7**	**-85.2**	**22.5**	**-7.9**
(i) PAYE	27.2	20.2	24.0	76.1	12.7	33.2
(ii) Corporate Taxes	-50.8	9.0	-20.5	-94.3	11.8	-23.5
(iii) Withholding Taxes	26.7	6.6	-5.4	-58.2	-0.7	-14.4
(iv) Individual Taxes	-0.4	0.4	-2.7	-9.4	-1.4	-3.3
(v) Others	-0.8	-0.3	-0.1	0.5	0.1	0.1
F. VAT Local and Import	**6.6**	**32.3**	**30.3**	**70.4**	**60.2**	**48.3**
(i) VAT Local	0.9	20.5	17.3	53.3	32.2	30.8
(ii) VAT Ordinary Import	4.8	7.7	10.1	-5.9	26.8	9.6
(iii) VAT Oil Import	1.0	4.1	2.9	23.1	1.2	7.8
G Traffic Revenue	**2.6**	**0.4**	**0.0**	**3.4**	**1.3**	**1.3**

Source: Calculated from Republic of Kenya, *Economic Surveys* and *Printed Estimates*.

*Estimates for the current year

** Average for 1997/98-2000/2001 period

rental income, withholding taxes and corporate tax. Significant growth potential also lies in the informal sector, though tapping such potential must consider the administrative costs likely to be associated with the nomadic nature of such businesses.

It is apparent therefore that the tariff revenue that Kenya is likely to lose as a result of the EAC customs union could be accommodated through improvement of tax administration with respect to the areas of growth identified, and by bringing new growth sectors (such as the relative better segments of the informal sector) into taxable brackets.

In order to translate the tax revenue potential identified above to reality, however, various policy and operational strategies must be implemented. In-depth joint audits with wider coverage, clear audit standards and audit disclosure procedures remain critical in the realisation of the tax potential over the period. In addition, integration of all tax administration business will not only enhance revenue collection but also result in effectiveness and efficiency in the use of resources. Besides, considering that compliance levels are as low as 30 per cent for income tax and about 60 per cent for VAT, there is no doubt that enhanced compliance remains a potential source of tax revenue growth. Equally, enhanced arrears collection will not only enhance revenue yield but also send strong signals towards compliance. It is therefore clear that Kenya's potential to increase revenue from sources within the economy other than tariffs is large.

5. REVENUE IMPLICATIONS OF A CUSTOMS UNION

This section presents an empirical analysis of the revenue implications of establishing a CET and removing internal trade tariffs for the EAC trade.

5.1 Revenue Implications of CET

A simple spreadsheet model[20] is used to derive the revenue implications of establishing a Common External Tariff. The model calculates the change in potential revenue resulting from the CET (the establishment of which is equivalent to a price change). The change in potential tariff revenue represents the difference between the new potential harmonised revenue (when the new harmonised tariff is assumed) and the old potential revenue.[21] The new potential harmonised revenue is the product of the new harmonised tariff rate and the new projected value of the imports of the line item taking account of the relevant elasticities. The spreadsheet model can be best exemplified in the following single equation, which distributes the sources of revenue change into price and quantity effects.

$$dR = M\left(\frac{-\eta t}{(1+t_o)} - 1\right)(t_0 - t_1)$$

[20] We are grateful to Geoffrey Mwau of the Economic Commission for Africa (ECA) for offering technical assistance with respect to the development of this model.

[21] Naturally the old potential revenue is the product of the statutory tariff rates for individual HSD8 commodities and the corresponding individual import values summed up. The change in potential revenue is therefore the difference between two hypothetical figures realizable only in an ideal "frictionless" world.

In this Equation[22] dR refers to the change in (potential) revenue, η refers to the import price elasticity of demand, M refers to the c.i.f value of the imported commodity and t_0 and t_1 refer to tariff rate before and after the CET, respectively. As such, the change in revenue can be attributed to the volume change–as imports respond, through the price elasticity of demand, to the change in prices–and due to the price change, which is the difference between the old tariff rate and the new tariff rate.

The new projected value of imports is the sum of the initial import value and the change in import values, which is derived from the product of the initial import value, and the value of the assigned elasticity[23] and the percentage change in the tariff levels. As such the change in the potential revenue will be brought about by the difference in the revenues that would have been collected under the two different tariff regimes. The major focus of the model is to distinguish the source of revenue change. The change in revenue could be due to a change in the quantity of imports that results from the change in tariff or due to a change in price that results from a tariff level change.

To implement the analysis, trade data containing Kenyan imports were divided between those from East Africa and those from outside East Africa (the rest of the world). Imports from the two sources were then divided into three groups namely: primary, intermediate and final products using the HS code. Table 8 shows the average unweighted tariff rates applying to Kenya's trade with her EAC partners and with the rest of the world (ROW) for the 1998/99 and 1999/2000 financial years. There is an apparent similarity in the tariffs for EAC and the ROW even though statistics show that there have been drastic reductions in tariffs on Kenya's trade with the EAC. This may be explained by the fact that the reported tariffs are

[22] See appendix B for the derivation of the entire model.

[23] The elasticities used in the simulation exercise are obtained from Stern *et. al* (1976).

unweighted averages, which may tend to exaggerate the effect of the drought (and the unusually prohibitively high tariffs) on the imports it provoked from the EAC. Even after weighting by value, however, there was no significant change.

Table 8: Average unweighted tariffs on Kenya's imports from EAC and the ROW

Types of commodities	Imports from EAC		Imports from the Rest of the World	
	1998/99	*1999/2000*	*1998/99*	*1999/2000*
Primary	11%(73)	16%(117)	14%(596)	15% (585)*
Intermediate	18%(121)	8%(81)	15%(1633)	15%(2031)
Final	14%(184)*	16%(217)	12%(2123)	12%(2120)

*The figures in parentheses show the number of tariff line items in each product category.

With respect to imports from the rest of the world, it is noted that the highest average unweighted tariffs seem to be on the intermediate goods at 15 per cent while the lowest are on final goods at 12 per cent. For imports from East Africa, intermediate goods seem to attract the lowest tariffs at 8 per cent. Nevertheless it is possible to see from Table 8 that the average unweighted tariff on imports from EAC is about 13.5 per cent for primary goods, 13 per cent for intermediate goods and 15 per cent for final goods. For imports from the rest of the world the average unweighted tariffs are 14.5 per cent, 15 per cent and 12 per cent respectively for primary, intermediate and final goods.

Table 9 shows the value of imports from the EAC and from the rest of the world. The imports from EAC have increased from 1998/99 to 1999/2000 while imports from the rest of the world have declined. This could be due to the fact that the capacity to import declined due to the drought that impacted negatively on the agriculture sector–the primary source of exports. It can be further noted that imports from East Africa are only about 0.3 per cent of imports from the rest of the world in value terms. The values of the different categories of imports also differ between the two sources. For

example, whereas in 1998/99 the majority of imports from the EAC were final goods, in 1999/2000 – a drought year – the majority of imports were primary goods. The composition of imports from the rest of the world is basically stable with final goods making up the bulk of imports in both years.

Table 9: Total import values (in US$) of different types of products from EAC and ROW

Commodity type	Imports from EAC		Imports from the Rest of the World	
	1998/99	*1999/2000*	*1998/99*	*1999/2000*
Primary	3,055,881	7,437,136	831,459,264	567,746,131
Intermediate	2,927,571	2,156,497	447,715,711	721,370,625
Final	4,672,408	2,481,119	1,160,893,878	1,035,652,729
TOTALS	10,655,880	12,074,762	2,440,068,873	2,324,769,486

From Table 9, it is also clear that final product imports from the rest of the world have the highest value followed by primary products and intermediate product imports in that order.

Table 10 shows the actual and potential revenues obtained from the different categories of imports. The potential revenue from the different types of products reveals that as expected from Table 9, final products imports are the highest source of potential duty revenue followed by intermediate and primary products, in that order. The same table also shows that the actual revenue realised also displays a similar trend with final products yielding the highest revenue followed by intermediate and primary products. The revenue leakages are largest in the case of intermediate goods, followed by final goods and primary goods. Intermediate goods being critical production inputs into the productive sector would be expected to have the highest number of exemptions and therefore the largest revenue leakages.

Table 10: Actual (and potential) revenues from different categories of commodities by source[a]

Commodity Type	Imports from EAC in USD		Imports from the ROW in USD	
	1998/99	***1999/2000***	***1998/99***	***1999/2000***
Primary	164,401 (35,799,942)*	229,569 (952,621)	62,347,626 (4,159,463,775)	59,499,809 (62,650,594)*
Intermediate	230,798 (36,192,058)	53,247 (301,735)	53,060,772 (5,361,427,593)	67,690,024 (83,519,776)
Final	282,962 (1,187,737)	265,871 (471,671)	155,339,404 (14,320,229,774)**	135,040,342 (111,870,026)
TOTALS	678,161 (73,179,737)	548,687 (1,726,027)	270,747,802 (23,841,121,142)	262,230,175 (258,040,396)

[a] The difference between the actual and potential revenue is called a leakage. Despite the discrepancy between the actual and potential revenue, the latter is more important for comparison across countries, as countries may differ in their ability to administer taxes.

*The figure in parentheses is the potential revenue.

** This abnormal figure is due to the fact that several entries in the duty rate column for a number of commodities read zero.

5.1.1 Simulation of revenue implications of a CET

In this subsection, simulations of the impact on government revenue in Kenya, and of imposing different CETs for the EAC customs union are presented. Table 11 shows the different CET scenarios whose revenue implications are simulated. In all scenarios, primary goods have the lowest CETs followed by intermediate and then final goods. Scenario 2 is expected to have the highest revenue loss followed by scenarios 3,1 and 4 in that order. Tables 12, 13 and 14 show the changes in potential revenue when various proposed CETs are imposed on different commodity categories.

Table 12 shows that given the demand elasticities used, a CET of 15 per cent on final goods will result in an increase in potential revenue. A CET of 20 per cent will lead to bigger increase in revenue than a CET of 15 per cent. Therefore, given actual (normal) elasticities and import data for 1998/1999, a CET of 20 per cent on final goods would have generated an increase in potential revenue amounting to 18.5 per cent of total tax revenue for the

country that year. Given the same circumstances however, a CET of 15 per cent would have generated an increase in potential revenue amounting to only 7.1 per cent of the total tax revenue.

The total changes in potential revenue for the CET scenarios reported in Table 11 are presented in Tables 15 to 18. The total changes are estimated by summing the change in potential revenues for the three different categories of imported commodities shown in Tables 11 to 14.

Table 15 shows that for actual/normal elasticities, CETs of 5 per cent for primary goods, 10 per cent for intermediate goods and 20 per cent for final goods would have resulted in an increase in potential revenue of US$ 41.7 million in 1998/99 (15.4% of total tax revenue that year) while it would have led to a decrease in revenue of US$ 13.2 million (5% of total tax revenue that year) in 1999/2000.

Table 11: Simulation scenarios

	Proposed CET rates (%)		
Scenario	***Primary goods***	***Intermediate goods***	***Final goods***
1	5	10	20
2	0	5	15
3	0	5	20
4	7.5	15	20
5	0	7	20
6	0	10	20

Table 12: Change in potential revenue (US$) with different CETs on final goods

Elasticity levels	**Proposed CETs on final goods**			
	15%		20%	
	1998/1999	***1999/2000***	***1998/1999***	***1999/2000***
Actual	19,324,252	8,541,284	50,106,201	32,600,140
Upper Case	7,716,721	2,549,818	11,235,923	8,533,851
Lower Case	25,128,018	11,537,017	69,541,339	44,633,652

Note: Figures in brackets are the potential revenue changes expressed as a proportion of the total tax actual revenue.

Table 13: Change in potential revenue (US$) with different CETs on intermediate goods

Proposed CET levels on intermediate goods		Elasticity levels		
		Actual	Upper case	Lower
5%	1998/99	(29,007,159)*	(26,785,802)	(30,117,837)
	1999/00	(54,148,140)	(50,477,776)	(55,983,321)
7%	1998/99	(35,770,009.24)	(35,552,889.55)	(35,878,569.08)
	1999/00	(137,555.3)	(124,195.6)	(144,235)
10%	1998/99	(7,837,699)	(17,835,561)	(8,340,227)
	1999/00	(19,811,932)	(6,832,642)	(20,800,117)
15%	1998/99	(9,894,105)	(6,245,204)	(11,718,555)
	1999/00	9,243,871	4,118,823	11,806,395

Table 14: Change in potential revenue (US$) with different CETs on primary goods

Proposed CET levels		Elasticity levels		
		Actual	Upper case	Lower
0%	1998/99	(41,594,638)	(41,594,638)	(41,594,638)
	1999/00	(62,650,594)	(62,650,594)	(62,650,594)
5%	1998/99	(575,323)	(1,128,972)	(298,499)
	1999/00	(25,954,701)	(26,527,523)	(25,668,290)
7.5%	1998/99	(17,914,107)	(15,063,407)	(19,339,457)
	1999/00	(9,407,543)	(12,067,564)	(8,077,536)

Table 15: Scenario 1: 5%, 10%, 20% for primary, intermediate and final goods respectively

Elasticity levels (US$)	1998/99	1999/2000
Actual	41,693,179 (1.7%)	(13,166,338) (-0.6%)
Upper Case	3,274,309	(35,829,233)
Lower Case	60,902,613	(1,834,755)

Note: Figures in brackets are the changes in potential revenue as a proportion of total tax revenue for that year.

Table 16: Scenario 2: 0%, 5%, 15% for primary, intermediate and final goods respectively

Elasticity levels (US$)	1998/99	1999/2000
Actual	(51,277,545) (-2.1%)	(108,257,450) (-4.7%)
Upper Case	(60,663,719)	(110,578,552)
Lower Case	(46,584,457)	(107,096,898)

Note: Figures in brackets are the changes in potential revenue as a proportion of total tax revenue for that year.

Table 17: Scenario 3: 0%, 5%, 20% for primary, intermediate and final goods respectively

Elasticity levels (US$)	1998/99	1999/2000
Actual	(20,495,596) (-0.8%)	(84,198,439) (-3.7%)
Upper Case	(57,144,517)	(104,594,519
Lower Case	(2,171,136)	(74,000,263)

Table 18: Scenario 4: 7.5%, 15%, 20% for primary, intermediate and final goods respectively

Elasticity levels (US$)	1998/99	1999/2000
Actual	22,297,989 (0.9%)	32,436,623 (1.4%)
Upper Case	(10,072,688)	585,110
Lower Case	38,483,327	48,362,511

Assuming again that the actual elasticities hold, scenario 2 CETs would have led to a loss of potential revenue equivalent to about 19 per cent and 41 per cent of total tax revenue in 1998/1999 and 1999/2000 respectively (Table 16). The corresponding figures for scenario 3 CETs are 7.6 per cent and 32 per cent (Table 17). For scenario 4 CETs, there would have been gains in potential revenue amounting to about 8 per cent of tax revenue in 1998/99 and 12 per cent in 1999/2000 respectively (Table 18). Results for scenarios 5 and 6 are reported in Tables 19 and 20, respectively.

From the foregoing, we can conclude that, as expected, the more drastic the reduction in tariffs, the higher the revenue loss. If we were to judge on the basis of revenue implications alone, scenarios 4 and 1 would be the best for Kenya. However, we need to bring an additional consideration to bear: a high CET would increase the likelihood and cost of trade diversion, raise the likelihood of agglomeration or clustering of economic activity, and therefore the necessity of politically divisive redistributions (World Bank, 2000).

Table 19: Scenario 5: 0%, 7%, 20% for primary, intermediate and final goods respectively

Elasticity levels (US$)	1998/99	1999/2000
Actual	(27,258,446) (-1.1%)	(30,188,009) (-1.3%)
Upper Case	(65,911,604)	(54,240,939)
Lower Case	(52,345,189)	(18,161,177)

Table 20: Scenario 6: 0%, 10%, 20% for primary, intermediate and final goods respectively

Elasticity levels (US$)	1998/99	1999/2000
Actual	673,864 (0.03%)	(49,862,386) (2.2%)
Upper Case	(37,191,345)	(71,952,304)
Lower Case	19,604,474	(18,161,177)

Decisions likely to increase the probability of trade diversion and agglomeration should be avoided if the new EAC is to survive. Combining this need to keep CETs low with:

(i) the fact that section four showed that the country has potential to make up for loss of tariff revenue through alternative tax measures,

(ii) the fact that a maximum CET of 20 per cent does not lead to excessively large revenue losses according to our simulations, and

(iii) the need to encourage value added manufacturing through easier and cheaper access to high quality raw materials and intermediate goods, we recommend the following CET: 0 per cent for primary goods, 5-10 per cent for intermediate goods and 20 per cent for final goods.

If the actual (normal) elasticities hold, this would imply an annual loss of potential revenue (averaged over 1998/99 and 1999/2000) ranging from US$ 25.3 million (when CET for intermediate goods is 10%) to US$ 52.3 million (when the CET on intermediate goods is 5%). The actual determination of the rate for intermediate goods requires more research to gauge the tradeoff between revenue loss and industrial development and technology transfer.

5.2 Revenue Implications of Eliminating Intra-EAC Tariffs

From Table 9, it is clear that imports from East Africa are an insignificant proportion of Kenya's total imports. Correspondingly, the potential and actual duty revenue from these East African imports are small. A customs union would require tariffs on intra-EAC trade to be eliminated. In this subsection, we look at the revenue implications of this potential revenue (in case of a frictionless world) and the actual revenue can be made to show the revenue that would be foregone.

Table 21 presents these revenue implications. The table shows that if intra-EAC trade tariffs had been eliminated by 1999/2000, Kenya would have lost a total of US$ 1.7 million in potential revenue. However, the actual tariff revenue that would have been forgone is US$ 548,689. Averaging over the two years reported in Table 21, it appears that the country stands to lose US$ 58.7 million annually in potential revenue and about US$ 613,400 per annum in actual revenue once intra-EAC trade tariffs are eliminated.

It is clear from the table that the largest revenue loss would be from final goods while the lowest would be from intermediate goods in which there

is very little trade. It is also clear that in 1999/2000, there was a drop in revenue from all categories of goods except primary goods for reasons already stated. Although the loss in revenue is clear, the exports arising from dynamics of trade such as competition and efficiency would be expected to outweigh the static revenue losses.

Table 21: Actual and potential revenue from Intra-EAC trade

Primary goods		
Years	Potential revenue (in US$)	Actual revenue (in US$)
1998/99	39,799,943	164,401
1999/2000	952,621	229,569
Intermediate goods		
Years		
1998/99	36,192,059	230,799
1999/2000	301,935	53,248
Final goods		
Years		
1998/99	39,693,164	282,962
1999/2000	471,671	265,872

6. VIEWS OF STAKEHOLDERS

A survey was carried out in Nairobi, Thika, Athi River, Namanga, Mombasa, Busia, Kisumu, and Nakuru to obtain stakeholder views on the costs and benefits of EAC integration. Two major criteria were used in choosing these areas for the survey. First, Nairobi, Thika, Athi River, Nakuru, and Mombasa were chosen because they are locations in which the Kenyan manufacturing industry is concentrated. Second, Namanga, Mombasa, Busia, and Kisumu were chosen because they are key border points in which substantial intra-regional trade takes place. Table 22 shows the type of respondents in the survey and their locations.

Table 22: Survey respondents: type and location

Type of respondent	Nbi	Tka	A/River	Nga	Msa	Bia	Ksu	Nku	Total
Manufacturing firms	32	7	5	0	7	0	3	5	59
Agricultural enterprises	13	3	0	0	3	0	0	0	19
Transporters, clearing & forwarding firms	35	1	0	3	19	6	1	0	65
Traders	15	8	2	3	6	2	1	4	41
Policy makers & implementers	7	0	0	0	0	0	0	0	7
Consumer organisations	0	0	0	0	0	0	0	0	0
Revenue authorities	2	0	0	0	0	0	0	0	2
Tour operators	9	0	0	0	0	0	0	0	9

KEY

Nbi - Nairobi
Tka - Thika
A/River - Athi River
Nga - Namanga
Msa - Mombasa
Bia - Busia
Ksu - Kisumu
Nku - Nakuru

6.1 Manufacturing Sector

Kenya's manufacturing sector is large relative to those of her East African neighbours. The actual number of firms is not known with certainty, however, and the sampling frame is not complete. For this reason, the study targeted what was considered to be a fairly large sample, at least 50, distributed across as many manufacturing sub-sectors as exist in the country. The directory of industries was used as the frame, from which firms were picked at random, that is, without their information on size and other attributes. The only information available was the manufacturing activity. Each enumerator then took a list of the targeted firms. Firms unwilling to participate were replaced with others. Fifty-nine firms, distributed across the country and manufacturing sub-sectors were interviewed as shown in Tables 23 and 25, respectively. The tables show that the coverage in terms of parts of the country and manufacturing sub-sectors was largely exhaustive. The sample was almost equally distributed among agro-based, engineering and construction, and chemicals and allied substances manufacturing sub-sectors (Table 22). The response rate was high, as the enumerators made several trips to the firms where questionnaires had been left. It was only in few instances that firms declined to participate.

Table 23: Distribution of manufacturing firms surveyed

District	Number of firms	% of all firms in sample
Nairobi	32	54.2
Mombasa	7	11.9
Thika	7	11.9
Nakuru	5	8.5
Athi River	5	8.5
Kisumu	3	5.1
Total	59	

Table 24: Distribution of sampled manufacturing firms by sub-sector

Type of manufacturing	No. of firms in sample	% of all firms in sample
Agro-based manufacturing	18	30.5
Engineering & construction	17	28.8
Chemicals & allied business	21	35.6
Others	3	5.1
Total	59	

The firms surveyed have been in existence for the last 24.8 years although the mode was 31 years. Only 13.6 per cent of the firms had branches in Uganda while only 6.8 per cent had branches in Tanzania. Most of the firms with branches in Uganda and Tanzania established them after 1997, after efforts to re-establish the East African Community were initiated in 1996. Only two firms had operations in both Uganda and Tanzania. About 27 per cent of the firms had operations in other parts of the world besides East Africa. It seems that with the starting of the EAC, firms operating in Kenya have set branches in the partner states.

The surveyed firms range widely in their output and capacity utilisation (Table 26). In general, output improved in 2000 while capacity utilisation remained more or less the same, at about 60 per cent.

The major constraints to manufacturing firms surveyed are shown in Table 27. Infrastructure (particularly electricity and water), high tariffs on raw materials, and government regulations are the major impediments to manufacturing in Kenya. Availability of raw materials, however, is also a serious constraint. Therefore, reduction of tariffs within EAC, reduction of tariffs on raw materials and improvement of the domestic supply situation especially infrastructure could boost manufacturing activity in the country.

The respondents reported the following VAT rates: 0, 10, 15, 16, and 18 percent. The reported excise duty rates were as follows: 0, 5, 35, and 85 percent. No export taxes were reported. On average, the ex-factory prices

are much higher than the prices reported for competing products, suggesting that the firms are very uncompetitive.

Table 25: Distribution of sampled firms by detailed manufacturing activity

Manufacturing activity	No. of firms	% of all firms
Food processing	9	15.3
Animal feeds	1	1.7
Beverages and tobacco	4	6.8
Other food products	1	1.7
Tanneries & leather products	1	1.7
Wood and wood products	1	1.7
Pulp and paper	1	1.7
Basic metals	3	5.1
Fabricated metal products	7	11.9
Machinery & equipment	3	5.1
Structural metal products	1	1.7
Other machinery & equipment	3	5.1
Basic industrial chemicals	2	3.4
Salts	1	1.7
Pesticides (include. pyrethrum extract)	2	3.4
Soaps, perfumes, cosmetics & toilet preparations	1	1.7
Paints, varnishes & lacquer	4	6.8
Pharmaceuticals, drugs & medicines	3	5.1
Other chemicals & allied products	7	11.9
Rubber products & textile manufacturing	3	5.1
Gemstones	1	1.7
TOTAL	59	

Table 26: Output and capacity Utilisation by the manufacturing firms (per firm) surveyed

	Mean	Median	Minimum	Maximum
Output in 1999, Ksh millions	492.6	186.0	0.5	6000
Output in 2000, Ksh millions	545.9	220.0	0.5	7000
Capacity utilisation in 1999, %	59.2	60.0	30.0	96.0
Capacity utilisation in 2000, %	58.5	60.0	14.0	95.0

Table 27: Major constraints to manufacturing firms surveyed

Constraint	% of firms affected	% of firms ranking it 1	Mean ranking
High tariffs on raw materials	64.4	30.5	2.03
Availability of raw materials	35.6	13.6	2.62
Labour	15.7	1.7	4.13
Technology	16.9	3.4	4.40
Government regulations	55.9	11.9	2.94
Electricity	72.9	33.9	2.09
Water	52.5	11.9	3.06
Infrastructure	76.3	16.9	3.04
Working capital	27.1	5.1	3.75
Other constraints	13.6	6.8	2.13

EAC trade and opinions on integration

The manufacturing firms surveyed sell most of their output (80.8% in 1999 and 81.7% in 2000) in the domestic market. About 7.6 per cent of the output on average was sold to Uganda in 1999 (9.1% in 2000). The corresponding figures for Tanzania were 4.6 per cent in 1999 and 7.9 per cent in 2000.

The majority (69.8%) of firms[24] indicated that Kenya is the country of origin for their competitors. For the other responding firms, Ugandan and Tanzanian

[24] Among the manufacturing firms, 89.8 per cent responded to the question.

competitors exist. Results of the survey show that Ugandan and Tanzanian firms are more competitive than Kenyan firms due to their advantage with respect to preferential tariffs on inputs, lower costs of water and power, reliable supplies of water and power, cheaper and reliable telecommunications, government subsidies and support, and lower domestic taxes especially in Tanzania. Competitive advantage among Kenyan firms, on the other hand, is found to arise from quality, scale of production, labour productivity, transporting costs, and tax evasion. To improve competitiveness, the firms suggested the following:

- Harmonisation of tariffs;
- Improvement of the transport network;
- Tightening of customs control;
- Subsidisation of water and power rates;
- Reduction of tariffs on imported products; and
- Lowering tax on local products.

Kenyan manufacturing firms hardly source any inputs (capital, raw materials, labour) from either Uganda or Tanzania. According to the survey, the firms obtain 52.5 per cent of their capital inputs from Kenya and the remainder from outside East Africa. The corresponding figures for raw materials are 54.2 per cent and 42.1 per cent. Major reasons why inputs from outside East Africa are preferred by Kenya's manufacturing firms include quality, availability, and price. On the other hand, inputs from Kenya are preferred to overseas ones by some firms on account of shorter delivery time, lower transport costs and availability. However, price and quality also play a role.

About 65.4 per cent of the surveyed firms are paid or pay cash on delivery for intra-EAC trade. Letters of credit and suppliers/trade credit are, however, also important modes of payments in East African trade. Very few firms use inter-company account transfers or other modes of payment.

Kenyan shillings and US dollars are the preferred currencies for settlement of intra-EAC trade. Even though 79.6 per cent of the firms that responded to the question have not experienced any problems with the current mode of payment, problems related to exchange risks, delays in the transfer of funds, and difficulties in securing confirmation of letters of credit were mentioned.

About 34.5 per cent of the surveyed firms reported that they do not receive any incentive or support from the government. Majority of the remaining firms reported receiving one or two types of incentive or support. The incentives/support cited by the majority of the responding firms are:

- Duty remission
- Export compensation[25]
- Trade promotion and exhibitions
- Tax holidays
- Export processing zones

Removal of these incentives/support is expected to have negative impacts by the majority of the firms; that is, 64.4 per cent of the responding firms or 49.2 per cent of all the sampled firms.

Table 28 shows that manufacturers in Kenya understand, to some extent, the objectives of the EAC. Nevertheless, they are uncertain with respect to specific details. For example, they are not sure whether the EAC entails reduction of tariffs or their elimination. Not surprisingly, only about 6.8 per cent of the surveyed firms were consulted during the establishment of the EAC. A number of firms reported that they were disappointed with implementation of the EAC agreement, noting that tariffs have not been lowered, harmonised, nor zero-rated, stakeholders have not been involved, and that there was too much talk and little action.

[25] Note that since export compensation was abolished some years back, respodents understood this to mean export promotion programmes in a broader sense.

Table 28: Manufacturers' understanding of EAC

What EAC means	No. of respondents	% of all respondents
Free movement of goods & people	28	47.5
Free movement of goods, capital & labour	43	72.9
Lower tariffs on goods within EAC	19	32.2
Zero tariffs on goods within EAC	29	49.2
Do not know	1	1.7

Removal of internal EAC tariffs is overwhelmingly expected by Kenya's manufacturing firms to have positive impact on production, capacity utilisation, exports, domestic sales, employment, and many other aspects as shown in Table 29.

Table 29: Expected impact of removal of internal EAC tariffs

Impact	No. of respondents citing	% of all respondents
Positive impact on production level	41	69.5
Increase in capacity utilization	43	72.9
Expand exports	45	76.3
Improve domestic sales	15	25.4
Expand employment	36	61.0
Improve profits	43	72.9
Change in technology	18	30.5
Change in goods produced	13	22.0
Relocation	3	5.1

Expectations with respect to common external tariff (CET) are not as uniform as those associated with internal EAC tariff, as Table 30 shows. The table, however, shows that a substantial proportion of the respondents may not have understood what a CET was and confused it with internal EAC tariff.

Table 30: Impacts expected by Kenyan Manufacturers with respect to different CETs

Expectation	10% CET	15% CET	25% CET
Loss of competitiveness for local products	37.1*	35.7	50.0
Local goods will be more competitive	25.7	17.9	33.3
The rate is ideal for finished goods	20.0	28.6	0
Not much impact on sales	11.4	10.7	6.7

The figures reported are percentage (of respondents responding to the question) that expects a given impact. For example, this figure indicates that 37.1 per cent of the respondents who answered the question expect a CET of 10per cent to lead to loss of competitiveness for local products.

About 72.9 per cent of the firms surveyed feel that the current rate of implementation of economic integration in East Africa is too slow while 22 per cent feel that the speed is just right.

6.2 Transporters and Clearing and Forwarding Firms

Since there is no complete frame of transport and clearing and forwarding firms, the postal directory was used to identify firms visited. Having no prior knowledge about their particulars, bias was minimised. The number of firms targeted was largely determined by resource availability. A total of 65 firms responded and the number was considered adequate and representative of the industry.

Nature and characteristics of the firms

Table 31 summarises the transport, clearing and forwarding firms surveyed. The majority of the firms were clearing and forwarding firms.

Table 31: Type of transport, clearing and forwarding firms surveyed

Type of firm interviewed	No. of firms	% of all firms
Clearing and forwarding firms	41	63.1
Passenger transport firms	6	9.2
Fuel transport firms	4	6.2
General cargo transport firms	10	15.4
Other transport firms	4	6.2
TOTAL	65	

Total sales for the average firm was Ksh 97 million in 1999[26] , although 48.7 per cent of the firms responding to the question had sales ranging from Ksh 100 million to 500 million the same year. About 75 per cent of these sales were done in Kenya while the rest were distributed as follows: Uganda (17.9%), Tanzania (2.8%), and rest of the world (4.5%). In year 2000, average sales per firm had increased to Ksh 107.3 million, with about 85 per cent of this value generated in Kenya.

About 89 per cent of the firms reported that they experience sales problems. These problems varied from country to country as shown in Table 32.

EAC trade and opinion on integration

Only 6 of the firms have established branches in Uganda while only 5 have offices in Tanzania. These branches are new relative to the parent firms, having all been established since mid-1980s.

The vast majority of the respondents perceive the EAC as entailing free movement of goods, capital, and people. Only about 9 per cent perceive it as involving lowering of tariffs on intra-EAC trade, indicative of imperfect understanding of what EAC entails. Only two firms participated in the

[26] Sales for transport firms averaged 111.3 million compared with Kshs 61.2 million for clearing and forwarding firms.

process of establishing the EAC. Only 18.5 per cent of the firms surveyed indicated that their expectations with respect the EAC had not been met. The unimplemented expectations include removal of travel and other trade barriers, reduction and harmonisation of documentation, EA passport, establishment of a customs union with one currency, inter-country consultations before implementation of EAC, and creation of widespread awareness of the contents of the EAC Treaty.

About 94 per cent of the surveyed firms perceive benefits from the EAC. The relative importance of perceived benefits are reported in Table 33.

Table 32: Major sales problems experienced by Kenyan transport and clearing & forwarding firms and where the problems are experienced

Problem experienced	% of all 65 firms citing it	Where most experienced?
Excessive documentation	61.5	Kenya, Uganda & Tanzania
Delays in customs clearance	72.3	Kenya, Uganda & Tanzania
Inefficient port services	49.2	Kenya
Poor rail service	35.4	Kenya
Poor roads	73.8	Kenya mainly but also Uganda and Tanzania
Insecurity	64.6	Kenya
Corruption	67.7	Kenya mainly but also Uganda and Tanzania
High road charges	55.4	Kenya, Uganda & Tanzania
Pilferage	33.8	Kenya

Table 33: Benefits of EAC as perceived by Kenya's transport and clearing and forwarding firms

Perceived benefit	% of firms citing	% of firms ranking it 1	Mean ranking
Increased business	89.2	61.5	1.45
Reduced documentation	70.8	13.8	2.35
Faster clearance of goods across borders	75.4	21.5	2.1
Reduction in freight and handling costs	43.1	1.5	3.21
Other benefits	13.8	6.2	2.89

Benefits related to increased business, reduced documentation, faster clearance of goods across the borders, and reduction of freight and handling costs are reportedly being enjoyed by some firms. To increase the benefits, transport and clearing and forwarding firms recommend the measures reported in Table 34.

Table 34: Recommendations to increase the benefits received by Kenya's transport and clearing and forwarding firms

How the benefits could be increased	% of firms recommending	% of firms ranking it 1	Mean ranking
Elimination of tariffs on intra-EAC trade	63.1	32.3	1.90
Removal of border crossing restrictions	70.8	12.3	2.57
Improvement of transport network	69.2	26.2	2.60
Elimination/reduction of non-tariff barriers	50.8	4.6	3.45
Increase in participation of private sector	47.7	12.3	2.84
Removal of domestic supply constraints	40.0	6.2	2.88
Greater integration beyond custom union	36.9	10.8	2.83

Table 35: Benefits elimination of tariffs on intra-EAC trade would have on Kenya's transport and clearing and forwarding firms

Benefit	% of firms recommending	% of firms ranking it 1	Mean ranking
Increased turnover and income	80.0	38.5	1.63
Increase in capacity utilisation	73.8	32.3	2.00
Reduction in costs	61.5	10.8	2.40
Reduction in paperwork	49.2	9.2	2.56

According to the firms, elimination of tariffs on intra-EAC trade would have substantial benefits to them in form of increased turnover and incomes, higher capacity utilisation, reduction in costs, and reduction in paperwork (Table 35).

The major costs of EAC as perceived by Kenya's transport and clearing and forwarding firms are increased competition (81.5% of the respondents), reduced business (33.8%), and increase in prices (16.9% of the respondents).

Reduction in business and increased competition were costs reportedly being experienced already.

In general, the majority of the respondents (55.4%) felt that the EAC is good for them and recommended hastening of its implementation process. Another 23.1 per cent of the respondents recommended harmonisation and reduction or elimination of tariffs on intra-EAC trade. Other relatively less important recommendations include increase in political will, greater transparency and improved dissemination of information about future EAC plans, elimination of corruption, improvement of infrastructure, and encouragement of other landlocked countries to join the EAC.

6.3 Agricultural Sector

Like in the case of transport and clearing and forwarding firms, a sampling frame for agricultural enterprises does not exist. Therefore, address directories and other available information were relied on to identify respondents. 19 enterprises, 13 in Nairobi and 3 each in Thika and Mombasa were interviewed. In the other areas visited, we could not identify appropriate agricultural enterprises.[27]

Nature and characteristics of the enterprises

The 19 respondents were distributed across various agricultural activities although the majority of them were dealing with horticultural products (Table 36). There was dominance by horticultural firms because Nairobi (where most horticultural firms have offices) dominated the sample. Despite this, the firms surveyed convey a clear perception of the EAC within Kenya's agricultural sector. The sample included some agricultural associations and organisations rather than just enterprises.[27]

[27] While farmers are very many in all parts of the country, not many would be able to attribute specific effects to EAC trade.

The respondents perform various functions, including production, marketing, and provision of advisory and extension services (Table 37).

According to the respondents, the agricultural sector in the country receives several types of incentives or support from the government (Table 38). Support in research and extension services was reported by the majority of the respondents, followed by support in marketing and trade promotions (58.1%). Others include export incentives and financial services.

Table 36: Distribution of the sample across agricultural activities

Agricultural activity or sub-sector	No. of enterprises	% of all 19
Tea	3	15.8
Coffee	1	5.3
Tobacco	1	5.3
Oil Seeds	1	5.3
Horticultural crops	9	47.4
Fish	1	5.3
Mixed farming	3	15.9
TOTAL	19	

Table 37: Functions performed by the agricultural sector respondents

Function performed	% of all respondents performing
Production	42.1
Marketing	68.4
Regulation	36.6
Policy formulation and guidance	26.3
Provision of advisory/extension services	36.8
Storage and warehousing	26.3
Other functions	26.3

Table 38: Government support or incentives received by agricultural sector

Type of government support or incentive	% of all 19 citing it
Financial support	31.6
Research and extension services	63.2
Low tariffs on inputs	21.1
Export incentives	42.2
Marketing, trade promotion fairs	58.1

Table 39: Understanding of EAC by respondents in the agricultural sector

What EAC means or entails	% of respondents thinking so
Free movement of goods, services and people	57.9
Free movement of goods, services, capital and labour	36.8
Lower tariffs on intra-EAC trade	63.1
Zero tariffs on intra-EAC trade	21.1

EAC trade and opinions on integration

The respondents in the agricultural sector are not fully aware about what the EAC entails. For instance, there is no consensus over whether the Community entails reduction or elimination of tariffs on intra-EAC trade (Table 39). Moreover, like the manufacturers and transporters and clearing and forwarding firms, few respondents (15.8%) were consulted during or involved in the process of EAC establishment.

Only about 21 per cent of the respondents answered the question of whether their expectation with respect to EAC had been met. Their expectations include formulation of a common agricultural policy, harmonisation of tariffs, removal of non-tariff barriers, political goodwill, infrastructure development, and formation of a customs union dealing in one currency.

To improve competitiveness in the EAC market, agricultural sector respondents requested several types of incentives or government support (Table 42).

The major positive impact agricultural sector respondents expect from the EAC is increased availability of inputs (31.6% of all the respondents). The other benefit expected is creation of more processing and forward linkages. Competition, accompanied by depression of prices and of local production, on the other hand, is the only important negative impact expected from the EAC, cited by all the respondents. The benefits of the EAC outweigh the costs according to about 74 per cent of all the respondents.

Table 40: Recommendations of agricultural sector on how to maximize benefits and minimize costs of EAC

	% of all respondents recommending
Recommendation to maximise benefits	
Faster pace of integration	36.8
Higher level of economic integration	36.8
Fixing a common external tariff	63.2
Removal of domestic production/supply constraints	78.9
Others	15.9
Recommendation to minimise costs	
Fixing a common external tariff	47.4
Compensation of losers	26.3
Increase government support	78.9

The respondents in the agricultural sector recommend a number of measures to maximise the benefits accruable from the EAC and to minimise the negative impacts of the Community (Table 40). The most important recommendation for maximising the benefits is the removal of domestic supply constraints while the key one for minimising the costs is increase in government support.

On the issue of a common external tariff, about 79 per cent of the respondents felt that a CET would have a significant impact mainly in the form of benefits,

the most important of which are increase in trade and investment, increase in production, and possible retaliation by affected third countries (Table 41). The same proportion of respondents recommended a CET.

Table 41: Impacts expected from a CET[28] by agricultural sector respondents

Impact from a CET	% of all respondents citing
Increase in production	52.6
Increase in investment and forward linkages	57.9
Increase in trade	68.4
Improvement in prices	15.8
Possible retaliation by affected countries	42.1
Deterioration in quality	10.5
Increase in consumer prices	15.8
Relocation of processing industries	21.1

Table 42: Support and Incentives that would improve competitiveness of Kenyan agricultural enterprises in the EAC market

Support or incentive recommended	% of all respondents recommending
Provision of subsidies to farmers	26.3
Reduction of tariffs on agricultural inputs	21.1
Improvement of access roads	26.3
Training, research and extension services	31.2
Others: price support, credit, market facilities, quality inspection, and protection of farmers	47.4

6.4 Trading Enterprises

There are many trading enterprises in the country, distributed in all parts of the country, and ranging from very small shops to fairly large enterprises.

[28] Seen as a higher rate than the currently prevailing tariffs.

Those likely to understand EAC issues are the relatively larger ones. For this reason, the sampling targeted larger trading enterprises in the eight areas visited (Table 22). A total of 41 trading enterprises were interviewed, majority of them wholesale and retail enterprises. There were, in addition, enterprises doing both wholesale and retail business and a few importers and exporters. Similarly, the products they traded in varied widely and included consumer goods, agricultural products and inputs, furnishings and hardware, automobiles and their accessories, textile products, electronics and accessories, pharmaceutical products, beer and cigarettes, and industrial chemicals and raw materials.

Nature and characteristics of the enterprises

Only 8 of the enterprises have branches or offices in Uganda or Tanzania and most of these offices are relatively young, 1-2 years only. About 32 per cent of the enterprises operate in other parts of the world. About 56 per cent of the firms, however, have plans to expand into the EA region. Their plans are largely motivated by growth and market prospects and therefore financial considerations. A few enterprises reported, however, that they were uncertain of success of the EAC while others reported that their type of business could not allow such expansion.

Business for the traders interviewed is affected by various factors, the most important of which are macroeconomic factors, infrastructure and services, governance factors, financial factors, and marketing-related factors (Table 43).

The respondents suggested various measures to deal with the constraints they face in their business. With respect to macroeconomic constraints, control of exchange rate to ensure stability, privatisation, reduction of tax levels, introduction of policies to regulate importation of second-hand products, and proper planning and policy implementation were the main solutions suggested. Improvement of road, rail, and communication networks, through privatisation of the networks for instance, was

Table 43: Factors affecting trade business, as reported by trading enterprises

Constraint affecting business	% of all respondents citing it
Macroeconomic factors	68.3
Infrastructure and services	61.0
Governance factors	53.7
Financial factors	48.8
Marketing related factors	31.7
Sourcing of supplies	12.2
Others	14.7

recommended as the solution to infrastructure and service problems by about 60 per cent of the traders interviewed. Reduction of taxation and interest rates, availing credit and removal of lending restrictions, introduction of government loans to the private sector, and streamlining of financial institutions were recommended as solutions to financial problems facing traders. With respect to governance, traders recommended improvement of political stability and security, introduction of business friendly policies, elimination of corruption especially at entry/exit points, transparency and reduction of red tape, minimisation of government role, and harmonisation of tax structures in the EAC. Removal of restrictions to EAC trade and establishment of a level playing ground was the main solution recommended to marketing problems.

Only about 13 trading enterprises reported receiving any incentive or support from the government, mainly in the form of trade promotion. However, a few traders also mentioned tax holidays, subsidised start-up capital from specialised institutions, export credit guarantee, and accelerated capital allowance. Only about 12 per cent of the respondents felt that removal of the support would have a significant negative effect.

EAC trade and opinions on integration

About 66 per cent of all the commodities traded by these firms in 1999 and 2000 were obtained from the EAC region. Over the same period, about 79

per cent of the commodities sold by the traders was sold within EAC. These statistics show the importance of domestic and regional trade as a proportion of total trade. Only 24.4 per cent of the trading enterprises interviewed reported facing competition from the rest of East Africa (that is Uganda and Tanzania). About 61per cent of all the respondents who responded to the question viewed competition faced from East Africa and the rest of the world as being helpful because it leads to low prices for consumers, standardisation of costs, and facilitates quality improvement. 36.4 per cent of the respondents felt that the competition was harmful, as it led to very low prices, dumping of poor quality products, and was unfair due to differential tax regimes.

The most stringent tariff barriers faced by Kenyan traders with respect to intra-EAC trade are high levels of customs and import duties, differential tariff levels within the EAC, and double taxation, in that order, while bureaucracy, customs clearance delays, licensing, and roadblocks are the most stringent non-tariff barriers (Table 44).

Table 44: The most stringent non-tariff barriers experienced by Kenyan traders in intra-EAC trade

Non-tariff barrier (NTB)	% of all respondents citing it
Bureaucracy	56.1
Customs clearance delays	53.7
Licensing	39.0
Road blocks	31.7
Others	14.6

Removal of tariffs to intra-EAC trade is expected to generate substantial benefits, according to the Kenyan traders interviewed. The most important benefits include expansion of the market, improvement in prices, increase in profits, and increased availability of trading commodities (Table 45). Some of the respondents, however, expect some adverse effects such as depression of prices and therefore profits. Not surprisingly, about 3 out of every 4 of the traders interviewed recommended either removal or reduction of tariffs.

Table 45: Effects of removal of tariffs on intra-EAC trade, as expected by Kenyan traders

Expected effect of tariff removal	% of all respondents citing it
Market expansion	75.6
Increased competition	75.6
Increased profits	63.4
Improved prices	61.0
Increased availability of trading commodities	53.7
Depressed prices	29.3
Depressed profits	24.4

There was no strong consensus over the appropriate common external tariff. However, at least half of the traders felt that the three East African countries needed to adopt the same CET.

About 65.9 per cent of the traders interviewed consider regional integration in East Africa to be useful for the region but about half of these feel the process of implementation has been too slow. Moreover, close to 10 per cent of all the traders complain that private sector participation in the EAC process is not enough. There is, in addition, caution that the process should not be rushed and that the obstacles that led to the collapse of the previous EAC need to be considered.

6.5 Tour Operators

All the 9 tour operators interviewed are located in Nairobi, where almost all of the country's tour operators have offices. Without prior information about their relative sizes and other parameters, the firms were picked from the postal directory. The sample is small because this category was added in the list of categories for study when observation at border points indicated that tourism trade across the EAC countries was an important economic activity. Only one of the 9 firms had a branch in Uganda and Tanzania.

Nature and characteristics of the enterprises

Tour operating firms reported a number of constraints to the production of their service, the most important of which are poor infrastructure and government regulations. Other relatively less important constraints are water, electricity, high tariffs on raw materials, and technology. Kenya and Tanzania were reported to be countries where the tour operators faced the problem of poor roads. Kenya was, however, singled out for the problems of insecurity, corruption, and high road charges.

Only two tour firms reported receiving any incentive or support from the government, both in the form of marketing and trade promotion. Only 22.2per cent of the firms, moreover, are likely to be adversely affected by the removal of such support.

EAC trade and opinions on integration

Although no tour operator was involved in or consulted during the process of EAC establishment, their understanding of what is entailed in the Community is fairly accurate. Like other categories of business people interviewed, however, their understanding is not perfect. About two-thirds of the respondents think that the EAC entails free movement of goods, capital, and labour. However, only about 22 per cent of the tour operators interviewed thought that the Community entailed lower tariffs or elimination of tariffs. There is therefore serious need for publicising what EAC entails and which targets are expected by when.

Tour operators in Kenya expect a number of benefits from EAC, the most important of which are increased business, reduced documentation, faster clearance of clients at border points, and reduction in freight and handling costs. Increased business is already being experienced by about 44.4 per cent of the tour firms while 11.1 per cent of the firms reported reduced documentation. The current benefits could be increased, according to the tour firms, mainly by improvement in the transport network, removal of

border crossing restrictions, elimination or reduction of non-tariff barriers, elimination of tariffs on intra-EAC trade, higher integration beyond a customs union, and removal of domestic supply constraints.

Elimination of tariffs on intra-EAC trade is expected by tour firms in Kenya to reduce paperwork, reduce costs, increase capacity utilisation, and increase turnover and incomes.

Tour operating firms in Kenya perceive the following as critical costs (in order of declining importance) from the EAC: increase in competition, increase in prices, and reduced business. Increased competition, reduced business, and reduced prices were already being experienced by 44.4 per cent, 33.3 per cent, and 33.3 per cent of the tour firms, respectively.

Tour firms did not have a clear opinion on the issue of a common external tariff. With respect to the current rate of economic integration in East Africa, 44.4 per cent of the firms felt that it was too slow while 33.3 per cent felt that the rate was just right. On general issues, some tour firms complained that there were too many restrictions at the Tanzanian border and that the reintroduction of the visa requirements for tourists was inappropriate. Others felt that EAC has little impact on the tourism industry.

6.6 Policy Makers and Implementers and Revenue Authorities

There were seven respondents in the policy maker and implementer category and three in the revenue authority category.

6.6.1 Policy makers and implementers

All policy makers and implementers felt that implementation of the EAC Protocol was on schedule. All the respondents play a role in the implementation of the Protocol, most of them in the actual negotiations and development of the customs union and trade protocol. One is involved in the coordination of government and NGOs. The actions respondents

had already completed by the time of the interview include formulation of the customs union protocol and initiation of negotiations, and training of personnel. It was reported that most aspects of the negotiations had been completed with consensus being reached easily in cases where gains were anticipated, consultations with the relevant authorities were regular, and that implementation is fast. Two respondents, however, complained that negotiations were taking too long to complete, because some partners were dragging their feet.

With respect to implementation of the EAC, four out of the seven respondents reported that the major difficulty being experienced was reaching consensus on a common external tariff (CET). Other difficulties cited by one respondent each are delays due to mistrust, indecision on tariffs, and creation of new documents. Moreover, membership to multiple integration schemes, perceived or real differences in development levels among the countries, and suspicion were reported as the key obstacles to the speedy implementation of the EAC.

Policy makers and implementers interviewed ranked expansion of trade, increase in investment, and easier movement as the benefits expected from the EAC, in that order. Increase in employment and productivity were other expected benefits but ranked lower in importance. It is mainly manufactured goods but also foodstuffs, and services like banking and insurance that are expected to benefit from the elimination of tariffs on intra-EAC trade. The same ranking applied more or less in the benefits already accruing from the EAC. The following were ranked as the most important means of maximising benefits from the EAC:

- Acceleration of elimination of tariffs on intra-EAC trade.
- Removal of non-tariff barriers.
- Higher integration beyond a customs union.

- Removal of domestic production constraints.
- Introduction of a CET

Other relatively less important are greater participation of the private sector, improved efficiency of border clearance, and removal of transport problems.

Policy makers and implementers reported the following perceived costs of the EAC:

- Conflict with other integration schemes.
- Loss of revenue.

Other relatively less important costs cited are loss of employment and loss of sovereignty. The costs reportedly already affecting the country include conflict with other regional schemes, loss of revenue, loss of employment, and collapse of industries. Fortunately, most of these costs (with the exception of revenue loss) are expected to decrease with elimination of intra-EAC trade tariff. There were no clear opinions on how the costs associated with the EAC could be ameliorated although a few respondents suggested a slower integration pace and compensation of losers.

Compensation mechanisms

All the respondents opined that the benefits of EAC outweighed its costs. Asked whether compensation of losers was a viable means of dealing with the costs associated with EAC, 71.4 per cent of the respondents replied in the negative. Country governments and individual industries or sectors were mentioned as actors that may need compensation. The most popular mechanism suggested for compensation is surcharging of the imports causing the losses, although there wasn't a similar level of agreement on the appropriate duration for such compensation.

Opinion on CET

All the policy makers and implementers interviewed supported a CET on goods from outside EAC and recommended the maximum level of 25 per cent. The majority of the respondents felt that this level was justifiable because of the need to protect local infant industries. Other reasons provided for recommending that level of CET are revenue protection, encouragement of intra-EAC trade, and its common application as the maximum rate in the EAC currently. A CET is expected to benefit the country by improving efficiency and market availability, and preventing revenue loss.

Membership to multiple integration schemes

The majority of respondents reported that cost-benefit analysis of membership to multiple integration schemes has not been done and that such membership has affected implementation of EAC protocols through divided loyalties and commitment, and inability and hesitance of some partner states to implement some of the protocols. Almost all the respondents, moreover, reported that membership to many regional integration schemes creates conflicts through conflicting policies of different schemes, and interruption of already agreed-upon processes. To address the issue, the following suggestions were made:

- Merging of EAC, SADC and COMESA.
- Membership to only one scheme for each country.
- Making EAC protocols compatible with existing trade blocks.

Support to exporters into EAC

Duty remission and export processing zones were cited as the incentives provided to Kenyan exporters into the EAC. Others are trade promotions and exhibitions, tax holidays, export compensation, accelerated capital allowances, and property rights protection. About 57 per cent of the

respondents felt that these incentives are likely to be affected by implementation of the EAC.

6.6.2 Kenya Revenue Authority

Interviews conducted among three top personnel of Kenya Revenue Authority (KRA) identified four key roles, besides revenue collection, that the authority plays towards implementation of East African Community treaty:

- Exemptions and drawbacks regimes management.
- Rules of origin application.
- Supervision of manufacturing Under Bonds (MUB), Export Processing Zones (EPZ) and Export Promotion Programs (EPPO).
- Application of Restriction and Prohibition provisions of the Treaty.
- Collection of statistics for economic planning and decision-making.

With respect to the above roles, KRA:

- Has seconded technical officers to various EAC committees.
- Attends Quarterly Meetings of Technical Officers of the EAC and Rwanda Revenue Authority.

KRA strongly believes that the implementation of the EAC Trade Protocol is on schedule. The Authority, however, has experienced both successes and challenges since the inception of EAC. Among the successes include:

- Complete harmonisation of the Tariff Codes;
- Simplification and harmonisation of trade documents and procedures;

- Establishment of East African Bill of Entry;
- Development of the Rules of Origin; and
- Sharing of information among partner States.

Certain areas of the Protocol continue to pose challenges, however, including:

- Establishment of Common External Tariff, particularly the harmonisation of rates and exemptions;
- Elimination of Non-Tariff Barriers; and
- Application of the Principle of Asymmetry.

The respondents believe that elimination of tariff on intra-EAC trade would have insignificant effect on Kenya's tariff revenue base, as the revenue arising from such trade is currently low in relative terms. In fiscal year 1999/2000, for instance, revenue from import duty accounted for only 18.9 per cent of the entire revenue and revenue from EAC trade accounted for a mere 0.4 per cent of the total tariff revenue. Moreover, if the EAC tariff is eliminated Kenya will compensate for the loss in revenue by:

- Identifying other tax potential sectors such as the informal sector;
- Adjusting domestic tax rates upwards; and
- Enhancing tax administration capacity to improve compliance and reduce evasion.

Elimination of the EAC tariff is perceived, by the KRA respondents, to confer some benefits to such sectors of the Kenyan economy as:

- Manufacturing
- Edible oil
- Detergents

- Motor vehicle assembly
- Plastics
- Transport sector
- Banking and insurance

However, it would also confer suffering to the agricultural sector (especially food processing), as the sector faces significant competition from other EAC states.

Other benefits associated with EAC integration include free movement of people, increase in volume of trade and investment, and increase in employment and consumer welfare arising from lower prices in that order of importance. So far, the only benefit being enjoyed is the free movement of people. In order to maximise the benefits associated with the EAC trade, the respondents felt that non-tariff barriers need to be removed, the pace of tariff elimination accelerated, and involvement of private sector increased. Besides the loss of revenue, other perceived costs of EAC tariff elimination include increase in crime as well as collapse of some industries. To mitigate such loses, the respondents felt that the EAC countries need to adopt a Common External Tariff, hasten the integration process, and reduce membership in multiple regional groupings.

On the issue of compensation, KRA respondents believe that mutual concession on tariff on specific products should be adopted. Moreover, revenue loss from tariff elimination should only be addressed when a country proves that there is no revenue leakage due to evasion and corruption and that the country optimally collects all the potential tariff revenue.

Unlike elimination of internal tariffs, adoption of a CET will have significant revenue implications to Kenya, according to the KRA personnel interviewed. Therefore, adoption of a CET of 25 per cent and lower would result in reduction in revenue while a rate higher than 25 per cent would enhance tariff revenue. There is a general consensus in Kenya that a CET at the rate

of 25 per cent is appropriate because (i) the EA countries are effectively using 25 per cent as a current rate on their finished products, (ii) the rate will not result in any significant loss in revenue, and (iii) the rate balances the objectives of local industry protection and removal of barriers to trade.

The establishment of a CET at 25 per cent will confer both benefits and costs to the Kenyan economy. Perceived benefits include protection of manufacturing and agricultural sectors from unfair external competition. Costs include reduced incentives for quality improvement and product promotion among local companies.

To address the issue of membership in multiple regional groupings and its effect on the EAC, the following initiatives were suggested:

1. Formation of EAC by Kenya and Uganda alone and its subsequent negotiation with Tanzania
2. Resignation of Tanzania from SADC
3. Resignation of all East African countries from COMESA and SADC

6.7 Summary of Stakeholder Views

Generally, the business community seems to understand what the EAC entails, but majority are uncertain with respect to specific issues. The level of understanding and perceived and experienced costs and benefits vary across stakeholders.

Manufacturers

- Although manufacturers in Kenya understand, to some extent, the objectives of the EAC, they are uncertain with respect to specific details. For example, they are not sure whether the EAC entails reduction of tariffs or their elimination.

- Majority of the firms find the speed of implementation of the integration to be too slow.
- Some firms are disappointed with implementation of the EAC agreement, noting that tariffs have not been lowered or harmonised, stakeholders have not been involved, and that there was too much talk and little action.
- Manufactures expect removal of internal EAC tariffs to have positive impact on production, capacity utilisation, exports, domestic sales and employment.

Transporters, clearing and forwarding firms

- Have a poorer understanding of the EAC than the manufacturers. The vast majority of respondents perceive the EAC as entailing free movement of goods, capital and people and only a few perceive it as involving lowering of tariffs on intra-EAC trade.
- While the majority feel that most of the expectations have been met, the following is yet be implemented:
    - (i) Removal of travel and other trade barriers
    - (ii) Reduction and harmonisation of documentation
    - (iii) Establishment of a customs union with one currency
    - (iv) Inter-country consultations before establishment of EAC
    - (v) Creation of widespread awareness of the contents of the EAC Treaty
- Some of the firms are already drawing benefits of the integration in form of increased business, reduced documentation, faster clearance of goods across the borders, and reduction of freight and handling costs.

- Majority of the firms perceive EAC costs to arise from increased competition, reduced business and increased prices. Reduction in business and increased competition were costs reportedly being experienced already.

Agricultural firms

- Firms in the agricultural sector are not fully aware of what the EAC entails.
- Those who are aware expect formulation of a common agricultural policy, harmonisation of tariffs, removal of non-tariff barriers, political goodwill, infrastructure development, and formation of a customs union dealing in one currency.
- The major positive impact agricultural sector respondents expect from the EAC is increased availability of inputs. Others include creation of more backward and forward linkages.
- Costs are expected to arise from increased competition, accompanied by depression of prices and of local production.
- However, the benefits of the EAC are expected to outweigh the costs.
- Majority of the firms feel that a CET set at an appropriate rate is of benefit, as it would lead to increase in trade and investment, and in production, and possible retaliation by affected third countries.

Traders

- Majority of the traders consider the community to be useful but the process of implementation is too slow.

- The negotiations need to include more private sector views.
- Kenyan traders expect removal of tariffs to intra-EAC trade to generate substantial benefits in form of expanded market, improvement in prices, increase in profits, and increased availability of trading commodities.
- Some traders expect some adverse effects in form of reduced prices and hence profits.
- More than 50 per cent felt a need for a CET set at an appropriate level.

Tour operators

- Tour operators seem to understand fairly well what EAC entails although not perfectly well.
- They expect benefits in form of increased business, reduced documentation, faster clearance of clients at border points, and reduction in freight and handling costs.
- Elimination of tariffs on intra-EAC trade is expected by tour firms in Kenya to reduce paperwork, reduce costs, increase capacity utilisation, and increase turnover and incomes.
- Tour operating firms in Kenya perceive the following costs from the EAC: increase in competition, increase in prices, and reduced business.

Policy implementers

- Expected benefits from integration within the EAC cited by policy makers and implementers include expansion of trade, increase in investment, and easier movement of people. Others include increase in employment and productivity.

- Manufactured goods, foodstuffs, and services like banking and insurance are expected to benefit from the elimination of tariffs on intra-EAC trade.
- Losses associated with EAC include conflict with other integration schemes and loss of revenue. Others include loss of employment, and sovereignty.
- The benefits of the EAC are expected to outweigh the costs in Kenya.
- Over the costs associated with the EAC customs union:
  - (i) The majority of the policy makers and implementers do not view the compensation of losers as a viable means.
  - (ii) The most popular mechanism suggested for compensation is surcharging of the imports causing the losses.
- A CET at a maximum level of 25 per cent was recommended by all the policy makers and implementers interviewed.

7. SOCIAL, POLITICAL, AND INSTITUTIONAL VIABILITY OF INTEGRATION IN EAST AFRICA

East Africa has a long history of cooperation and integration, as was discussed in sub-section 2.2. Despite this long history and the fact that Kenya, Tanzania, and Uganda are already closely linked by common history, shared infrastructure, shared language (Kiswahili) and culture, the old EAC collapsed in 1977. Why did the old EAC collapse? Now that a new EAC has been created, what social, political, and institutional mechanisms have been put in place to ensure success this time round? This section of the report attempts to deal with this question. Since the factors that led to the collapse of the old EAC have been adequately studied in the past, however, we will concentrate more on the second part of the question.

Literature shows that successful integration requires political will of leaders of the member states; macroeconomic and socio-economic stability; gradual and consistent integration process starting with lower stages and then deepening while harmonising the interests of all participants along the way; diversified production infrastructure; and balancing of regional interests with the need to provide favourable conditions (for trade and cooperation) for non-member countries. It also requires proper design to minimise income transfers across member states and mechanisms for compensation when the income transfers are unavoidable; and that members attach adequate value to membership into the RI arrangement.

The old EAC collapsed largely because of two reasons. First, there were ideological differences particularly between Kenya, which advocated capitalism complemented by social interventions, and Tanzania, which pursued socialist policies. Political differences between Uganda (under the rule of Idi Amin) and Tanzania, and a general increase in mistrust among the three leaders following Amin's forceful takeover of the government, aggravated these differences. Perhaps the greatest weakness in the RI

arrangement then was that it was centred around the three East African leaders and not on any serious political, social or economic ideals. Second, the old EAC generated huge income transfers in favour of Kenya to the extent that Tanzania and Uganda felt that they were not receiving a fair share of gains from the Community (World Bank, 2000; Venables, 1999). Through agglomeration and relative comparative advantage differences that favoured Kenya, manufacturing was concentrated in the country. Therefore, inadequate mechanisms for dealing with unequal effects of the common market also contributed to the collapse of the EAC, as did perceived discrimination in the operations of state trading corporations. Other factors cited in the preamble of the current EAC Treaty as reasons for the collapse of the EAC were the lack of a strong participation of the private sector and civil society and lack of adequate policies to address the problem.

How does the Treaty for the new EAC handle these weaknesses that led to the collapse of the older agreement? Let's start by looking at the Treaty. The Treaty for the establishment of the East African Community, ratified in November 1999, sets out principles for economic, social and political cooperation. It covers a wide range of fields: trade, investment and industrial development, standardisation and quality control, finance, infrastructure, human resource development, agriculture and food, environment, health, law, and political matters. The objective of the community is to develop policies and programmes for widening and deepening cooperation in these fields. This will be achieved through the establishment of a customs union, a common market, a monetary union, and ultimately a political federation. The strategy of the EAC is to achieve economic integration before political integration.

The EAC Treaty outlines the following principles to guide economic, social and political cooperation (EAC, 2000: 14):

(i) Mutual trust and political will and sovereign equality;

(ii) Peaceful coexistence and good neighbourliness;

(iii) Peaceful settlement of disputes;

(iv) Good governance;

(v) Equitable distribution of benefits; and

(vi) Co-operation for mutual benefit.

These principles show that both political and economic motivations have stimulated the revival of the Community. The operational principles outlined in the Treaty are subsidiarity, variable geometry, complimentarity and asymmetry.

To achieve its objectives, the Community Treaty puts emphasis on (i) policies that are pro-market, pro-private sector and pro-liberalisation, (ii) provision of adequate and appropriate enabling environment for the free movement of goods, persons, labour, services and capital.

The Treaty establishes a number of organs and institutions to perform the functions of the Community. These are the summit, the council, the coordination committee, sectoral committees, the East African Court of Justice, the East African Legislative Assembly and the Secretariat.

The Treaty adopts a consensual decision making process. The Summit, which is the top most organ in the treaty comprising of the heads of state of the three countries make decisions by consensus. The same is also true for the Council, which is made up of Cabinet Ministers. Consensus as a decision making process has its advantages[29] but runs the major risk of decisional paralysis. A consensus to do something might be part of a definite tendency towards comity in relationships among the leaders–the sense of not wanting to confront a leader who feels strongly about a particular issue. The result is likely to be that no decision is made. In the case that a decision is made to do something, the comity element still exists but in this case is likely to lead

[29] For example, one of the reasons why the EU has managed to deepen RI without huge income transfers that cause conflict is consensual negotiations that accommodate all members' worries through compensation (World Bank, 2000).

to no implementation. The over reliance of consensus in the treaty therefore provides potential impediment to the implementation of the Treaty.

The current EAC Treaty recognises the need for political commitment by the member states for integration and cooperation to succeed. The implementation of the whole Treaty no doubt rests on political will since even though the potential benefits of deep integration are larger than lower levels of integration, such integration leads to greater loss of sovereignty. A casual observation of events leading to the signing of the Treaty indicates that the political will to succeed seems to be there this time and the leaders are ambitious enough in their outlook of where they want to take the Community. In addition, there are no major tensions between the leaders of the three countries and mutual trust and understanding could be expected to develop further, as they continue meeting over the EAC business. Unlike the previous agreement which hinged a lot on the individual leaders in the three countries, the current agreement is "a people-centred and market-driven cooperation" (EAC, 2000:14). This might be mere rhetoric, however, considering the lack of widespread consultation and poor information dissemination to stakeholders revealed in section 6.

That the countries are pursuing different political systems with Kenya and Tanzania pursuing multi-party democracy while Uganda is pursuing what it calls 'no-party democracy' is also worrisome. This lack of harmonised political systems and the fact that political scenarios change very rapidly expose the Community to the whims of the politicians. Ideally, the critical decisions of the Community should be removed from the hands (or whims) of the heads of state. The new EAC Treaty has failed to do this, as it leaves immense power in the hands of the heads of state (or the Summit). The Summit is empowered by Article 63 of the Treaty to assent to or reject Bills passed by the East Africa Legislative Assembly (EALA). If assent is denied, such a Bill has to be taken back to the assembly for discussion and re-submitted to the heads of state. If at this point a Head of State withholds assent to a re-submitted bill, the bill lapses. This weakens the legislative

assembly yet it is a more objective institution (relative to the Summit) with respect to critical decisions over the destiny of the Community. EALA is already fighting to have this power imbalance addressed and to have the EAC integration strategy changed so that political integration is hastened, as a way of entrenching the Community and making it more difficult for its break up.[30] EALA has asked for a referendum to decide on the issue of immediate pursuance of an East African Political Federation.

An area of potential conflict in the current agreement is the sharing of the benefits and costs of integration. Although this was an important factor in the collapse of the former EAC, the current Treaty does not deal with the issue adequately. The Treaty recommends application of the principal of asymmetry but in many ways remains too general and lacks details on how to deal with equity issues. Yet, as we have seen in the preceding sections of the paper, it is a major determinant of whether the EAC integration will succeed.

On the social front, it is significant to note that unlike the defunct Treaty, the current one comes out strongly on the role of the private sector, civil society and women in development in the region. Article 127 of the Treaty undertakes to provide for the creation of conducive environment for private sector development through an appropriate investment code, protection of property and other rights, and proper regulation of the private sector. The challenge is how to motivate the private sector to take a leading role in the cooperation. Article 121 outlines the commitment of the states to the promotion of women in development in the region. Perhaps the greatest weakness of the Treaty on the gender issue is the treatment of women as a separate category in the development process rather than as an integral development issue. As we have already argued, moreover, a major determinant of the success of EAC integration will be the level of

[30] *The EastAfrican*, January 28, 2002.

involvement of stakeholders in decision-making and implementation. So far in the integration process, this leaves a lot to be desired going by stakeholder views.

Viability of EAC integration

So, is EAC integration viable?

Socio-culturally and geographically, the three East African countries are suited for integration. The people share a common history of colonial rule under the British, culture, and language (Kiswahili). Geographically, moreover, not only do the three countries share one of the world's largest natural resource (Lake Victoria), they also share infrastructure, a factor that is critical to Uganda, which is landlocked. Kenya and Tanzania, moreover, share another world-famous natural resource; the Mara-Serengeti ecosystem that is famed for its rich wildlife.

Economically, Kenya has for a long time bought hydroelectric power from Uganda while Uganda uses the port of Mombasa for almost all of its trade. There is also an oil pipeline that feeds Uganda and the two country's rail services are inter-connected. The three countries are also fairly well inter-connected through air transport services. In terms of economic policy, the three countries have been implementing unilateral trade liberalisation under the Bretton Woods Institutions funded structural adjustment programmes (SAPs) and have therefore converged significantly. Moreover, the three economies are facing the same challenges of tackling poverty and therefore tend to have similar socio-economic policies.

Further, domestic political pressures and lobbies that often shape RI in many parts of the world have also been favourable in Kenya. The widespread feeling is that the government is not moving fast enough with respect to EAC integration.

While all these factors favour successful RI of the three countries, there are a number of other factors that are not that favourable. First, in the economic sphere, the three countries are low-income countries although Kenya is slightly better off. Yet, we are informed by experience that RI between low-income countries tends to result in divergence rather than convergence in incomes, trade diversion rather than trade creation, and to attract "tariff jumping" foreign direct investment (FDI) (Venables, 1999; World Bank, 2000), factors that reduce the economic and political viability of such RIs. Second, the discussion on the political situation has shown that even though political will does not seem to be a problem for the moment, the immense power that heads of state continue to hold over the destiny of the Community is potentially disastrous. Third, lack of adequate involvement of stakeholders despite the rhetoric in the Treaty could also affect successful implementation of the EAC. Fourth, non-tariff barriers (such as administrative delays, lack of information at border points or delays in getting it, pre-shipment requirements, technical and standardisation requirements, and bureaucratic administration of rules of origin) are a serious bottleneck to the successful implementation of the EAC Treaty. Finally, membership to multiple RI schemes is likely to adversely affect implementation of EAC Treaty through contradictory obligations, increase in complexity that may adversely affect decision-making by the private sector and therefore affect investment, and through diversion of the energy and commitment that is required to pursue depth and width of EAC integration.

On balance, EAC integration is viable but the political, social, and economic challenges summarised in the preceding paragraph have to be addressed.

8. MECHANISMS FOR COMPENSATION OF LOSERS/SHARING BENEFITS

Compensation for loss or sharing of benefits from creation of an EAC customs union is of concern to Kenya as indicated by policy makers and implementers interviewed. Empirical analysis shows that Kenya stands to lose US$ 58.7 million annually in potential revenue and US$ 613,400 in actual revenue from removal of intra-EAC trade import duties. Moreover, if the CET structure that we have proposed (0%, 5-10% and 20% for primary, intermediate and final goods respectively) is adopted, the country stands to lose potential revenue in the region of US$ 50 million annually (assuming normal import price elasticities of demand). This amounts to 19.6 per cent of the average total tax revenue collected in the country during the 1998/99 and 1999/20000 fiscal years. Of course the actual revenue loss would be much less, considering the large leakages reported in an earlier table. This confirms the fears of the policy makers. The policy makers moreover indicated that the country would also suffer loss of sovereignty and employment. Other stakeholders who expected and/or were already experiencing losses from the creation of the EAC customs union include:

(i) Transporters, clearing and forwarding firms who expect loss of business because of increased competition.

(ii) Agricultural firms who expect losses from increased competition that is likely to lead to depressed domestic prices.

(iii) Traders who expect depressed prices for the commodities they deal in because of increased competition.

(iv) Tour operators who expect increased competition and reduced business.

Despite the perceived losses of benefits by both government officials and other stakeholders, they all indicated that the losses are likely to be outweighed by expansion in trade, increased investments and easier movement of people and goods within the EAC partner states.

The issue of distribution and benefits arising from the EAC customs union is critical if the weaknesses that led to the collapse of the old EAC are to be avoided. While the dynamic gains from trade expansion (arising from the establishment of a customs union) are expected to more than compensate for the losses discussed above, it may not be necessarily so for the other partner states. It is for this reason that this section discusses compensation mechanisms that have potential for being applied in the EAC customs union.

The country, as discussed already, is capable of making up for the loss of revenue associated with elimination of intra-EAC trade taxes through broadening of the tax base (VAT and other growing sources of tax revenue), bringing the relatively well-off segment of the informal sector into the tax bracket, and through improvement of tax administration. If the other partner states lack this capacity, they are likely to push for compensation.

Several compensation mechanisms have been tried out in different regional integration schemes. First, the most important way to solve a potential problem is to prevent it or at least to reduce its magnitude. The need for compensation in a regional integration arises because of different effects on members of the RI scheme, of tariff revenue loss, trade diversion and agglomeration of economic activity. Setting of an optimal level of CET and, generally, good design of RIAs are important ways of preventing or minimising the need for compensation. We have argued elsewhere that a CET structure (of 0%, 5-10% and 20% for primary, intermediate and final goods, respectively) is a good starting point. This may need to be adjusted, however, as leaning from experience takes place.

Second, direct compensation of losers through such instruments as budgetary rebates could be used, as in the EU. The revenue collected from a CET could be distributed to the partner states through a formula that takes into account differential impacts of the CET to the member countries. Alternatively, the revenue collected could be placed in a central budget (like in the EU) and be used for programmes agreed upon consensually. The

policy makers and implementers interviewed do not favour such direct compensation. The alternative of placing revenue from a CET in a central budget is also not politically feasible as trade taxes are still an important component of government revenue in each of the EAC countries. The policy makers and implementers prefer the use of surcharges on imports (for some time) for industries that are likely to suffer most. This recommendation is in line with the principle of asymmetry within the EAC Treaty. Use of surcharges could be supported so long as the level is determined consensually to minimise the adverse effects it may have.

Third, a development fund could be established from which disadvantaged industries or countries could be compensated and regional programmes funded. Each partner state would be required to contribute to the fund but through the principle of asymmetry. Investment in common services such as infrastructure could be facilitated by such a fund, with support from international development agencies. This option has the advantage of reducing costs of trading within the east African region and can therefore benefit all stakeholders. Indeed most stakeholders hold the view that poor infrastructure is a major hindrance to trade in the region.

Fourth, built-in safeguard mechanisms such as appropriate rules of origin and support of infant industries could be used to ensure fair competition and provide opportunity for the relatively less industrialised countries to industrialise.

Finally, allowance of gradual adjustment process in which weaker economies are allowed more time to attain set integration targets (such as complete elimination of tariffs) is also a feasible compensatory mechanism. In fact, it has the advantage that the East African partners are already applying it.

In conclusion, these mechanisms are not mutually exclusive and perhaps, a combination of some of them may be a superior strategy than any of them alone. A combination of good design of the regional integration agreement, modest surcharges agreed upon consensually, establishment of a

development fund but for common services rather than for compensation, and a gradual adjustment process, in our opinion, have the potential to spur integration in East Africa into higher heights.

9. THE WAY FORWARD: RECOMMENDATIONS

1. Overall, there is agreement that RI is beneficial particularly when designed properly. In the case of EAC, moreover, there is potential to expand trade within the partner states. This research has demonstrated that Kenya does not stand to lose much revenue from the elimination of intra-EAC trade tariffs and that, though quite substantial, the revenue loss from a CET could be made up from alternative taxes. Stakeholders from various sectors of the Kenyan economy are in favour of quick and deep integration because they expect overall benefits from such integration to outweigh the costs in the long run. Most stakeholders, moreover, consider the speed of integration to be slow and would like the removal of internal tariffs to be effected as soon as possible. There are also complaints from stakeholders that removal of travel barriers, and reduction and harmonisation of documentation have not been implemented effectively. The country therefore needs to participate actively in the implementation of the EAC Treaty and to push for faster integration. Our recommendation is that the government leads the process.

2. Non-tariff barriers (such as administrative delays, lack of information at border points or delays in getting it, pre-shipment requirements, technical and standardisation requirements, and bureaucratic administration of rules of origin) are a serious bottleneck to the successful implementation of the EAC Treaty. We recommend to the Government of Kenya and the EAC Secretariat (and other institutions) to deal with this issue seriously and find effective ways of easing such barriers. Stakeholders in the three countries have a responsibility to report such barriers. One way in which this issue could be dealt with is for the EAC to establish points in all three countries where stakeholders could report the barriers they encounter.

3. Simulation results show that CET has significant revenue implications to the country, with the loss being higher at the lower levels of CET. Considering these revenue implications and balancing them with (i) the potential to make up for the lost government revenue, (ii) potential dynamic gains from improved trade, (iii) the need for cheap and high quality raw materials and intermediate inputs for industrialisation, (iv) infant industry arguments, and (v) the tendency of high CETs to lead to trade diversion and agglomeration of economic activity, we recommend the following CET structure: 0 per cent for primary products, 5-10 per cent for intermediate products, and 20 per cent for final goods. This recommendation is made to the government to facilitate its negotiations with the other partner states.

4. Considering the experience of RI in Africa (including the original EAC that collapsed in 1977), successful integration within the framework of the EAC requires political commitment, establishment of institutions to facilitate consensual decision-making, and institution of mechanisms for equitable or fair distribution of costs and benefits of integration. This recommendation is made to all governments and other stakeholders involved in the EAC integration process.

5. The current EAC Treaty grants excessive power to the Heads of State (or the Summit) and therefore fails to adequately address the key cause of the break-up of the original Community. For instance, Article 63 empowers the Heads of State to assent to or reject Bills of the East African Legislative Assembly, weakening it substantially. There is need therefore to review parts of the Treaty and to secure as much political will as possible even as economic integration proceeds. This is a recommendation for the three governments, the already created institutions of the EAC, and agencies that shape politics and policy in the three countries.

6. The objectives of the EAC Treaty and in particular creation of a customs union are not well known to the majority of the stakeholders, implying

that adequate consultations and discussions over the integration process have not been made. Most stakeholders in fact feel left out on discussions over most aspects of the customs union. There is need to disseminate information regarding the objectives of the Treaty and what it entails to all stakeholders, and to consult stakeholders as much as possible. This recommendation is made to the government and the EAC secretariat. Stakeholder bodies such as the Kenya Association of Manufacturers and the Federation of Kenyan Employers could also play an important role in dissemination of information and coordinating stakeholder response.

7. Membership to multiple RI arrangements has been identified as a potential hindrance to successful EAC integration. Such membership will require excessively expensive policing of rules of origin, interfere with the "fast-track" objective of the EAC, engender complexity and therefore affect private sector decision-making, and divert official attention from crucial and difficult issues of depth and width of integration within EAC. Stakeholders interviewed recommended (i) merging of SADC, EAC and COMESA, (ii) the three East African countries relinquishing membership to all RIAs except EAC, and (iii) making EAC protocols compatible with existing trade blocs. We support the third recommendation and urge the EAC secretariat, other EAC institutions, and the governments of the three countries to make this an important issue for negotiation and agreement.

8. Since the issue of compensation of losers from RI is critical for the socio-economic and political sustainability of RI arrangements, it is important that EAC member states reach an agreement over this issue as soon as possible. It is one of the key factors that led to the collapse of the older EAC. After reviewing the mechanisms used in other RIAs, we have reached the conclusion that they are not mutually exclusive and that, perhaps, a combination of some of them may be a superior strategy than any of them alone. Our opinion is that a combination of good

design of the regional integration agreement, modest surcharges agreed upon consensually, establishment of a development fund but for common services rather than for compensation, and a gradual adjustment process has the potential to spur integration in East Africa into higher heights. This recommendation is made to the Government of Kenya and the EAC Secretariat to inform negotiations.

9. Now that the three East African countries have signed the EAC Treaty, which emphasisas pro-market, pro-private sector and pro-liberalisation policies, the challenge is for them to create an environment that motivates the private and civil sectors of their economies to exploit the opportunities created by the Community. We recommend to the Kenyan Government therefore that, in order to maximise net benefits from the Community, there is need for legal, regulatory, and policy reforms to get rid of anti-business elements, development of infrastructure, and development of efficient capital markets. Without these, implementation of the customs union may not yield maximum net benefits to the country.

10. More research is also required to facilitate integration within East Africa. Some of the issues that need urgent research include (i) dynamic analysis of the costs and benefits of integration to each country, and (ii) analysis of trade-off between revenue loss and industrial development with different CETs for intermediate goods. This recommendation is made to the government, the EAC secretariat, and research institutions like ACEG, which has funded this study.

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APPENDIX A: GROWTH AND CHANGES IN COMPOSITION OF TAX REVENUE

The framework used in this part of the study borrows heavily from the work of Abedian and Standish, (1984), which was used to examine the supply-side of public output as viewed through the total and major components of government expenditure. We therefore desegregate the tax revenue by heads in order to determine the relative significance of each tax head and its contribution to the growth of total tax revenue.

The tax revenue heads are denoted as X_i, representing import duty, excise duty, Air Passenger Service Charge, Other, income tax, VAT and traffic revenue (see table 3). It is then postulated that three variables are very important in determining the factors that lead to growth in these tax revenue heads. These variables are:

(1) X_i/G -the relative size of each tax head in the short run

(2) $\delta X_i/X_i$ - the proportion of growth of each tax head.

(3) $\delta G/G$ - the proportion of growth of total tax revenue.

The relative contribution of each tax head to changes in total tax revenue in any particular period is then calculated as:

$$\left[\left\{ \frac{X_i}{G} \right\}_{t-1} \cdot \left\{ \frac{\delta X_i}{(X_i)_{t-1}} \right\} \Big/ \left\{ \frac{\delta G}{G_{t-1}} \right\} \right] = \alpha_i$$

So that;

$$\sum_{i=1}^{7} \alpha_i = 1$$

Where, G = total tax revenue, X_i= tax head i of tax revenue, and t = current time period. Each of the tax heads in equation (1) has its own fiscal significance.

First, $(X_i / G)_{t-1}$ represents the short run share of a tax head to the total tax revenue. Its relative size underlines the fiscal significance that the state attaches to it. Second, $\delta X_i / (X)_{t-1}$ is significant in two ways: (i) it shows the dynamics of the components of tax revenue, and (ii) an analysis of $\delta X_i / (X_i)_{t-1}$ for various periods illustrates the acceleration or otherwise in the expansion of various tax heads. Third, compared with $\delta G / G_{t-1}$, the size of $\delta X_i / (X)_{t-1}$, indicates whether or not a tax head is to increase, decrease, or maintain its relative significance. Generally three possibilities exist:

(1) If $\delta X_i / (X)_{t-1} > \delta G / G_{t-1}$, the share of X_i in total tax revenue will rise.

(2) If $\delta X_i / (X)_{t-1} < \delta G / G_{t-1}$, the share of X_i in total tax revenue will decline.

(3) If $\delta X_i / (X)_{t-1} = \delta G / G_{t-1}$, the share of X_i in total tax revenue will not rise or fall.

The relative contribution of each of the tax heads and their main components to the changes in total tax revenue 1995/96 – 2000/2001 period is estimated using equation (1) and the results presented in Table (3).

APPENDIX B: MEASURING THE REVENUE IMPACT OF A COMMON EXTERNAL TARIFF - THE ANALYTICAL MODEL

Assume that the price of an imported commodity is P and that the tariff is reduced from t_0 to t_1 . The domestic price changes from P(1+t_o) to P(1+t_1) Also, the quantity demanded changes from Q_0 to Q_1 depending on the price elasticity of demand for the commodity. For the purposes of the study, we shall assume that the effects of the cross elasticities are of the second order and thus can be ignored for estimation purposes.

In the case of a tariff reduction, $t_0 > t_1$ and its effect is to increase the quantity demanded implying that $Q_0 < Q_1$ The impact on government revenue will thus depend on two opposing effects: a price effect represented by P(t_0-t_1) which is negative; and a quantity effect represented by Pt_1 (Q_1-Q_0) which is positive. The combined effect will therefore be equivalent to:

$$dR = Pt_1(Q_1 - Q_0) - P(t_0 - t_1)Q_0 \tag{1}$$

Where *dR* represents a change in government revenue as a result of the reduction in the tariff.

From equation 1, PQ_0 is the c.i.f value of the imported commodity. Denoting PQ_0 by M, equation 1 can be rewritten as follows:

$$dR = M(t_0 - t_1)\left(\frac{t_1(Q_1 - Q_0)}{Q_0(t_0 - t_1)} - 1\right) \tag{2}$$

Let the price elasticity of demand be represented by the following

$$\eta_d = \frac{(1 + t_0)(Q_1 - Q_0)}{-Q_0(t_0 - t_1)} \tag{3}$$

Hence, the change in government revenue can be represented by the equation:

$$dR = M\left(\frac{-\eta t}{(1 + t_0)} - 1\right)(t_0 - t_1) \tag{4}$$

Where η_d is the elasticity of demand for the imported commodity.

From equation (4) the following deductions can be made:

1. If, $n_d = -\frac{(1+t_0)}{t_1}$

   the change in revenue is equal to zero. This says that if the demand elasticities are such that the two offsetting effects in equation 1 cancel each other, the net effect on revenue is zero. Another obvious result is that there is no impact on revenue if tariffs do not change, that is if

   $t_0=t_1$

   If the commodity imported is perfectly inelastic (i.e. zero elasticity of demand), the second term in equation the change in revenue will be the maximum that can be realized. This will be the case if:

   $$dR = M_{cif}(t_0 - t_1)$$

2. If the quantity effect is stronger than the price effect, revenues may increase as a result of a deduction in tariffs. However, this can only occur if the demand elasticity is greater than

   $$n_d = -\frac{(1+t_0)}{t_1}$$

   This is extremely rare because it requires that the elasticity of demand be unreasonably large to allow for the net effect to be positive. As a result, tariff reduction will most likely lead to a reduction in government revenue.

In order to estimate the change in revenues, we shall use the model represented by equation (4). The data requirements for this model are minimal and can be easily obtained except for the elasticities, which must be estimated. Based on the third deduction, the elasticity is such that revenues will be lower.

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