



# Political Economy of Regional Integration in Sub-Saharan Africa

Edited by Paul Brenton  
and Barak Hoffman



WORLD BANK GROUP

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# Chapter 1: Political Economy of Regional Integration in Sub-Saharan Africa: A Summary

## 1. Introduction

Regional integration in sub-Saharan Africa (SSA) is crucial for its further economic development and, more importantly, its structural transformation away from agriculture toward higher value-added activities, such as manufacturing and services. Yet there are many paths toward greater integration, some of which are easier than others. In addition, integration need not follow a linear path or occur mainly through formal inter-governmental economic coordination. In order to gain insights into how regional integration is occurring in SSA, determine impediments to it, and develop recommendations for how the World Bank and other development agencies can help further facilitate it, the World Bank commissioned a set of political economy of regional integration studies covering sector analyses of agriculture,<sup>1</sup> financial services,<sup>2</sup> professional services,<sup>3</sup> trade facilitation,<sup>4</sup> and transport.<sup>5</sup> These studies comprise the main chapters of this volume. This introductory chapter summarizes the findings from the sector studies and derives recommendations for the World Bank and other development agencies in their effort to support deeper regional integration in Africa.

In a comparative context, the findings of the studies suggest cautious optimism for regional integration efforts in sub-Saharan Africa. They also question perceptions that regional integration in SSA is doomed to be less successful

than in other parts of the world. Economic integration is typically difficult, especially among less developed economies. In addition, failed integration attempts and slow implementation of integration policies is a global pattern, not only an African one. Furthermore, efforts at integration are more likely to succeed when they have strong internal support among the governments and/or private sectors of the member states as well as take a pragmatic and flexible path to integration rather than a rigid and all-encompassing one. There is no question that it is these factors that are behind recent progress in regional integration in SSA. Similarly, economic integration is more likely to succeed when it occurs alongside regional attempts at improving political stability and/or developing joint infrastructure. We see evidence of this in the sub-Saharan Africa as well. For these reasons, arguably, regional integration in sub-Saharan Africa is perhaps somewhat more successful than one would predict given the challenging environment in which it is occurring. The studies that follow highlight a number of these accomplishments and suggest guidance for efforts to contribute to these positive outcomes.

## 2. Paths to Integration

There are many ways that countries in SSA can integrate their economies and some of them are easier and more sensible than others. The textbook economics method, progressing sequentially from free trade to deeper economic integration, is one of many and perhaps not the most sensible for SSA. Venables (2003), for example, argues that free trade areas among countries with differing levels of economic development can have polarizing effects: the relatively less developed economies may suffer losses, while the more advanced regional economy secures most of the gains. The reason for this is because economic integration can permit the more developed economy to dominate the higher value-added sectors due to its relative advanced position (Krapohl 2010; Venables 2003).

<sup>1</sup> Swinnen and Janssen 2015.

<sup>2</sup> Arriola and Osoro 2015.

<sup>3</sup> Dihel and Jelenic 2015.

<sup>4</sup> Kirk 2015.

<sup>5</sup> Hoffman and Kidenda 2015.

There is empirical support for this in SSA. For example, one of the reasons the original East African Community (EAC) collapsed in 1977 was because of Kenya's domination of it (Venables 2003). Moreover, the South African Customs Union (SACU) has deterred structural transformation of Botswana, Lesotho, Namibia, and Swaziland (Alden and Soko 2005). More broadly, this is evident in the financial, telecommunications, and consumer retail sectors where South African and, more recently, Kenyan and Nigerian firms are developing a strong regional presence.

While market integration is essential for firms in the region to create scale economies and achieve productivity gains through agglomeration, due to the real losses less developed economies can suffer, other forms of integration are equally as important and are occurring. In particular, development of joint infrastructure, especially in the transport and energy sectors, is an extremely beneficial form of regional integration in SSA. There are a number of reasons for this (Venables and Collier 2008; Draper 2010; Hartzenberg 2011). First, as a result of the large number of countries in the region and their comparatively small populations, building infrastructure at the national level is expensive due to its high fixed costs. Regional infrastructure projects, by contrast, achieve economies of scale not possible at the national level. Second, while there are significant positive externalities for coastal countries to link to their landlocked neighbors, the former are unlikely to take these into account and thus provide a lower level of national infrastructure than they would if the countries were a single entity.

Some governments in the region have recognized these benefits and are investing substantial effort in corridor development strategies. The most successful one to date is the Maputo Development Corridor that links Johannesburg and Maputo. Others include the Standard Railway linking Djibouti and Ethiopia, Eskom's attempts at building a regional electricity network in Southern Africa, and the nascent Standard Gauge Railway in East Africa. The latter two face substantial implementation challenges due to their cost and complexity. In addition, many governments in Africa have increasingly come to recognize the benefits of trade facilitation by coordinating operations of customs and other agencies. The growing number of One Stop Border Posts is a highly visible example of this.

A second crucial type of regional integration is cooperation to enhance regional political stability<sup>6</sup> (Draper

2010; Kurlantzick 2012; Venables and Collier 2008). After many decades of non-interference, most governments in the region realize these benefits and are actively pursuing them. This is most evident in the African Union's (AU) peacekeeping efforts in the DRC, Somalia, and Sudan. These efforts are a radical departure from the Organization of African Unity's policy on non-intervention. It is also apparent at the sub-regional level. The Economic Community of West African States' (ECOWAS) joint effort to fight terrorism is one such example. Some East African Community (EAC) member states also have taken an active role in attempting to stabilize Somalia and South Sudan. Taking this responsibility is commendable and sensible given that the spillovers from instability are large as are the economic benefits from peace. It also sets a foundation for efforts for future integration. By contrast, divisions within the Southern Economic Development Community (SADC) over Zimbabwe have hindered progress in regional integration in Southern Africa. Similarly, COMESA's experience demonstrates that political instability in some member states (primarily Libya, South Sudan, and Sudan) creates large barriers to market integration because such efforts are not a priority for these states.

A third path toward greater integration is through the independent efforts of the private sector (Byiers et al. 2013; Cowles 1995; Mattli 1999). This is very evident in the financial, telecommunications, and retail sectors. While firms are mainly undertaking these expansions to increase their own profits, they nevertheless facilitate greater regional integration. The study on financial services discusses in detail how this is occurring at the moment in East Africa. Another example is the effort supermarkets are undertaking to develop backward linkages in the agricultural and food processing sectors. East African regional chains are very vocal about their efforts to source locally. While the sector is small, it nevertheless has the potential to improve integration in the agricultural and transport sectors. The agriculture study, for example, shows that the sector is lagging in developing value chains in medium and low value staple crops that are somewhat more difficult to process, such as maize and wheat. The consumer retail sector has the potential to help address this issue through increasing the size of the local food processing sector. In addition, the transport sector study shows how the development of regional supply chains has led to improvements in the efficiency of the transport network in the EAC.

Due to these multiple and complementary paths to integration, one of the main findings of the studies is that the amount of integration we currently see in SSA is substantially greater than an examination of formal efforts to

<sup>6</sup> This is not unique to Africa. For example, enhancing regional stability was the original rationale for the creation of the Association of Southeast Asian Nations (ASEAN).

integration, such as implementing policies or transferring authority to supra-national organizations, would suggest. In addition, they demonstrate that these efforts can facilitate the more difficult adjustments that market integration can necessitate. Finally, the studies help elucidate which paths toward integration are easier than others and why. Such insights are crucial for creating programs to support it. Below we discuss this in detail and situate it within the broader literature on the political economy of regional integration.

### 3. Political Economy of Regional Integration

The literature on the political economy of regional integration is not large, but its findings are relatively consistent. Most studies agree that three main factors determine whether and how regional integration will occur. Integration is more likely to occur when:

- Private sector support is strong
- At least one government takes the lead on implementation
- The number of actors is small

#### 3.1. Strong Private Sector Support

Of the three factors, strong private sector support is by far the most important for successful economic integration (Byiers et al. 2013; Cowles 1995; Mattli 1999).<sup>7</sup> While this finding is unsurprising, it nevertheless is worth discussing in detail because formal regional integration efforts in SSA often do not actively involve the private sector<sup>8</sup> (Hartzenberg 2011). That economic integration can only succeed through the activities of the private sector is nearly tautological for market economies. Governments can provide inducements for firms to invest and increase trade among a regional economic community (REC), yet it is up to firms to initiate these actions. In many cases, the regional interests of private firms also are quite distinct from those of governments (Alden and Soko 2005). The most unambiguous policy recommendation from the studies is that if governments would like to make more rapid progress in economic integration, soliciting greater input from firms

which operate regionally and/or those wishing to do so would greatly improve these prospects.

Prior to discussing the results of our studies in this area, it is useful to highlight the role of the private sector in creating one of the most successful contemporary RECs, the EU. The view that integration in the EU offers a textbook model of gradual efforts to deepen economic cooperation is not consistent with the way the process actually unfolded (Cowles 1995; Mattli 1999). Many studies that wonder why economic integration in SSA is unfolding so slowly and argue that regional institutions do not serve substantive purposes often compare these efforts unfavorably to the EU integration process. Looking back at the way it actually occurred in the EU offers a useful corrective. The 1957 Treaty of Rome provided the foundations and outlined the process for regional integration in Europe. The EU did not come into existence for another thirty-five years and it did not achieve a monetary union for close to five decades later. Moreover, efforts at European integration stalled for decades following the signing of the treaty and pessimism about it was common. For example, a 1982 editorial in *The Economist* claimed, “A 25-year-old in a coma is a pitiful sight. Next Thursday marks the 25th anniversary of the signing of the Treaties of Rome, which created the European Economic Community. It will be celebrated with a sickly silence.” To ensure that no reader would misinterpret the editorial, a tombstone reading “EEC Born March 25, 1957—Moribund March 25, 1982” sits at the top of the page.

The impetus for the rapid progress toward further integration that began in the 1980s came not only from governmental efforts, but private sector pressure as well. Starting in the mid-1980s, lobbying pressure for integration from leaders of some of Europe’s largest companies, such as Philips, Shell, Siemens, Unilever, and Volvo became increasingly intense. Their chief complaint was (Cowles 1995, 507):

In reality, despite ambitions to liberalize trade... Europe remains a group of separated national markets with separated national policies and separated industrial structures. This prevents many firms from reaching the scale necessary to resist pressure from non-European competitors.

Comparing the evolution of integration in sub-Saharan Africa to that of the EU can help clarify views about the perceived slow pace of it in the former. Wondering why governments agree to integration policies, but fail to implement them is not unique to Africa. Rather, implementation of

<sup>7</sup> Private sector support is less necessary when integration is part of a strategy to increase security and state stability. These studies are beyond the scope of this work.

<sup>8</sup> As we discuss below, the private sector more commonly works to impede integration efforts in sub-Saharan Africa.

many of the parts of the Treaty of Rome followed decades of increasing private sector integration, it didn't precede it (Cowles 1995; Mattli 1999). In addition, while governments and the private sector often support integration, they do so for different reasons and, as a result, achieve it through different means. This is very evident in the studies of the agricultural, financial services, transport, and trade facilitation.

The study on financial sector integration in the EAC makes the contrasting views between governments and the private sector clear. The key priority among the former is a monetary union. As a result, governments and officials in the EAC devote an enormous amount of time focusing on the conditions necessary to achieve it, such as the timeline for introduction and macro-economic convergence criteria. They have not allocated commensurate effort to regulatory harmonization in the financial sector nor does the EAC have an official role as a financial sector regulator.

By contrast, banks in the region are chiefly interested in increasing their profits. They are not motivated toward EAC integration for political reasons, but economic ones. While they would welcome regulatory harmonization because it would allow them to work more efficiently, they have found ways to operate regionally despite poor government coordination by registering as domestic businesses in other countries. This is a sub-optimal outcome as it fragments bank operations, impedes the development of regional capital markets, and reduces competition. Nevertheless, it is a stable *status quo* because banks that have the capacity to expand have found a way to do so and adopting different standards of operations in various countries places the burden of adjustment on the banks, not the governments. The latter therefore can avoid difficult coordination negotiations across borders.

The study of the transport sector in the EAC is also an excellent example of the private sector acting in a manner similar to that in Europe, albeit at a much smaller scale. Especially along the Northern Corridor of the EAC, transport sector efficiency is improving at a fairly rapid pace. One of the main reasons is because various firms in the private sector, especially transporters, logistics providers, and traders are placing pressure on governments in the region, especially the Government of Kenya, to increase the efficiency of operations at Mombasa port, reduce the number of roadblocks and weighbridges along the roads, and reduce time at borders. It is also clear that their motive is in pursuit of their own profits, not regulatory harmonization as an end to itself. For example, while many firms in the region have strongly encouraged governments to enact the aforementioned changes, demands to liberalize

the trucking sector regionally so any truck can pick up and deliver cargo between any two points in the region are not nearly as strong.

Finally, the studies of the agricultural sector and on trade facilitation demonstrate clear and conflicting private sector and government interests in agricultural trade. Over the past few decades, liberalization, democratization, and, more recently, rising food prices have led to significant increases in agricultural production. The extent of the increase is a function of two factors: value chain complexity and crop value. Growth has been weakest in medium and low value crops with complex value chains, while growth has been higher in crops with low value chain complexity and agricultural products with high prices. For the latter, high prices provide an incentive for producers to internalize the value chain. This situation exists because while governments have ended policies that deter production, they have not enacted ones to encourage it, especially among complex value chain products. Rather, market failures, such as poor contract enforcement and costly oversight, deter investment in these sectors.

The result is that production methods for many staple crops still rely on rather rudimentary procedures, leaving them heavily exposed to adverse shocks. When this occurs, many governments in the region scramble to secure sufficient food stocks, often through export bans. While they have not delivered food security, such measures deter investment in growing staple crops for export. Along the same lines, fears among urban consumers that they may not have sufficient food often push governments to take an anti-trade bias, at least publicly. Even though there is no question that regional food markets would do a better job of ensuring food security than unilateral measures, collective action problems, specifically that partner governments will close their borders if food shortages appear imminent, have led to non-cooperative equilibria. In addition, although governments have liberalized the domestic agricultural sector, high transport costs and non-tariff barriers, such as complex regulatory standards, further deter trade.

By contrast, there is little doubt that farmers are eager to trade. The agricultural sector has responded positively to liberalization reforms and rising food prices. Overall, average annual output growth in the sector has been about 4.5% since 1990 and accelerated to 5.2% since 2007 when prices began to rise. In addition growth in low and medium value crops with complex supply chains has been very high since 2007, suggesting that the private sector can respond effectively to the aforementioned market failures as crop prices rise through, for example, engaging more

intensively with farmers to ensure they fulfill their commitments to buyers. While official data show that about 25% of intra-African trade is in agriculture, this is a severe understatement because it neglects the very sizable amount of informal trade, which, in turn, reflects continued presence of policy and regulatory barriers to formal trade.

Problems with regional integration in the agricultural sector are closely tied to difficulties with increasing production as well. This includes problems of land ownership, poor use of inputs and capital intensive production methods, and threats of expropriation when negative shocks occur. Developing value chains toward more enhanced production is therefore central to any policies to support greater trade in agriculture. Fortunately, we see some evidence of how this could occur through the expansion of regional supermarkets. While these efforts are small, they nevertheless hold the promise of creating spillover effects and a larger constituency for agricultural trade.

A key issue for deeper regional integration of agriculture in Africa is that while tariffs on regional trade in outputs have declined, restrictive policies may have shifted to distorting regional trade in inputs. From a political economy view, control over inputs can be important. Fertilizer and seed subsidies have been used in many SSA countries and have been targeted at specific groups of farmers. There is increasing evidence that regulations and input distribution costs (including taxes) are hurting farmers. Cross-border movement of seeds and fertilizer is hampered by Sanitary and Phytosanitary (SPS) requirements and other regulations, differences in certification and standards between countries and the resulting issues of checking compliance at the borders (World Bank 2012). Lack of agreement on standards between countries as well as mistrust in other countries' testing and certification capabilities often translates into duplicate procedures, associated with high costs. These duplicate procedures also raise revenue for certifying bodies, which creates an additional obstacle for removing them (Keyser 2015).

### 3.2 Lead Government

The second finding common to many political economy studies of regional integration, including our own, is that integration agreements are more likely to succeed if at least one government takes the lead on implementing it (Mattli 1999; Mansfield, Milner, and Pevehouse 2008). This is not a surprising finding and there are two main reasons for it. One, enacting regional integration agreements requires an extensive amount of inter-governmental coordination. As a result, it is subject to many collective action

problems (Mattli 1999). Implementation is more likely to succeed if at least one government takes the lead in solving these coordination problems. Two, regional integration can cause permanent losses for some sectors of certain economies (Krapohl 2010; Venables 2003). It is understandable that governments may be reluctant to impose them in the absence of pressure.

The EU is a particularly salient example of the importance of one country taking the lead in implementing regional integration agreements (Mattli 1999). Due to the large number of countries in the organization and the numerous complex integration negotiations, it is unreasonable to believe that countries would coordinate their positions voluntarily. Rather, integration became far more likely to occur when Germany took a lead role in pressing for it in areas such as setting the integration agenda and being the largest contributor to the EU. Because Germany is the largest economy in the EU and large parts of its private sector support integration, it is able to fill this lead role effectively.

We see similar patterns across sub-Saharan Africa. While government support tends to be congruent with private sector interests this need not be the case. In particular, the divergent interests toward regional integration between Kenya and South Africa explain a large part of the variation in the relatively impressive performance of the EAC compared to SADC.

After South Africa's democratic transition and global diplomatic normalization, the country's private sector aggressively pursued economic opportunities throughout the region (Alden and Soko 2005; Amos 2010; Hentz 2005; Krapohl, Meissner, and Muntzschick 2014). Today, South African firms trade and invest in a range of sectors across the region, including mining, construction and manufacturing, agriculture and food processing, financial services, consumer retailing, transport, tourism and hospitality, and telecommunications. In addition, South Africa's regional trade is heavily concentrated in SADC. For these reasons, the country is in a strong economic position to take a lead role in deepening SADC integration. However, this is not occurring for a number of reasons.

First, while SADC is a large market for South African exports, the country views global integration as a more promising development strategy than regional integration (Alden and Soko 2005; Amos 2010; Hentz 2005; Krapohl, Meissner, and Muntzschick 2014). As a result, its export-oriented growth strategy focuses globally, especially toward the EU where it has a free trade agreement (FTA). By contrast, there is no EU-SADC FTA since the EU refused granting South Africa the same types of preferential access it



allows less developed countries in the region to its markets. By contrast, the EAC and the EU recently enacted an FTA that includes all members of the former.

The unilateral agreement between the EU and South Africa has caused numerous strains in SADC that has contributed to its current fragmentation and indefinite suspension to working toward a customs union (Amos 2010; Hentz 2005; Krapohl 2010; Krapohl, Meissner, and Muntshick 2014). First, because the agreement lowered South Africa's common external tariff, other members of SACU had concerns that they would lose revenue from imports under the revenue sharing agreement. That South Africa negotiated the agreement without involving the other four members of SACU subsequently became a considerable source of tension between those countries and South Africa. Second, the South Africa-EU FTA contributed to the fragmentation of other SADC members into three different blocs to negotiate Economic Partnership Agreements (EPA) with the EU. In particular, the latter has not pushed to develop an EPA that covers all SADC members except South Africa. Finally, because the various trade agreements among SADC member states with the EU are different from each other, they substantially complicate the development of a SADC customs union. This is one reason efforts toward further integration have stalled and SADC is now engaged in developing the COMESA-EAC-SADC Tripartite agreement, which is seen as a critical stepping stone toward the grander plan for a continental free trade area by 2017.

Second, while South African firms have a strong presence in the region, the Government does not always advocate for the interests of its domestic private sector (Alden and Soko 2005). South Africa not only has a large trade surplus with the rest of the region, it also exports many finished products to SADC member states, but mainly imports primary ones. More broadly, its history of apartheid as well as its economic domination of the region makes the government somewhat reluctant to exercise a leadership role in SADC out of concerns over a backlash due to perceived South African hegemony.<sup>9</sup> In this context it is useful to recall that SADC grew out of an older regional integration effort, the Southern African Development Coordination

Conference (SADCC), whose main purpose was to reduce Southern Africa's economic ties to South Africa.<sup>10</sup>

Third, domestic politics interferes with the ability of the government to take a lead role in regional integration (Alden and Soko 2005). The country continues to struggle with high rates of unemployment and the Congress of South Africa Trade Unions (COSATU) is very vocal in challenging policies that may negatively impact its members. Economic liberalization already has adversely impacted South Africa's labor intensive manufacturing sectors. Exposing the country to greater competition to that sector of the economy is therefore a highly sensitive issue in South Africa. As a result, the SADC FTA protects this sector in South Africa. This undermines the capacity of South Africa to serve as catalyst for structural transformation in SADC.

However, there are two SADC regional integration efforts that are a priority for the government. The first is the highly successful Maputo Development Corridor (Alden and Soko 2005; Byiers, Vanheukelom, and de Roquefeuil 2013). This project forms the core of a massive growth in bilateral trade and foreign direct investment from South Africa to Mozambique since the turn of the millennium. The second, and somewhat less successful, effort has been to place Eskom at the center of Southern Africa's electricity generation and distribution network. While Eskom imports from Lesotho and Mozambique, and exports to Botswana, Lesotho, Namibia, and Swaziland, the Government of South Africa has much greater ambitions. They have not yet come to fruition due, in part, to shortages within South Africa and challenges with the development of the Inga Dam in the DRC.

The Government of Kenya, by contrast, is eager to take a lead role in EAC integration (Booth et al. 2014). The two most recent presidents of Kenya have been strong proponents of regional integration. Both presidents have very close ties to the private sector, ran on pro-business platforms, and have largely been receptive to private sector interests. In addition, both presidents have supported reforms to liberalize the economy and placed serious effort in improving the country's transport infrastructure. As a result, a wide range of Kenyan firms have developed

<sup>9</sup> South Africa's GDP accounts for about 60 percent of total SADC GDP and the majority of South Africa's exports go to SADC member states.

<sup>10</sup> SADCC is a good example of a reasonably successful regional integration effort whose purpose was mainly political, not economic. The organization's main purpose was to isolate South Africa regionally, push for the end of apartheid, and press for Namibia's independence. It grew out of an earlier initiative of the Front Line States (Angola, Botswana, Mozambique, Tanzania, and Zambia) to secure these objectives as well as assist in Zimbabwe's efforts at independence.



and/or expanded their regional operations. Many of these have become household names, such as Safaricom, Kenya Commercial Bank, Equity Bank, Kenya Airlines, Nakumatt, Tusky's, and Uchumi. For these reasons, the Government of Kenya has become not only supportive of integration efforts, but also has taken a lead in implementing them. Recent examples include expanding Mombasa Port, starting construction on the Standard Gauge Railway, and implementing the Single Customs Territory.

The chapter on the transport sector provides insights into the catalytic role that a lead state can play in implementing regional integration agreements. Kenya's central role in integrating the transport sector is clear. While the Governments of Rwanda and Uganda had been urging the Government of Kenya to improve its transport infrastructure for years, because Kenya is a far larger economy and controls access to the sea, there was little these governments could do to impose a solution on Kenya. By contrast, the recent increases in efficiency and reduction in transport prices along the Northern Corridor reflect quite deliberate efforts by the Government of Kenya to address problems in the port and along the roads. Likewise, there is also no question that Kenya is taking the lead role in expanding the regional transport network through projects such as the Standard Gauge Railway and expanding Mombasa Port.

However, the modal finding from the studies is that most states in the region are often unwilling to take a lead role in furthering integration. This is not surprising because many economic integration policies will impose losses on some sectors of some of their economies. Many studies attribute reluctance to inflict these harms to lack of political will, a somewhat vague and unclear term. A more elucidating explanation is that governments are unlikely to cause some sectors of their economies to suffer, even if the aggregate gains outweigh the costs, absent stronger countervailing pressure. The chapters in this volume provide numerous examples of this:

- The chapter on trade facilitation demonstrates that the Government of Zambia was a principal cause of COMESA's delay to implement a Regional Customs Bonds Guarantee.<sup>11</sup> The Government of Zambia was

mainly reacting to the concerns of its clearing and forwarding agents that would have been adversely harmed by it.

- The chapter on trade facilitation also demonstrates that many governments are reluctant to reduce the number of regulatory agencies involved in trade, despite the large inefficiencies and dubious value they create, because many of them self-fund through the fees they generate through inspections.
- The chapter on agriculture shows that even though export bans on staple crops in aggregate worsen food security in sub-Saharan Africa, governments nevertheless often implement them due to domestic fears that trade will exacerbate food shortages.
- The study of professional services reveals that governments in the EAC are reluctant to integrate some sectors of their economy, despite shortages of skilled experts in areas such as law and engineering, in order to limit the amount of competition.
- The study on the transport sector makes clear that trucking firms are not supportive of efforts to liberalize the sector within the EAC and governments are therefore not pressing the issue.

### 3.3 Number of Actors

The final main finding in the literature on the political economy of regional integration is that negotiations become more difficult as the number of actors rises (Byiers, Vanheukelom, and de Roquefeuil 2013; Mansfield, Milner, and Pevehouse 2008; Matti 1999). This is not surprising and is consistent with the broader literature on bargaining and collective action. The two main reasons are because transactions costs and the probability of divergent preferences both increase as the number of actors rises. This finding relates very closely to the one on leadership. While negotiations can succeed among a small set of individuals even in the absence of a clear leader, this becomes more difficult as the number of parties grows. NAFTA and the failed Latin American Free Trade Association (LAFTA) are clear examples of this. The United States and Canada already had a free trade agreement when Mexico proposed NAFTA. In addition, Mexico is far more tightly integrated and dependent on the US economy than the Canadian one. As a result, the negotiations were largely bilateral. LAFTA, by contrast, was a far more unwieldy REC and its negotiations have been far more complex as a

<sup>11</sup> Many countries demand that transporters of transit cargo purchase a bond guarantee when entering a country as a deterrent to selling the goods in the domestic market. Border agencies return the money when they determine the truck remains sealed at the border. The Regional Customs Bonds Guarantee would eliminate these national policies in favor of a single COMESA-wide bond.

result. LAFTA began in 1962 with seven members<sup>12</sup> and expanded to 11<sup>13</sup> in 1970. They were able to establish a free trade zone. However, LAFTA's internal divisions led to the emergence of blocs with divergent preferences among its more and less developed members over the unequal distribution of gains and losses within the REC. While better leadership might have been able to resolve these differences, lack of it exacerbated the differences between the two groups of states. The organization folded in 1980 due, in part, to a stalemate on this issue (Mattli 1999).

Following a similar logic, the larger the number of actors and/or organizations within a country that have influence over integration policies, the more difficult it becomes. The case studies of professional services, trade facilitation, and the transport sector clearly support these findings. For example, the study of professional services shows that reaching agreement across a range of professions among all EAC member states required reaching consensus among a number of government ministries and professional organizations on many issues, such as educational requirements, licensing procedures, and migration. Many of these groups had divergent preferences and/or wanted to place coordination problems on counterparts in other countries. Reducing the number of participating EAC members and sectors turned an impasse into an opportunity because those with divergent preferences choose to not participate. This suggests that a variable geometry approach to integration where a subset of countries and/or sectors that have an interest in greater integration move among themselves may be more effective than a more rigid and comprehensive framework. Moreover, the study of the transport sector demonstrates that effective coordination in that sector solved many impediments to integration. The chapter details how joint-border committees, comprised of representatives from the public and private sector, have made very impressive progress in streamlining border crossing procedures between Kenya and Uganda.

By contrast, the chapter on trade facilitation demonstrates very clearly how the proliferation of regulatory agencies has, in effect, become a non-tariff barrier. A number of governments in SSA have allowed these to continue to grow using the argument that they perform a vital quality control function. However, in many countries this has led to the creation of agencies that self-fund through

the fees they collect and, as a result, have a strong incentive to broaden their mandate. Efforts to end or reduce these activities are very difficult because in many cases it requires either eliminating many positions in these agencies and/or having the government fill the funding gap that would result from fewer inspections. The aforementioned progress on the border of Kenya and Uganda has solved this problem not by getting rid of these tests, but by having organizations work more efficiently with each other. This is an acceptable solution to transporters and traders because they care more about lengthy border procedures than the costs of the tests.

## 4. A Comparative Analysis of Africa's Regional Integration

Most studies of regional integration in sub-Saharan Africa offer fairly pessimistic prognoses. The most common themes are that RECs have failed to spur trade, there exists weak commitment to regional integration, and countries join many RECs, but fail to enact policies necessary for integration to occur (Draper 2010; Hartzenberg 2011; Yang and Gupta 2007). These are all somewhat valid complaints. Regional integration can be difficult and Africa is far from the only region that suffers from failed RECs. Nevertheless, as the preceding sections have made clear, in a comparative context, when viewing Africa's level of integration through a broader lens than only formal economic integration arrangements, there are numerous reasons for optimism that integration will strengthen in the future.

First, and most important, one crucial reason African regional trade is small is because few countries in SSA have structurally transformed their economies (Venables 2003; Venables and Collier 2008; Yang and Gupta 2007). As a result, a large portion of imports into Africa are of finished goods that few economies in the region produce on a large scale. Therefore we can't separate low levels of trade in Africa from its lack of structural transformation. Because the latter largely has not yet happened in the region, African economies remain heavily dependent on imports of finished goods only produced in other regions of the world.

Second, when we broaden our lens beyond economic integration alone, it is clear that regional integration is occurring in many important areas and is providing large economic benefits. The clearest example is in security and stability. Conflict is economically disastrous, while peace pays a large economic dividend. The region has come a long way from the non-interference policy of the OAU,

<sup>12</sup> Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay.

<sup>13</sup> Bolivia, Colombia, Ecuador, and Venezuela.

and its tolerance for coups and regional wars. Today, the AU and sub-regional organizations are leading efforts to provide peace and stability. In addition, countries are coming together to build regional infrastructure, such as the Maputo Development Corridor, the Standard Gauge Railway in East Africa, and regional electricity networks in Southern Africa. These efforts will take time to come to fruition, but will help solve two critical challenges to economic development in the region, costly and unreliable electricity and high transport costs.

Third, while many criticisms of RECs in SSA are valid, they also lack historical and contemporary context. It is certainly true that many of them suffer from poor design and weak commitment to implementation. Overlapping membership is also a challenge. However, Africa is hardly unique in this regard (Krapohl 2010; Mattli 2009). Europe suffered from lack of government interest in integration for many decades prior to the rapid and unexpected progress it started making in the 1980s. The European Free Trade Area was also a poorly designed and unsuccessful attempt at European Integration. Latin America had its share of failed RECs, such as LAFTA and the Central American Common Market, as well. Finally, the Association for South East Asian Nations (ASEAN) languished for many years, suffered poor leadership and interest in integration, and traded little among member states before developing into a more cohesive organization. This is not to excuse African countries for failing to learn the lessons of other unsuccessful RECs. Rather it simply points out that Africa's experience is typical, not an anomaly.

Fourth, comparing progress in implementing RECs in SSA to more successful ones, such as ASEAN, the EU, Mercosur, and NAFTA, is fundamentally misleading for a number of reasons. For example, the economics of integration in Africa are far more challenging for African RECs than these four. According to Krapohl (2010, 18):

economic asymmetries in and between regions have various consequences for regional integration in the South which leads to the fact that the character of such integration projects differs fundamentally from regional integration in the North. The success and stability of regional integration in the South is much more dependent on the reaction of extraregional actors, Rambo [going alone] situations occur more easily due to intraregional competition, implementation problems are consequently more severe and regional institutions are less likely to solve these problems.

SADC is the most prominent case of the aforementioned challenges to regional integration in SSA as we explained above. In addition, ASEAN and, to a lesser extent the EU, began primarily as integration efforts to promote regional peace and stability, not economic integration. Rather, this cooperation later facilitated progress on economic integration. Furthermore, ASEAN's biggest success was negotiating FTAs with China, Japan, and Korea (Kurlantzick 2012). This is the exact type of agreement the EU was unwilling to negotiate with SADC, but was with the EAC. The latter greatly increases the prospects for successful regional integration in East Africa. Finally, Mercosur was the outcome of close to thirty years of failed regional integration attempts of various kinds in Latin America.

The pessimistic view that regional integration can only play a limited role in Africa because of relatively small size and similarity of endowments between countries is still common. Our studies challenge this conventional wisdom. It is becoming increasingly apparent that there is enormous scope for increased cross-border trade and investment in Africa.<sup>14</sup> Moreover, with rising incomes in Africa there are growing opportunities for cross-border trade in basic manufactures, such as metal and plastic products, and processed food that are costly to import from outside the region. The potential for regional production chains has yet to be exploited and cross-border trade in services offers similarly untapped opportunities.

How then can this potential be achieved and regional integration leveraged to drive trade and structural transformation in Africa? Our studies provide numerous examples of how successful integration efforts are occurring in contemporary sub-Saharan Africa and document impediments to it are being overcome. The key messages are the need to mobilize the private sector to drive and frame regional integration efforts, the importance of a country or group of countries leading the integration process, and finally that progress is more likely between smaller groups of countries and actors. The latter suggests that while large regional organizations such as SADC, COMESA, and ECOWAS may be able to play key roles in areas such as security they will be less successful in driving economic integration across a large group of countries. Hence, success is more likely to come from allowing a flexible or variable geometry approach which allows for a subgroup of members to pursue common interests in deeper

<sup>14</sup> See, for example, the various contributions in Brenton and Isik (2012).

integration, and at different speeds, within the overall integration process of the regional bloc. This is the typical pattern of regional integration. The split in the EU between countries which use the Euro and those that do not is one prominent example. The evolution of NAFTA from an FTA between Canada and the United States is another. In the final section below, we provide concrete suggestions for Bank staff working to accelerate regional integration in SSA.

## 5. Recommendations

The studies suggest the Bank could engage in useful efforts to facilitate greater integration efforts. Below we offer a few recommendations.

- **Prioritize flexibility over rigidity.** It is tempting to want to work through existing regional economic organizations, such as COMESA, ECA, and SADC, to pursue integration efforts. However, most of Africa's RECs have states with highly divergent integration priorities. Working through formal RECs therefore can often be more of an impediment to integration than a benefit. Instead, in many instances, it makes sense to allow a subset of countries to move forward in one area and use these gains to work on a broader set of issues and/or countries.
- **Encourage simplicity over complexity.** Many integration efforts stall because they pursue complex negotiations across a range of government agencies. This approach gives groups opposed to integration leverage to block progress toward it. In addition, it also strains the capacity of many governments. One way to minimize these impediments to integration in some areas is to encourage mutual recognition of standards rather than policy harmonization. Within a REC, for example, countries could choose to recognize the standards of the most stringent member state in the particular sector.
- **Reach out to the private sector.** Governments are unlikely to impose losses on certain groups absent pressure to do so from another set of domestic actors. In addition, Bank projects often focus most of their attention on working with governments. Reaching out to private sector actors that have an interest in integration can help shift momentum toward this outcome. In addition, firms already operating regionally may have innovative insights that might prove useful for Bank staff working on integration projects.

- **Focus on joint infrastructure.** Africa's infrastructure deficit is large and the costs of developing it are daunting. In many instances, it is sensible to consider infrastructure development from a regional point of view rather than a national one. Not only can this help leverage economies of scale in financing infrastructure development, it can also help create the foundations for greater integration efforts by reducing costs of trade. The returns to these investments are enhanced when they are accompanied by policy reforms that remove barriers to the movement of goods, investment, services, and people. For example, investments in connective transport infrastructure need to be accompanied by measures that lead to faster border procedures, the removal of roadblocks, fewer weighbridges, and greater competition among transport providers.

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# Chapter 2: Political Economy of Agricultural and (Regional) Trade Policies and Value Chain Performances in Sub-Saharan Africa

## 1. Introduction

Recent events in agricultural and food markets have led to what some have referred to as “a cacophony of policy responses” (Bryan 2013). In many cases governments interrupted trade flows, effectively banning food exports, which in turn caused even larger shortages in importing countries and enhanced price spikes (Anderson, et al. 2013). Also in Africa, government responses were sometimes quick with sudden reversals and in conflict with their formal commitments to open up regional trade in food.

It is also argued that the actual impacts of regional trade commitments in sub-Saharan Africa, due to weak implementation in practice, on farmers and traders are limited at best; that tariffs and non-tariff barriers (NTBs) remain significant impediments to regional trade in food and in crop inputs; and that productivity of staple crops, grown mostly by small-scale farmers which constitute a plurality of the labor force in most countries in sub-Saharan Africa, continues to stagnate.

In this chapter we review the evidence for these claims and analyze the political economy of decisions regarding removing barriers to (regional) food trade in Africa and how political economy factors influence the implementation of regional trade commitments. We also present a value chain perspective to interpret the performance of commodities and sectors following agricultural and trade policy changes.

A key observation regarding the literature is that much of the recent studies on policy interventions—and also on the political economy influences—seem to consider the current situation as a “new paradigm” focusing very strongly on local and temporary factors, thereby largely

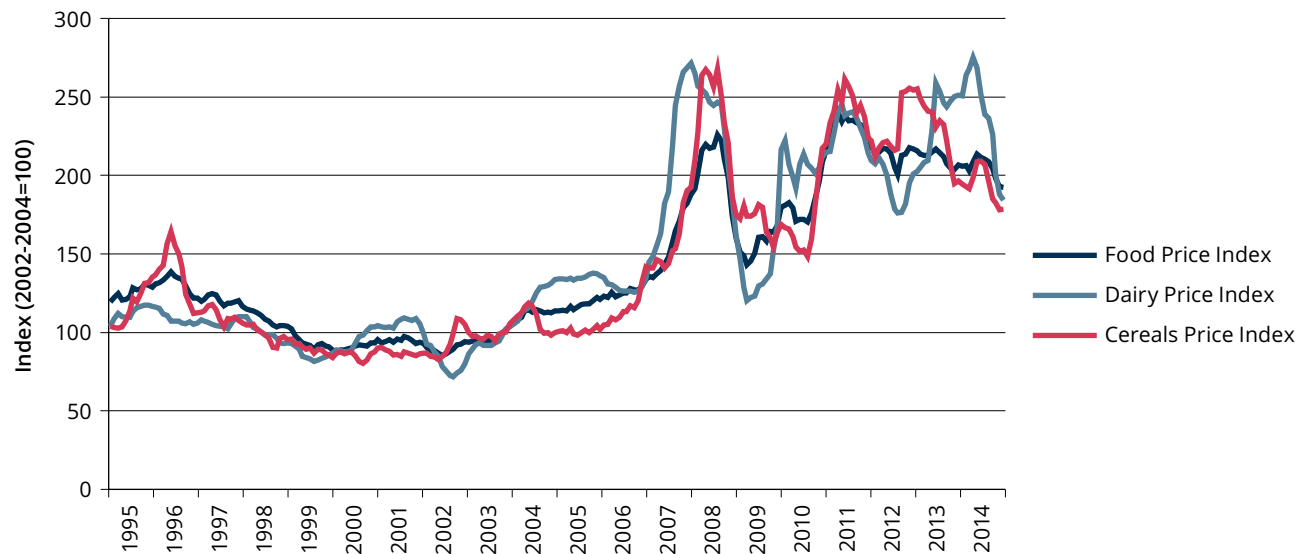
ignoring how it fits in a longer policy development and how it compares to other regions of the world. The latter is important to identify what is specific to the country or region or the time period, and what is not. For example, earlier studies, focusing primarily on the period before the food price spikes in the mid 2000s (as illustrated by Figure 1), identify major changes in Africa’s agricultural trade regimes and policies, with important implications for today’s farmers.

In this way the focus of the literature on policy reactions and political economy mimics the switch in focus of the literature on the impact of food prices on malnutrition and poverty, where in the past much of this literature emphasized the impacts of detrimental trade practices of developed countries on rural poverty in Africa through its negative impact on global prices, while recent literature has emphasized and focused on the negative impacts of high food prices on poverty and food security through its impact on consumption (Swinnen 2011; Swinnen and Squicciarini 2012). However, recent evidence suggests that the earlier paradigm remains very useful to understand the impacts of agricultural trade policies and food prices on rural poverty in Africa and elsewhere (e.g., Headey 2013, 2014; Verpoorten et al. 2013). It is therefore crucial to use an integrated longer-run and global framework to understand the current developments and their effects (Naylor 2014).

The chapter starts with documenting the RTAs in SSA and then provides a brief summary of the literature with a review of key arguments and shortcomings. In particular, we will emphasize that to correctly assess the RTA impact and political economy it is important to distinguish the recent policy reactions to the global food price spikes from earlier government interventions, and to put these policy reactions by African governments in a global perspective.

One should recognize that there has been significant reform and an overall reduction of government trade interventions in agricultural markets over the past twenty-five



**FIGURE 1: Global Food Price Index**

Source: FAO

years, with major heterogeneity in this, across commodities (staple foods versus other commodities, and even within staple foods), across countries, and over time.

In addition, several of the observed policy developments are not specific to SSA, but appear to be very similar to policy changes in other parts of the world. Two examples of these are the recent increase in NTBs and the ad hoc responses to the food price spikes in recent years (see e.g., Wodon and Zaman 2008). This suggests that there may be broader forces at work than country-specific or region-specific explanations.

In drawing conclusions for the future, we point out that Africa has, on average, experienced (a) strong growth over the past decade; (b) a series of structural transformations (e.g., in access to information and in the development of—global and local—value chains), factors which distinguish it from the African economic and institutional developments of the previous decades; and (c) wide differences in commodity performance, both before and after the price spikes, which can be attributed to differences in the institutional organization of commodity value chains. In fact, the structural shift to higher food prices has caused significant increases in growth in output and productivity of the lagging agricultural sectors in SSA, in particular cereal production. All this has potentially important implications for the political economy of agricultural and trade policies. In this chapter we will try to integrate these factors, and explicitly account for them, in our analysis.

## 2. Regional Trade Agreements in Sub-Saharan Africa: The Literature

Regional integration in Africa has a long history and can be traced back to the establishment of the South African Customs Union (SACU) in 1910 (Geda and Kebret 2008). Since then, regional integration has come a long way.<sup>1</sup>

Today, Africa is home to about fourteen regional trade or cooperation agreements (Meyer et al. 2010).<sup>2</sup> The most important trade agreements include the Economic Community of West African States (ECOWAS), the Economic

<sup>1</sup> This is not just an African phenomenon, but a global, fairly recent, evolution. Some 489 regional trade agreements (RTAs) have been notified to the World Trade Organization (WTO) or its predecessor, the GATT, and 297 of those agreements are in force. The proliferation of RTAs has been a relatively recent phenomenon: in 1991 there were only 50 RTAs in existence, and this number has since been steadily increasing. In 2005, 180 RTAs were in force, demonstrating the accelerated spread of agreements in the last few years.

<sup>2</sup> According to UNECA and AU (2013), only eight RECs are recognized by the African Union. Note however that there seems to be no consensus within the literature about how many RECs there actually exist within Africa. This is probably due to different or inconsistent use of the definition of a REC.

Community of Central African States (ECCAS), the Southern Africa Development Corporation (SADC), Community of East African States (COMESA), and the East African Community (EAC). Most countries are members of multiple RTAs or Regional Economic Communities (RECs). Only twelve countries belong to a single organization and one African country belongs to four different RECs (Engel et al. 2013).

**ECOWAS** was founded in 1975. In 1993, the treaty was revised to accelerate the process of integration. In 2006 its member states agreed on joining the existing UEMOA Common External Tariff (CET) (Engel et al. 2013). ECOWAS plans to launch a custom union in 2015 (UNECA and AU 2013). Today ECOWAS includes Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, Guinea-Bissau, Ivory Coast, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

**ECCAS** was founded in October 1983. Due to financial complications, it had to halt its activities for several years. It launched its Free Trade Agreement in 2004 but is facing important practical challenges (UNECA and AU 2013). Today ECCAS includes Angola, Burundi, Cameroon, Central African Republic, Chad, Republic of the Congo, DR Congo, Equatorial Guinea, Gabon and São Tomé and Príncipe.

**SADC** was founded in April 1980 and was originally named Southern African Development Co-ordination Conference (SADCC). In August 1992, SADCC was transformed to SADC. From 2000 onward, the organization has gradually worked on cutting tariff and non-tariff barriers between member states. Since 2008, SADC countries form a free-trade area with 85 percent of its trade duty-free. SADC plans to become a customs union in the nearby future (Engel et al. 2013). Today SADC includes Angola, Botswana, Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe.

**COMESA:** the idea originated in the mid-1960s but the COMESA treaty itself was signed on November 5, 1993. It established a FTA on 31st October 2000. COMESA launched its custom union in 2009. Today, COMESA includes Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, and Zimbabwe.

**EAC** was signed on 30 November 1999 and entered into force on 7 July 2000. With the launch of its common market in 2010, the EAC can be seen as the most advanced community in SSA (Engel et al. 2013; UNECA and AU 2013). Today, the EAC includes Burundi, Rwanda, Kenya, Tanzania, and Uganda.

In 2008, COMESA, SADC, and EAC moved toward a tripartite free trade area, bringing together all twenty-six member countries (Engel et al. 2013).

**APEI**, the Accelerated Programme for Economic Integration (the most recent RTA), was launched in September 2012. As the name suggests, APEI aims at speeding up economic integration between the member states. APEI includes Malawi, Mozambique, Zambia, Mauritius, and Seychelles.

In the remainder of this chapter we will compare our SSA averages with indicators for four regional areas: ECOWAS, EAC, SADC, and APEI.

Several studies have been conducted on Regional Trade Agreements (RTAs) in sub-Saharan Africa. Some papers looked at specific RTAs and regions, such as Geda and Kebret (2008) and Mima and Mainville (2013) on ECOWAS, Afesorgbor and van Bergeijk (2011) on ECOWAS and SADC, AECOM (2011) on SADC, Soko (2007) on SADC and SACU, Khandelwal (2005) on COMESA and SADC, Harris, Chambers, and Foresti (2012) on West Africa, World Bank (2009) on Eastern Africa, Mbekeani (2013) on Southern Africa, Karugia et al. (2011) on EAC, and UNECA (2011) on the tripartite free trade agreement. Other studies covered RTAs across the continent. These include Hartzenberg (2011), Keyser (2015), Khadiagala (2011), Meyer et al. (2010), UNECA and AU (2013), and Yang and Gupta (2005).

Some of the key findings of these studies are the following (see also Engel and Jouanjean (2013) and Engel et al. (2013) for reviews).

- Over the past decades, there has been a move toward greater regional integration within Africa, at least formally (Afesorgbor and van Bergeijk 2011; UNECA 2011). Existing trade agreements have been deepened and new arrangements were signed (Geda and Kebret 2008; Yang and Gupta 2005; UNECA 2011). The latter can be illustrated by the recent launch of the Accelerated Programme for Economic Integration (APEI). APEI aims at speeding up economic integration and to go beyond the provisions of the existing RTAs.
- Although intra-regional tariffs have come down substantially, barriers to trade seem to persist (Engel et al. 2013; Mima and Mainville 2013; Karugia et al. 2011). Reasons include issues related to infrastructure and trade related services (Bouët, Mishra, and Roy 2008; Pannhausen and Untied 2010), the presence of strong anti-reform lobbies (Hellman 1998), the fact that many countries have had mixed experiences with past reforms (McCorriston, et al. 2013) and the role bribery plays in total transport costs.

### BOX 1: Country Coverage of RRA/NRA by Regional Trade Agreement

1. EAC
  - Includes Burundi, Rwanda, Kenya, Tanzania, and Uganda
  - RRA/NRA coverage: Kenya, Tanzania, and Uganda
2. APEI
  - Includes Seychelles, Mauritius, Malawi, Mozambique, and Zambia
  - RRA/NRA coverage: Mozambique and Zambia
3. ECOWAS
  - Includes Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, Guinea-Bissau, Ivory Coast, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo
  - RRA coverage: Ghana, Ivory coast, Nigeria, and Senegal
  - NRA coverage: Benin, Burkina Faso, Ghana, Ivory coast, Mali, Nigeria, Senegal, and Togo
4. SADC
  - Includes Angola, Botswana, Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe
  - RRA/NRA coverage: Madagascar, Mozambique, Tanzania, Zambia, and Zimbabwe
5. SSA
  - Includes Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Congo (Brazzaville), Democratic Republic of the Congo, Côte d'Ivoire, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Réunion, Rwanda, Sao Tome and Principe, Senegal
  - NRA coverage: Benin, Burkina Faso, Cameroon, Chad, Ghana, Kenya, Madagascar, Sudan, Senegal, Togo, Nigeria, Mozambique, Mali, Ethiopia, Ivory coast, Tanzania, Uganda, Zambia, and Zimbabwe
  - RRA coverage: Cameroon, Ghana, Kenya, Madagascar, Sudan, Senegal, Nigeria, Mozambique, Ethiopia, Ivory coast, Tanzania, Uganda, Zambia, and Zimbabwe

- Related to this, many studies state that there has been a significant increase in non-tariff barriers to trade (NTBs) (Kalaba 2012; Hoekman and Nicita 2011; Keane, Cali, and Kennan 2010).
- Most studies agree that overall, RTAs in Africa have been poorly implemented. One reason often cited is the fact that many countries are members of multiple RTAs (Khadiagala 2011). This could lead to conflicting regulatory requirements and unnecessary increased human and financial costs associated with membership. However, not everybody agrees with these latter conclusions. For example, Afesorgbor and van Bergeijk (2011) argue that there is a positive impact of multiple-membership if the additional membership complements the integration process of the original RTA.
- Studies point out problems of legitimacy and design of the RTAs. One issue is that most African countries are reluctant to give up their autonomy over economic

policy-making, especially in times of crisis. Another relates to the design and implementation of African RTAs which diverges from traditional RTAs in that they are often considered in their member countries as establishing flexible regimes of cooperation as opposed to containing rules requiring scrupulous and rigorous adherence (Gathii 2009).

- There was widespread introduction of agricultural regulations, including significant trade barriers, in recent years in staple food markets. Many studies have pointed at the ad hoc interventions in staple food markets, marked by discretionary use of policies, such as export restrictions (bans and quotas), which may have enhanced price volatility rather than reduced it.

While all these studies provide useful insights, there are several caveats to take into account.

- It is not always clear what is meant by “staple foods,” and to what extent “staple foods” is a group of commodities

with common characteristics, and regulated by similar policies.

- It is important to put the RTA analysis in a global and in a longer term perspective. Several of the observed policy developments are not specific to SSA, but appear to be very similar to policy changes in other parts of the world. Two examples of these are the recent increase in NTBs and the chaotic responses to the food price spikes in recent years. This suggests that there may be broader forces at work than country-specific or region-specific explanations.
- One cannot interpret the recent changes without taking a broader perspective on policy changes over the past twenty-five years.
- Similarly, one cannot evaluate the failure of RTAs to prevent major policy interventions in the past years without considering a broader perspective. The political incentives to intervene, and in quite dramatic fashion, during the 2007–2012 period has been global and one should be careful in concluding that it is due to failures of African RTAs. The failure of RTAs to prevent the sudden growth in export bans, etc., should take into consideration the global phenomenon that (a) export policy constraints are often not (or very weakly) regulated in international trade agreements, and (b) that the interest in doing so has just emerged after the food price spike-induced policy interventions.
- Again, looking at the medium- to long-term perspective, which should be the target for RTA planning, structural developments such as sustained economic growth in Africa, increases in foreign direct investment (FDI), and the associated growth of value chains, significant investments in food processing, and the spread of ICT and commercial mass media are all likely to fundamentally transform the political economy of agricultural trade policies.
- The reports pay little attention to the role of value chains and how they may affect the impact of trade liberalization on sector performance. This may need a more complex framework of analysis (i.e., one that integrates the institutional organization of the value chains).
- There is little discussion about the issue that RTAs also have potentially detrimental effects by causing trade diversion.

We believe that these elements are crucial to get an appropriate perspective on the role of RTAs and their

constraints. In this chapter we will try to address some of these factors in our analysis. We also identify several areas where further research and data collection would be useful for a better understanding.

### 3. Observations and Stylized Facts on Agricultural and Trade Policies in SSA and RTAs

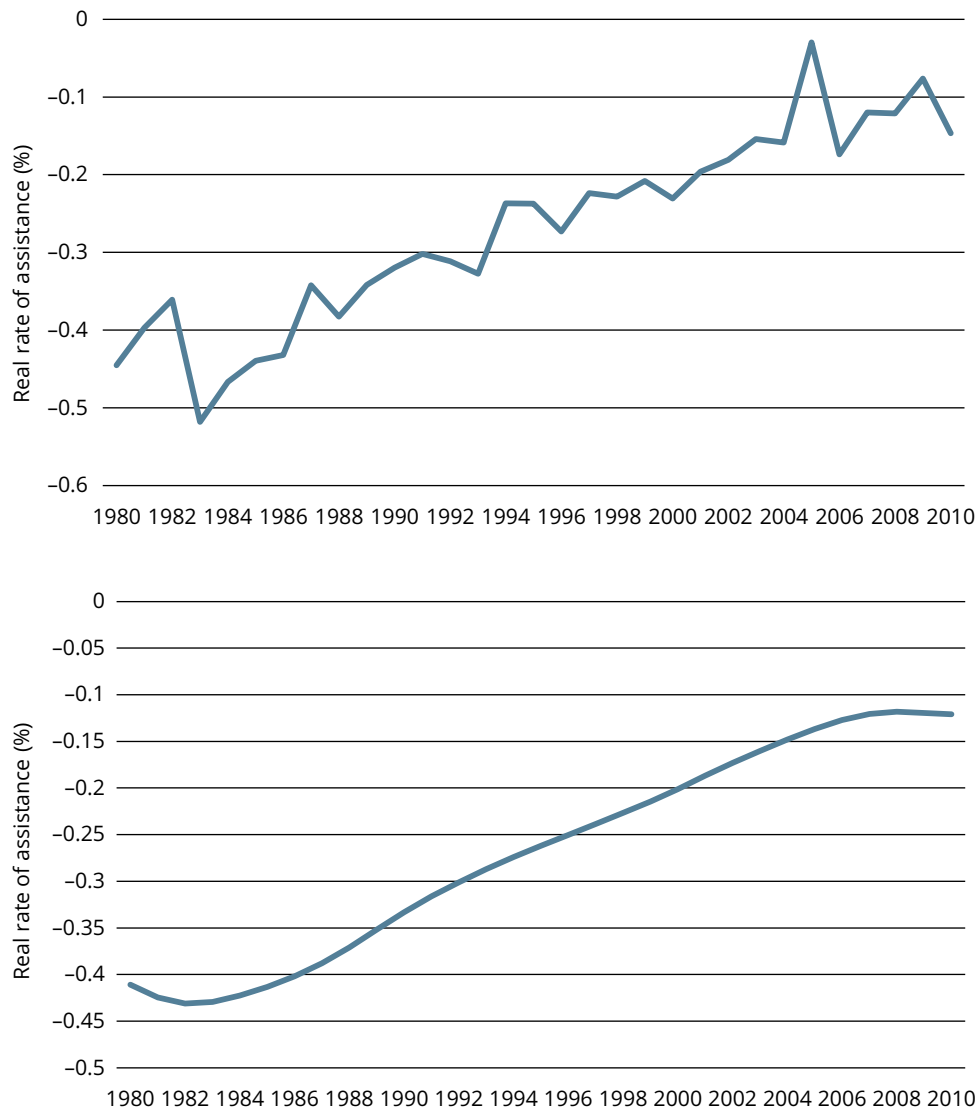
We now review how agricultural trade policies in SSA have evolved over the past decades and how this relates to regional trade agreements. As we will document there have been major changes in agricultural and trade policies in SSA and in the various RTAs. These observations and stylized facts will serve as inputs into the political economy analysis.

To document the (changes in) agricultural and trade policies, and to provide us with stylized facts, we use the best indicator available, which are the Real Rates of Assistance (RRAs) and Nominal Rates of Assistance (NRAs) from the World Bank's Agricultural Distortions Project, led by Kym Anderson (Anderson 2009; Anderson and Masters 2009).<sup>3</sup> For SSA the dataset includes data from nineteen countries (Box 1 lists the countries and their grouping by RTAs that we will use). We will present both the actual numbers and “smoothed” graphs, which are used to better illustrate historical trends.

Figure 2 shows the evolution of RRAs for SSA as a whole since 1980. The figure clearly demonstrates the very substantial reduction in taxation of agriculture in SSA over the past thirty-five years. The average level of taxation reduced from more than 40% in the early 1980s to around 15% in the early 2000s. In fact, the average RRA in 2005 was close to 0. However, the figures also clearly show the impact of the food price spikes after 2007 and how it caused a reversal, at the aggregate level, of policies. In recent years the average RRA fell again to around 15%.

These RRA evolutions are consistent with various case studies documenting the reduction in agricultural taxation over the 1985–2005 period, and the introduction of various measures to limit the increase in food and agricultural prices since 2007. These are the aggregate indicators. Not surprisingly, these average trends hide much heterogeneity across countries and commodities.

<sup>3</sup> See Anderson (2009) for definitions and an elaborate discussion of RRAs and NRAs.

**FIGURE 2: Real Rate of Assistance to Agriculture (RRA) in SSA (Actual Numbers and Smoothed)**

Source: World Bank Data Estimates of Distortions to Agricultural Incentives

### 3.1 Variations among RTAs

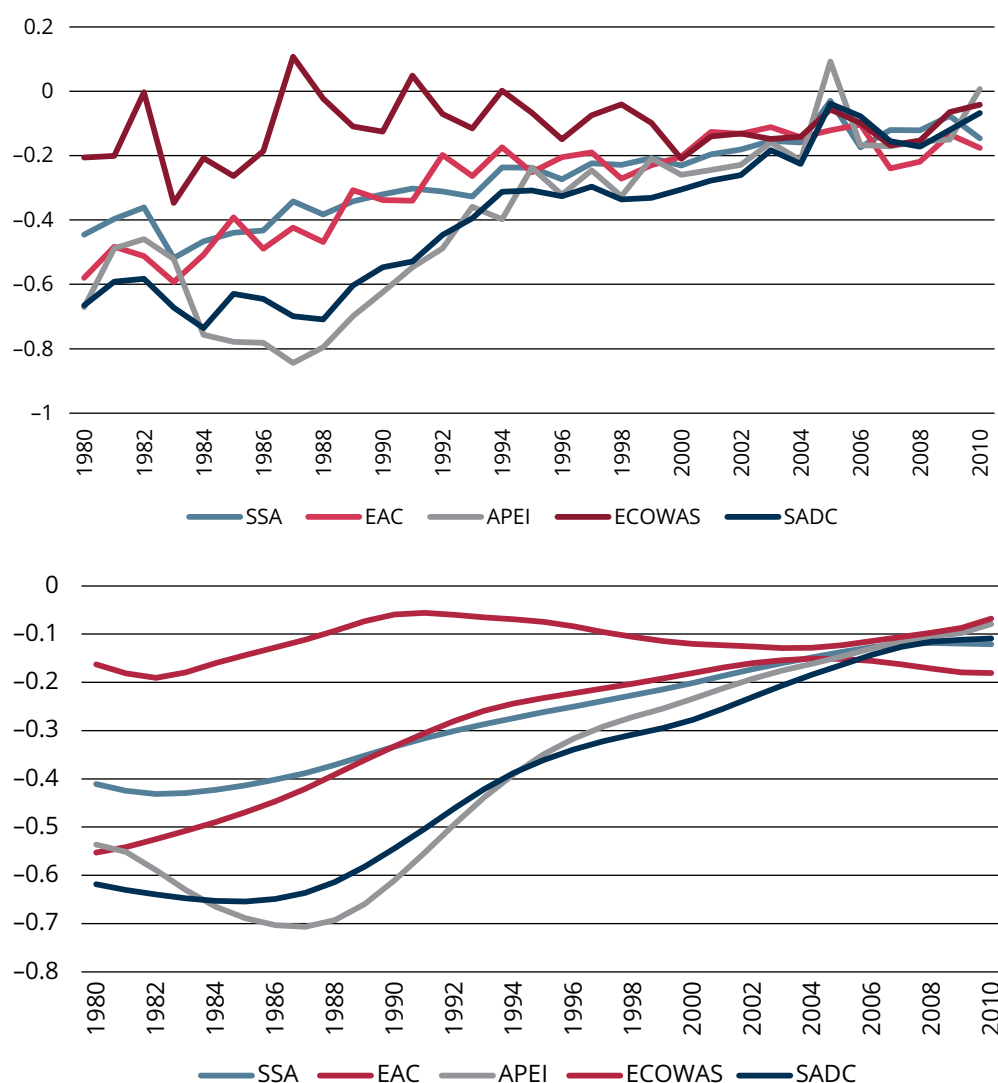
Figure 3 shows that the level of taxation varied significantly between RTAs in the 1980s: from 10–20% in ECOWAS to 60–70% in SADC and APEI. Yet across the entire continent there was a significant reduction in taxation and the RRAs in all RTAs converged to around 15% in 2005. Since then there has been a divergence again with average taxation increasing again (RRAs becoming more negative) in East Africa (EAC) while falling further (RRAs increasing) in the other RTAs.

### 3.2 Import—Competing versus Exportable Commodities

As Anderson and Masters (2009) already indicated, there is important heterogeneity in the RRAs and NRAs in sub-Saharan Africa not just between countries (and RTAs) but also among different commodities. One of the key distinctions they make is between “import-competing” and “exportables.” They conclude

- that there exists an overall anti-trade bias with imports facing import tariffs and exports facing export taxes; and

**FIGURE 3: Real Rate of Assistance to Agriculture (RRA) by Regional Trade Agreement (RTA) (Actual Numbers and Smoothed)**



Source: World Bank Data Estimates of Distortions to Agricultural Incentives

- that there was a significant RRA gap between exportables, which were heavily taxed, and import-competing products, which received some government protection, albeit relatively minor on average.

### 3.3 Staple Foods versus Other Agricultural Commodities

To further understand the variations among specific crops and sub-sectors, we focus on staple crops versus other types of commodities. Following Poulton, Kydd, and

Dorward (2006) and Swinnen, Vandeplas, and Maertens (2010), we disaggregate into several subgroups:

- industrial crops (IC, including coffee, cocoa, tea, rubber, oil crops, cotton, and tobacco),
- fruits and vegetables (F & V),
- roots, tubers, and pulses (RTP),
- cereals.

Notice that “staple food crops” thus include two of our groups: “roots, tubers, and pulses” and “cereals.”

While these groups still include a mix of products, the commodities in these groups share important common characteristics (which we will discuss below in more detail), and which will influence the impact of trade and market liberalization on the commodity performance.

If we look at the taxation/protection rates by commodity groups, again we see major differences. For SSA as a whole, staple crops were much less taxed than industrial crops and F&V. In fact, the NRAs of both staple crop groups have been close to zero for the entire period. Roots, tubers, and pulses have been close to zero and there were few, if any, domestic regulations of their markets.

While cereals have been exported and imported, on average, government policies, as captured by the NRAs, were neutral and, if anything, they were positive. For example in the years 1987, 1991, 2005–6, and 2009, years of falling global cereal prices, there were brief periods of NRAs of 10–20%, probably reflecting domestic stabilization measures.

Figure 4 clearly illustrates how the taxation of industrial crops and F&V was the main reason for the low average NRAs in the decades before 2000. NRAs were –30% to –50% in the 1980s and have gradually increased to taxation rates of 5–10% (NRA = –5 to –10%). These commodities were the main export commodities and governments taxed them heavily. This tax was gradually removed over the past twenty-five years with liberalization processes, often as part of broader structural adjustment programs.

Figures 5 and 6 illustrate commodity specific NRAs by RTA. These figures show that for three of the four commodity groups the patterns which we just identified for SSA as a whole hold for each of the four RTAs: NRAs around zero for roots, tubers, and pulses; increasing from heavy taxation to much less taxation for industrial crops and F&V.

Only for cereals do we observe significant differences among regions. Cereal producers received significant support in EAC from 1990–2005, and in ECOWAS for the entire 1980–2005 period, but in both regions this support has disappeared with increasing cereal market prices in recent years.

In contrast, cereal production was significantly taxed in APEI and SADC in the 1980s but this taxation was removed and NRAs were close to zero for the 1993–2005 period in both regions. (There are no NRAs for SADC after 2005 and APEI.)

### 3.4 Declining Import Tariffs

While the NRAs document a reduction of taxation of farmers in SSA, data on import tariffs suggest that other important policies have also been liberalized over the past twenty years. As Figure 7 shows, based on World Development

Indications, applied weighted tariffs for primary products have fallen in SSA over the 1995–2011 period: from an average of around 14% (which includes many agricultural products, including staple foods) to around 6% in 2004.

These are low numbers and average tariffs have remained low over the past decade. The food price spikes in the late 2000s did not change this. If anything they reinforced the trend toward lower tariffs as governments reduced tariffs on food imports. Figure 7a and b illustrate that there are significant differences in average tariffs between the RTAs, but that the pattern of significant tariff reductions to low average tariffs in recent years is common for all RTAs.

### 3.5 Increased Export Constraints since 2007

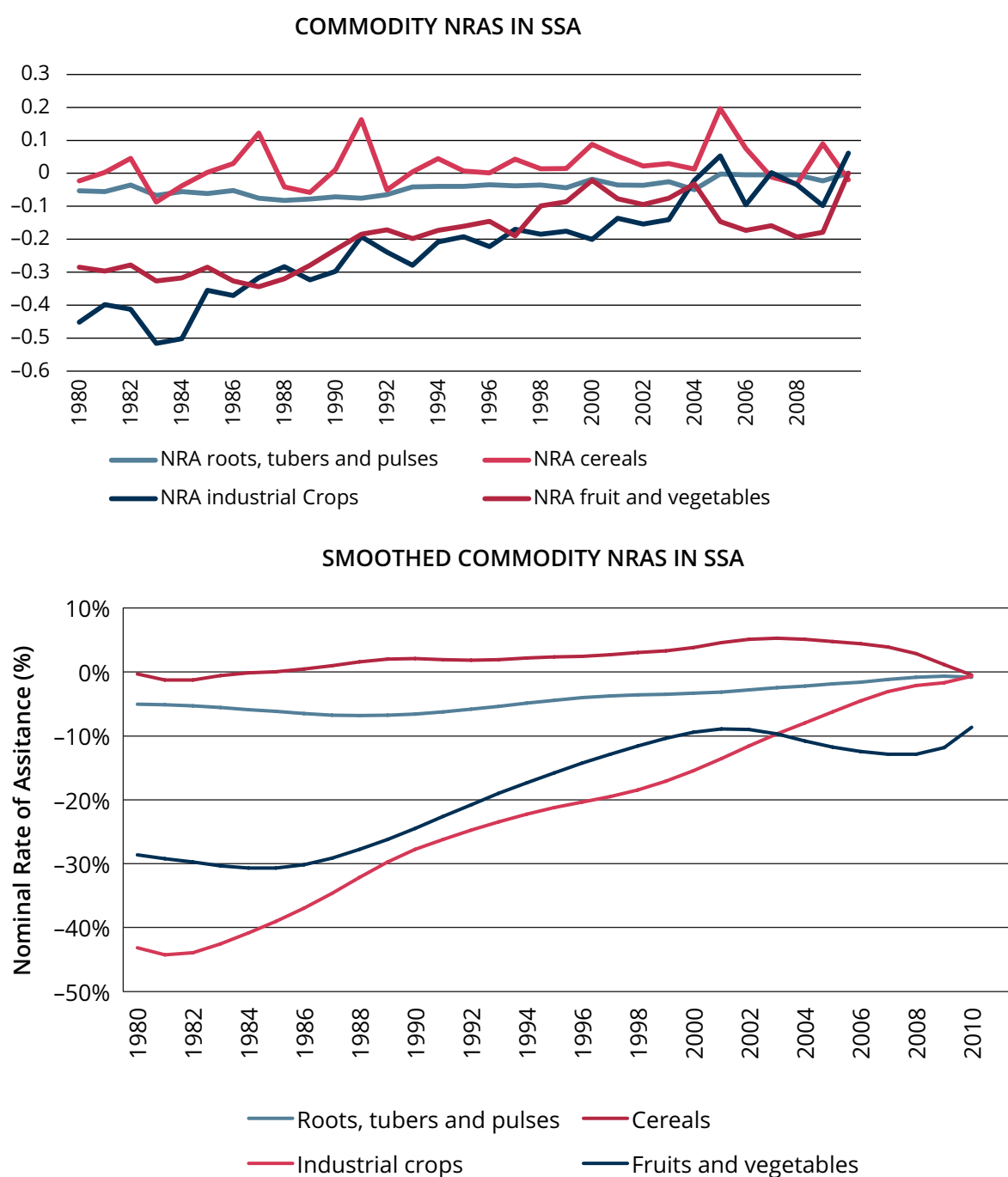
The food price increases after 2007 did induce other government regulations to limit the price increases. In particular governments tried to limit the outflow of food by imposing export constraints (mostly export bans) on food exports. Various studies document the introduction of such export bans, in particular on cereals (e.g., Dorosh, Dradri, and Haggblade 2009; Bryan 2013).

However, these policy changes were not limited to SSA. In fact in many developing and emerging countries the same policy changes have been observed, including in countries like China, India, Russia, Ukraine, Kazakhstan (Barrett 2014; Ganguly and Gulati 2013; Sedik 2011). In a comparative analysis Wodon and Zaman (2008) find that 22% of African countries introduced export restrictions compared to 33% in non-African countries they studied (see Figure 8).

### 3.6 Input Subsidies

Many African countries have implemented input subsidy programs in the past decade. For example, Jayne and Rashid (2013) document extensive government expenditures on fertilizer subsidies in the SSA countries since 2008. Several of these programs started earlier. However, these input market programs are not captured by the NRAs and RRAs since the input values for the indicators are mostly zero. One reason may be that there are no official data on these subsidies—for most countries (Jayne and Rashid 2013, have computed their estimates from “secondary data”). In any case, the RRAs and NRAs are probably overestimating taxation (underestimating subsidization) because of this. However, as we explain later in the document, regulations of input markets may also hurt producers, which would have the opposite effect on RRAs and NRAs.



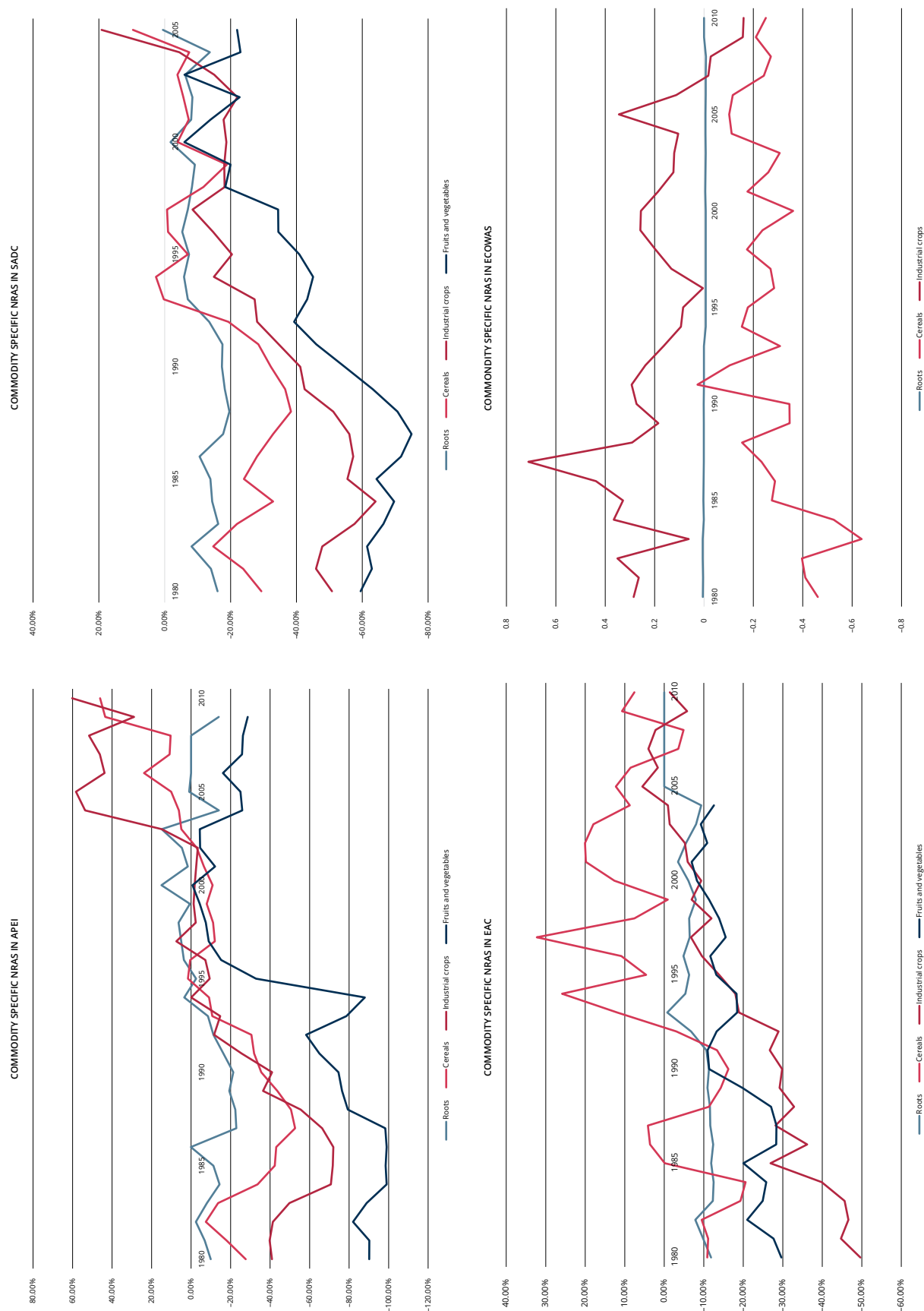
**FIGURE 4: Nominal Rate of Assistance to Agriculture (NRA) by Commodity Groups**

Source: World Bank Data Estimates of Distortions to Agricultural Incentives

### Summary

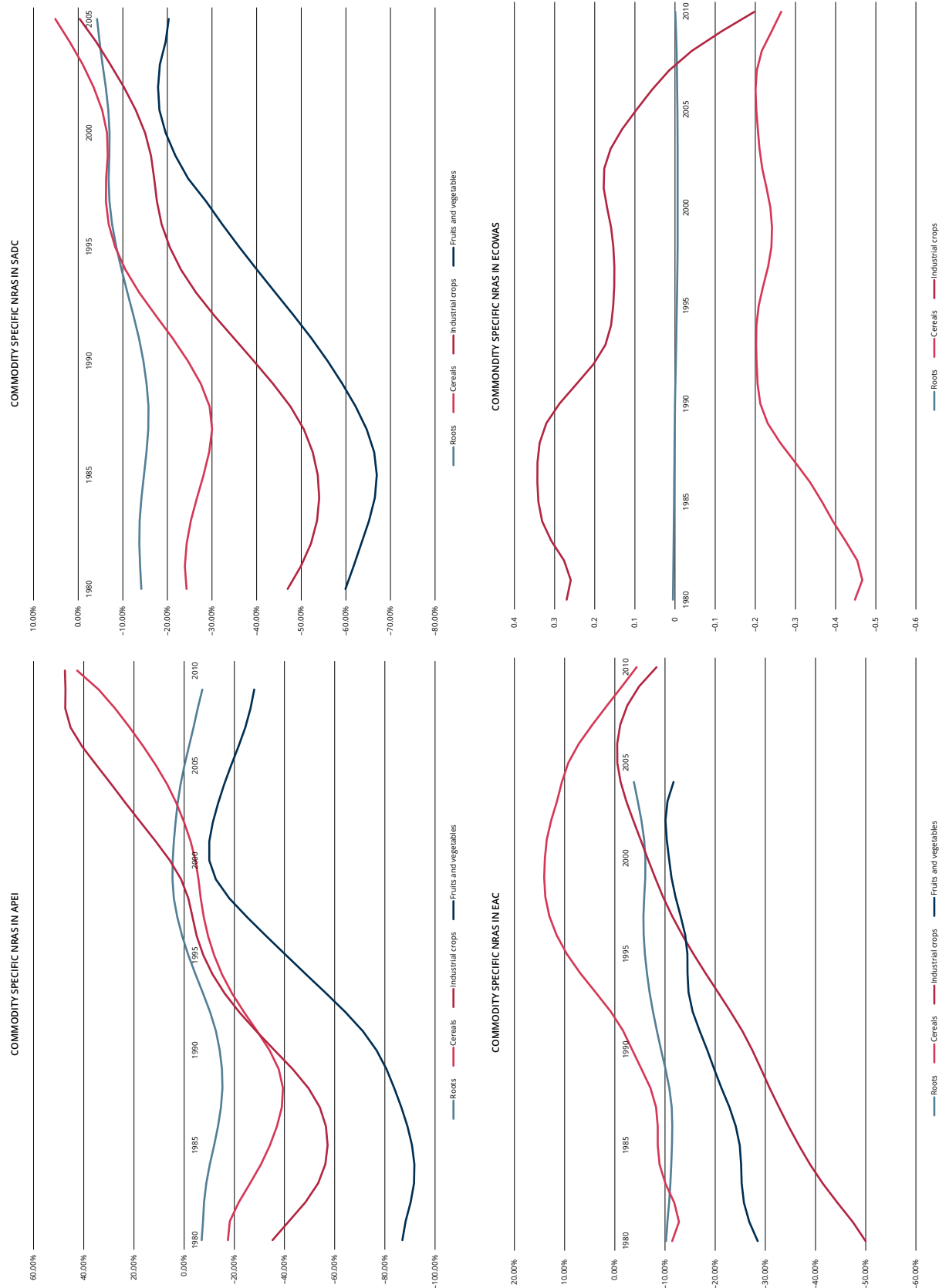
In summary, the longer run empirical evidence as presented here does not seem to lead to a conclusion that we need to explain the “persistence of agricultural trade barriers,” as argued in some other reports.

In fact, the nature and extent of trade barriers has changed greatly over the past two decades and we have witnessed a period of significant liberalization of agricultural trade, including a dramatic reduction of export taxes and import tariffs.

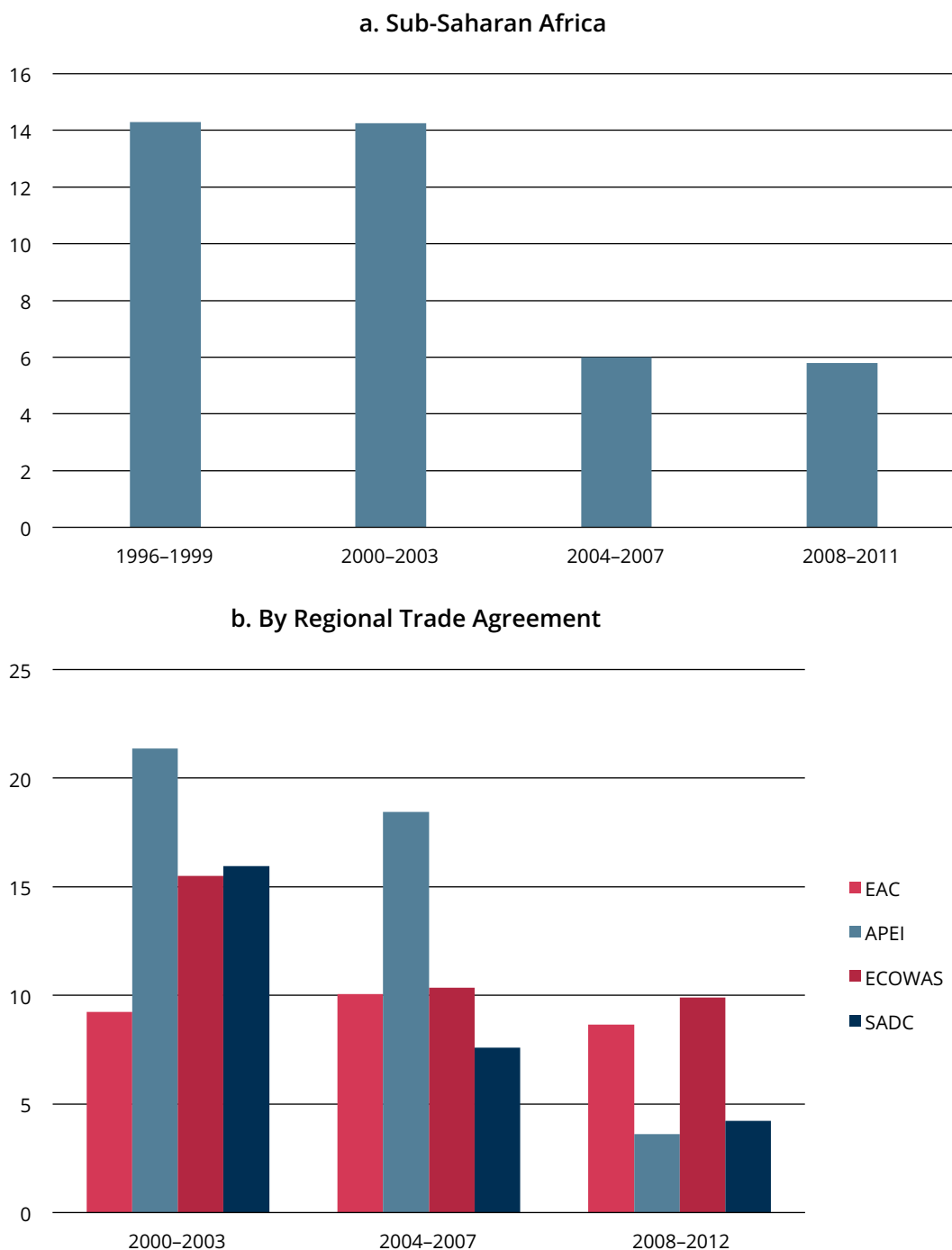
**FIGURE 5: Nominal Rate of Assistance to Agriculture (NRA) by RTAs and Commodity Groups—Actual**

Source: World Bank Data Estimates of Distortions to Agricultural Incentives

FIGURE 6: Nominal Rate of Assistance to Agriculture (NRA) by RTAs and Commodity Groups—Smoothed



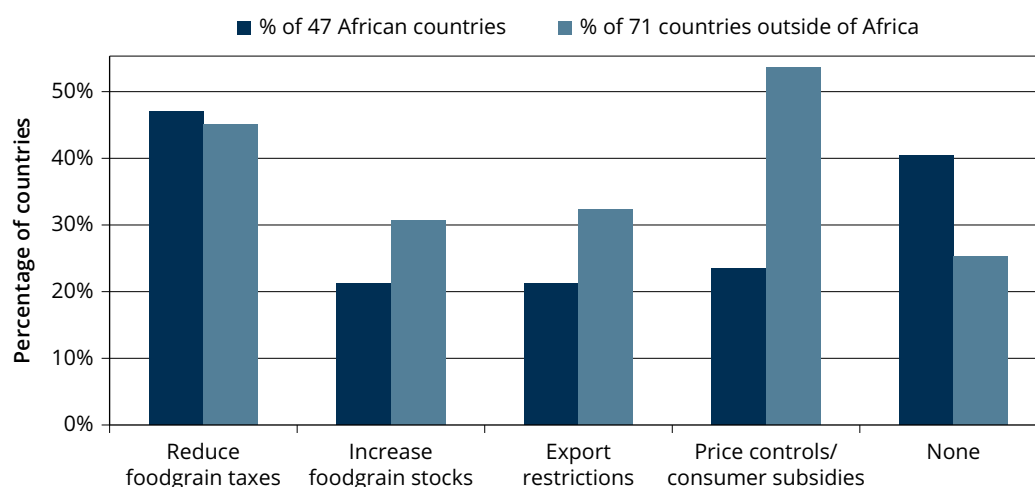
Source: World Bank Data Estimates of Distortions to Agricultural Incentives

**FIGURE 7: Applied Weighted Mean Tariffs for Primary Products for SSA and by RTA**

Source: World Bank Data Estimates of Distortions to Agricultural Incentives

The policy changes after 2007 have not so much returned to previous (regional) trade obstacles—since tariffs were kept low or were even further reduced—but changed the nature of the trade interventions with a shift

from export restrictions on cash crops (“industrial commodities”) to cereals. In fact, export taxation of cash crops seems to be lower than ever (with RRAs close to zero) in the past decade. In other words, the “reversal” in RRAs was

**FIGURE 8: Food Price Policies of African Countries and the Rest of the World**

Source: Wodon and Zaman (2008)

not a return to old interventions but due to a switch in taxation from industrial crops to cereals.

On average for SSA the NRA for cereals was only 5% lower in the late 2000s compared to the early 2000s. However the decline seems to be considerably stronger in EAC (around –15%) and especially in ECOWAS (around –30%). Yet, these declines in NRA may be overestimated in recent years as increased input (fertilizer) subsidy programs are not captured in the NRAs and RRAs. Moreover, a significant part of staple food commodities had no policy regulations or trade restrictions throughout the entire period.

Many studies claim that with a reduction in tariffs, etc., there has been an increase in NTMs (e.g., Kalaba 2012; Hoekman and Nicita 2011; Keane, Call, and Kennan 2010). However (as we will argue in more detail in section 6 of this chapter) it is unclear how much impact these interventions had (and in the case of standards even in what direction the impact was). In fact, it is not clear whether trade suffers more from too many standards or from too few (efficiently enforced) standards.

In the next section we use a political economy framework to explain the changes in the nature and extent of trade barriers, and draw conclusions on how RTAs could affect these in the future. Such analysis is not only important to understand the policy changes and the (lack of) importance of RTAs in the past, but also for the future. In

order to have a perspective on the future political economy constellation, and how to influence this, it is important to also understand the factors that underlied the major trade policy transformation that occurred over the past decades in African agriculture.

## 4. Political Economy

### 4.1 Anti-Trade Bias and Variations in Taxation to Commodity Groups

There are several reasons to expect differences in NRAs not only among countries but also among specific agricultural commodities within a country. One explanation relates to the stylized fact of a significant anti-trade bias over the past decades: exportables were often taxed while import-competing commodities were often protected by tariffs, a phenomenon which was general in Africa and elsewhere (Anderson 2009).

A first factor is a reason similar to that underlying countercyclical support (see further). Theory predicts that governments are more likely to support (sub-) sectors with a comparative disadvantage (imports) than (sub-) sectors with a comparative advantage (exports). Since benefits from market returns are lower in sectors with a comparative disadvantage, those sectors' incentives to seek income from government support are also relatively

higher.<sup>4</sup> In these (sub-) sectors, returns to investment in lobbying activities dominate returns from market activities and so indirectly support an anti-trade bias.

Second, tariff revenues and export taxes increase government revenues, while export and import subsidies require outlays. It is always less contentious for governments to tax than to subsidize trade: taxing raises government revenue and, in the case of larger economies, improves their terms of trade, whereas trade subsidies do the opposite.

In African countries in which tax-collection institutions are weakly developed, trade taxes (either import tariffs or export taxes) are often an important—or the only substantive—source of tax revenue (Rodrik 1995). This revenue motive for governments will affect not only total RRAs but also the choice of policy instruments. If the tax infrastructure is less developed, governments have greater incentives to use tariffs instead of policies such as direct income support to assist farmers.

Empirical evidence for the government-revenue motive is mixed. Dutt and Mitra (2010) find some support for it, but Masters and Garcia (2010) and Bates and Block (2010, for Africa in particular) find either mixed or conflicting evidence.

However, it may be that the revenue motive has weakened over time as developing countries have learned to introduce and apply value-added taxes more efficiently (Tanzi and Zee 2000) and, in more recent years, as new information technologies have lowered the cost of providing conditional cash transfers to targeted groups (Alatas et al. 2012). These factors may be elements in the significant reduction in export commodity taxation and import tariffs that we documented above.

### **Absence of Government Interventions in Parts of the Staple Food Market**

A key observation is that NRAs are close to zero for the staple food group of “roots, tubers, and pulses.” This can probably be explained by two factors. The first is the absence of trade in these commodities. Hence govern-

ments cannot raise revenues from taxes on either imports or exports of these commodities.

The second reason is related to trade but is a more general point and concerns the costs of implementing (and enforcing) certain policies. These costs can differ strongly depending on the nature of the commodity. For example, commodities which are perishable and require processing (with scale economies), such as sugar, cotton, and dairy products, are typically marketed through processing companies—a point at which governments can intervene at relatively low cost. For the same reason, governments can use their control over border crossings and ports as a mechanism for lowering enforcement of tax implementation. However roots, tubers, and pulses are often produced by small farmers and transacted at decentralized locations, often local markets, in small volumes among numerous agents. This makes it very costly for governments to regulate, tax (or subsidize) these commodities.

## **4.2 Political Economy of Reduced Trade Distortions 1985–2005**

The previous factors explain the differences among commodity trade restrictions, but not why trade policies have changed over the past twenty-five years.

### **RTAs**

One explanation could be the introduction of RTAs. There is no obvious way to quantify the impact of the RTAs on trade restrictions and other agricultural policies in a systematic way with the data that are available. A simple visual comparison of the NRAs/RRAs “before and after” the introduction of the RTAs (or when there were significant formal “deepenings of RTAs”) suggest that the RTAs are introduced during or after periods of liberalization rather than preceding them.

Figures 5 and 6 illustrate how NRAs were stable during the period of SADC introduction. In EAC, NRAs in cereals were very volatile before and became more stable afterward, and then declined in the years with high food prices. In other commodities there was no change in the trend. For ECOWAS, the introduction and deepening of the RTA seems to have occurred when reductions in cereals NRA was already going on (and they did not prevent a rebound around 1998–2002). For the other commodities there is no change in trend. Obviously, such visual correlation cannot show (absence of) impact, but it appears to be in line with other arguments that the RTA impact has been mostly formal and less so effective. In fact, it may be that RTAs were part of a period of liberalization rather than the other way

<sup>4</sup> Other factors explaining commodity differences include demand and supply characteristics. Raising tariffs on commodities which are more important for consumers, such as staple foods, will be opposed more often than will raising tariffs on commodities which are less important as a consumption item, and vice versa for producers (Anderson 1995; Swinnen 1994). Demand and supply elasticities also affect the distortions and costs of policies (Gardner 1983).

around. Hoekman and Winters (2009) in fact argue that most significant economic reforms within trade agreements are typically driven by domestic purposes rather than by trade rule constraints (i.e., “most reform is unilateral”).

RTAs, as other trade agreements, have their limitations in what they can achieve in terms of contributing to domestic reforms or policy consistency. This is, in particular, in sectors where there are typically both consumers and producers on both sides of the trade equation, and which have long traditions in policy interventions—as in agriculture.<sup>5,6</sup> In other words, most gains from trade can be achieved among countries with strongly different comparative advantages, something which may be less the case among neighbouring countries, especially with high trade costs.

Hence, in line with Hoekman and Winters (2009) and Hoekman and Kostecki (2013) we forward alternative drivers for trade policy changes and the improvement in policies for African farmers, one external and one internal: (1) liberalization forced by the structural adjustment programs in the 1980s and 1990s and (2) changes in the fundamental political economy equilibrium caused by growth and economic restructuring, lowering of information costs, and changes in governance structures.

### **Structural-Adjustment Programs and Policy Conditionality**

In the 1980s, international financial institutions (such as the World Bank and the International Monetary Fund) started imposing policy conditions on African countries as part of their lending. The structural-adjustment programs

(SAPs) in Africa in the 1980s and 1990s were very controversial. These programs often required the borrowing governments to liberalize their policies, with the justification that such changes would enable them to repay the loans on schedule. Some policy reforms were reversed after the loans were in place, but many appear to have stuck (Akiyama et al. 2001; Kherallah et al. 2002).

There is little quantitative empirical evidence on how important the structural adjustment programs were in influencing agricultural trade policies directly in Africa (or anywhere else). Swinnen, Vandeplas, and Maertens (2010), using different indicator variables, do not provide causal evidence, but document that in sub-Saharan Africa, the introduction of the structural-adjustment programs are correlated with a significant reduction of taxes on farmers. They find that they are correlated with an average increase in RRAs of approximately 20 percentage points. Williamson and Haggard (1994) suggest that the most important impact of the SAPs was not direct but indirect. They argue that the most useful effect of these programs came not in the form of hard conditionality (“leverage”) but rather from shifting the domestic intellectual climate and public discourse in these countries toward favoring freer markets.

### **Political Reforms, Infrastructure, Information Costs, and Economic Growth**

Whatever direct or indirect influence the SAPs had, their impact on reduction of taxation of farm exports has probably been helped by fundamental changes in the political economic equilibrium over the past twenty-five years in Africa (Anderson, Ivanic, and Martin 2013).

Several African countries have experienced democratization over the past decades. The implications for agricultural trade policies are not straightforward.<sup>7</sup> The very

<sup>5</sup> The GATT went through almost four decades and several trade rounds, significantly reducing tariffs in trade in industrial goods, before agriculture was included in the GATT/WTO Uruguay Round agreement in 1992, with trade rules which had limited impact on actual agricultural policies. Until today, one has not managed to agree on further agricultural trade policy restrictions.

<sup>6</sup> One illustration of this is the difficulty and sensitivity of effectively integrating agriculture in virtually all trade agreements. One of the earliest examples of regional trade agreements is the 1948 Benelux agreement between Belgium, the Netherlands, and Luxembourg, which had to be postponed for more than a year because of conflicts over agricultural trade rules. Similarly, it took ten years after the signing of the Treaty of Rome which founded the European Economic Community in 1957 for the agricultural policy and trade rules to be implemented. In the Central European Free Trade Association (CEFTA), the RTA which integrated the Central European countries in the decade between the transition to market economies and their integration to the EU, the CEFTA agreement was only agreed after all the main agricultural commodities had been moved to appendices, providing them

exceptions from trade liberalization and market integration. (As a consequence, a paradoxical effect of the integration of the CEFTA countries into the EU in 2004 was the liberalization of agricultural trade among the CEFTA countries, with important impact on their trade in agricultural and food products.) And before EU Accession agriculture was one of the most sensitive areas in the EU-CEFTA trade integration discussions (Pokrivcak 2007).

<sup>7</sup> Theoretical formulations have been advanced to explain how democratization will affect public policies. Models based on the median-voter theorem predict that democracies tend to redistribute from the rich to the poor. This is expected in democracies because the distribution of political power (measured by votes) is typically more equal than the distribution of income and wealth (Alesina and Rodrik 1994; McGuire and Olson 1996; Persson and Tabellini 1994). Similarly, democratic regimes could lead to trade policy reforms if these reforms created more winners than losers (Giavazzi and Tabellini 2005).



factors that make it difficult for farmers to organize politically (such as their large population size and wide geographic dispersion in many African countries) render them potentially very powerful in electoral settings (Bates and Block 2010; Varshney 1995).

Under autocratic regimes, governments (rulers) can follow their personal preferences to a greater extent in selecting policies. So the impact of democratization is likely to depend on the previous governments' preferences such as left-wing or right-wing ideologies or their regional interests. Bates and Block (2010) show that the regional backgrounds of leaders in Africa significantly affected their policy preferences. Leaders who drew their political support from cities and semi-arid regions (as in Tanzania and Ghana) seized a major portion of revenues generated by the export of cash crops (coffee and cocoa). In contrast, in countries where leaders drew their support from regions where cash crops were important sources of income (such as in Kenya and Ivory Coast), leaders employed the power of the state to defend the fortunes of their (wealthy) regions and imposed little, if any, taxation on coffee and cocoa exports.

Whatever the autocrats' preference structure, be it ideological or regional, introducing democracy is likely to reduce the influence. A recent study by Olper, Falkowski, and Swinnen (2014) using the time-series and cross-sectional variation in the World Bank's RRA data shows that, on average, democratization contributed significantly to the reduction of agricultural taxation in developing countries, presumably because it, on average, provided more influence "through the power of numbers" to farmers and rural households.

Improvements in rural infrastructure have affected agricultural interests' ability to organize for political action. Olson's (1965) collective-action theory predicts that in poor countries, food consumers (net buyers of food) will wield more political power than farmers (and even more than the subset of net sellers of food). Consumers are often concentrated in cities, where political action-coordination and enforcement costs are more favorable than in the rural areas where farmers reside. However, as the economy develops—and especially, as the share of agriculture in employment declines and rural infrastructure improves—the cost of political organization for farmers decreases. This cost reduction is likely to increase the effectiveness of farmers' representation of their interests and, as a consequence, of their lobbying activities (Rausser, Swinnen, and Zusman 2011).

Information plays a crucial role in political markets, organization, and policy design. Forces that change information costs may cause changes in public policies, including agricultural protection. One example is enhanced rural communication infrastructure, which occurs either through public investments (as in many high-income countries earlier in the twentieth century) or, more importantly for Africa, through technological innovations and commercial distributions (as in the recent dramatic increase in mobile-phone use in Africa).

Another influencing factor is the spread of mass media such as television and radio (McCluskey and Swinnen 2010). Access to mass media empowers people politically, and a more informed and politically active electorate increases the incentives for a government to be responsive (Besley and Burgess 2001; Strömberg, 2004a).<sup>8</sup>

Mass media can also alter the political-economy mechanisms between group size and political mobilization by providing more information to larger groups (such as farmers in Africa), because of scale economies in media markets, and thus enforcing their lobby power (Kuzyk and McCluskey 2006). Olper and Swinnen (2013) empirically find confirmation that the spread of mass media has contributed to the reduction of taxation of farmers in developing countries by reinforcing the influence of large groups (farmers and rural households).

There has been significant economic growth in SSA over the past decade. Economic growth typically coincides with a rise in urban-rural income disparities, creating political incentives for farms to demand—and politicians to supply—policies to reduce that income gap. Moreover, the structural changes that accompany economic development alter the political costs and benefits and, thus, adjust the political-economic equilibrium. Such shifts in the equilibrium have led countries to move gradually from taxing to subsidizing agriculture relative to other tradable sectors.

With economic growth, the costs of agricultural protection also change (Anderson 1995; Swinnen 1994). With growing incomes, the share of consumer expenditures on food declines typically, which reduces urban and industrial

<sup>8</sup> This influence has been found for various types of government and aid programs in Africa, such as disaster relief (Francken, Minten, and Swinnen 2012), less corruption in public food provision (Besley and Burgess 2002), and rural educational spending (Reinikka and Svensson 2005).

interests' opposition to agricultural trade protection. In other words, even though the share of farmers in the voting population also declines, less opposition to protecting farmers arises when there are fewer of them. Swinnen (1994) shows that under plausible assumptions, the second of those two effects dominates.

The growth and concentration of agribusinesses and food-processing companies, which are sometimes aligned with farm interests in lobbying for agricultural policies, serve to strengthen pro-farm interests (Anderson 1995; Swinnen 2011). If farm lobbies and agribusiness interests can coalesce and are well capitalized and concentrated, they can be an important force in orchestrating public policies that benefit their interests.

### 4.3 Political Equilibria in Times of High and Volatile Food Prices 2005–2013

We now turn to explaining the changes in the cereals markets in recent years, and the role that RTAs have (not) played. In this we need to distinguish between the level of trade protection (measured NRAs) and the instruments. We start with explaining the levels.

One key factor in the (political economy of the) changes in policies is what happened on global food markets. Figure 1 illustrates the well-known spike in food prices which started in 2007 and continued in the spring of 2008, the consequent fall in 2009 and the new rise in 2010 and after.<sup>9</sup> The key point is that these price changes not only transformed the food security discussions in Africa and beyond, but also the political economy of agricultural trade and domestic policies, in particular in the cereals markets.

The policy adjustments over the past decade which we documented in section 2 are an example of what is sometimes called "the countercyclical bias" in agricultural trade policies.

Agricultural and food market interventions result from policies designed to alter the resulting distribution of income from what would otherwise emerge under unfettered market outcomes. Changes in food prices may cause important changes in income and welfare distribution.

<sup>9</sup> Important sources on the policies during those periods are Anderson and Masters (2009) for "low price period" and various chapters in Barrett (2014), Naylor (2014), and Pinstrip-Anderson (2014) for the "high price period."

There are theoretical explanations<sup>10</sup> and substantial empirical evidence that this induces governments to intervene in order to (partially) offset these market developments (Swinnen and de Gorter 2002). This tendency involves increasing import tariffs or export subsidies when market prices decline and suspending import tariffs or export subsidies and increasing export taxes when market prices rise. Hence, both exporting and importing nations alter their trade taxes, but in opposite directions.<sup>11</sup>

These factors may explain the shift in trade policies, but they do not explain the nature and instruments if the policy changes.

### Policy-Making in Volatile and Uncertain Times: Fire Brigades!

In times of unexpected and dramatic changes in market conditions with potentially large welfare effects (and thus potentially strong political implications), governments have the tendency to introduce policies quickly, not always fully understanding the implications, and then introducing follow-up regulations to address unexpected side-effects of the policies. These are examples of what I have previously referred to as "Fire Brigade Policy-Making" (Swinnen 1993).

<sup>10</sup> Changes create political incentives to exchange government transfers for political support. The nature of the mechanism through which these changing political incentives operate has been modeled in various ways. For example, Swinnen (1994) has used a politician-voter interaction model, in which differences in marginal utility determine political support and induce politicians to implement policies to counter market developments. Others focus on interest groups' unequal ability to appropriate the benefits of lobbying (Baldwin and Robert-Nicoud 2007). In an expanding industry versus in declining industries Freund and Özden (2008) and Tovar (2009), focus on the importance of aversion to loss in determining political reactions in order to explain why declining sectors such as agriculture receive support and why governments alter their trade restrictions in response to volatility in international prices of food products.

<sup>11</sup> These policy adjustments can thus exacerbate the international price spike. They cause large transfers between food-exporting and food-importing countries by amplifying changes in the terms of trade, favoring food exporters during upward price spikes and food importers when prices slump. Since each country group's action reduces the capacity of the other country group to insulate its domestic markets, little stands to be gained from such measures—and much stands to be lost (at least for one group each time, via the terms of trade) (Anderson and Martin 2013).

These features are certainly characteristic of many government reactions to food price spikes in 2008 and 2010—see Bryan (2013) for a review and the chapters in Barrett (2014) and Pinstrip-Andersen (2014).

Studies document the shift from price measures such as tariffs or export taxes to quantitative measures such as restricted export licenses or outright export bans.<sup>12</sup> Given the fact that export taxes result in government revenue and the fact that African governments have used export taxes on agricultural products extensively over the past decades, it may seem somewhat surprising that many African governments have turned to NTMs, in particular quantitative constraints, to deal with the recent food price increases.

The reason is that in times of uncertainty and confronting an emerging crisis, governments tend to believe that quantitative measures are more likely to be effective in getting the desired result in an uncertain environment. For example, imposing export tariffs to achieve a certain price level and guaranteed availability of food may appear more complicated (and more risky) than imposing an outright ban which supposedly will keep sufficient food in the country and food prices low(er).

However, of course, this logic is too simplistic to fit reality, as the measure itself may induce hoarding and/or smuggling of agricultural products, and may thus undermine or even counteract the measure. Several studies document how such quantitative interventions (such as export bans) have contributed to, rather than solved, volatility and price increases in the markets (e.g., Anderson and Martin 2013; Jayne and Tschirley 2009).

#### 4.4 Regional Trade Agreements: Balancing Commitments and Flexibility

The observation that the African RTAs have not been able to constrain governments turning to ad hoc interventions in recent years is not an African, but a global phenomenon, at least among developing and emerging countries. The dramatic and rapid interventions, typically through quantitative measures have not only been observed in African RTAs, but in many countries across the globe, such as in China, India, Russia, and Kazakhstan, (Barrett 2014; Sedik 2011).

Across the globe, regional or multilateral trade agreements to desist from such insulating actions have been elusive. Bound tariffs were agreed to in the Uruguay Round Agreement on Agriculture, but tariff bindings were set well above applied rates for many countries. Meanwhile, food-export subsidies are still permitted (see further), and export taxes and import subsidies remain undisciplined by the WTO.

So what does this imply for (the political economy of) RTAs? To answer this, let us first return to the basic motivation for RTAs.

#### Commitment, Flexibility, and Escape Clauses

It is important for the functioning (and the approval) of RTAs, as any international trade agreement, to find the right balance between commitments and flexibility (WTO 2007).

There are two main reasons why commitment is important. The first is that without commitment to a trade agreement countries can be tempted to manipulate their terms of trade in order to derive economic benefits to the detriment of their trading partners. This is likely to lead to retaliation from other countries, and thus to a decline in trade (Bagwell and Staiger 1999; 2003).

The second principal reason is that commitment to liberalization obligations under a trade agreement provides government's credibility (and political cover) to overcome domestic political obstacles. By having its policy options constrained due to international trade agreements, the government can make a credible announcement to liberalize, signalling to domestic lobbies that it cannot afford to back down from its commitments without facing the costs of retaliation from its trading partners (Maggi and Rodriguez-Clare 1998).

For both reasons commitment and strict rules are "good" and flexibility to deviate are "bad." However, there are other reasons why trade agreements would not be concluded (or at least would not be as "deep" in terms of the level of obligations) if commitments made could never be changed.

A major argument in favour of leaving a degree of policy discretion to members is the presence of uncertainty over future developments, be they economic shocks or changing political constraints, at the time when a trade agreement is signed. Short of re-negotiating the entire agreement, an "escape clause" may allow a country to do so, even if this implies a failure to honour some of its commitments for a limited amount of time (Bagwell and Staiger 2005; Bagwell 2009). A temporary breach of obligations

<sup>12</sup> A related political economy analysis is on the impact of WTO on instrument choice (see e.g., Swinnen, Olper, and Vandemoortele 2011); and on the political economy of food standards in trade (Swinnen and Vandemoortele, 2009, 2011).

can be efficient, as the costs for the member affected by an unforeseen event may exceed the benefits foregone by its trading partners (Sykes 2006). However, such “escapes” have to be strictly time-limited and subject to the presence of specific conditions in order to avoid moral hazard (i.e., an abuse that would destabilize the entire agreement).<sup>13</sup>

Moreover, the efficiency of “escape clauses” increases with the level of uncertainty (Rosendorff and Milner 2001). If African countries are facing systematically higher uncertainty over the future, a generally higher level of flexibility may be appropriate.

In summary, RTAs need to find a proper balance between the preservation of predictability through a set of rigid and enforceable obligations on the one hand and the provision of flexibility through temporary deviations from commitments under certain (well specified) conditions on the other. Flexibilities can be justified for a variety of reasons and a crucial challenge for RTAs is thus to accommodate needs for flexibility without undermining the fundamental rationale/functioning of a trade agreement.

### **RTAs, Food Prices, and Export Restrictions**

How does food security and food prices fit in this perspective? It is clear from recent experiences that countries/governments are willing to break trade agreement rules if basic needs such as food security are at play, typically associated with very strong political pressure. They will typically argue that such exceptional circumstances require (temporary) exceptions to the trade rules.

In line with the arguments outlined here, some trade agreements recognize these pressures, and in order to allow the overall trade agreements to be approved or to function, explicitly allow for this type of exceptions. For example, while the WTO prohibits the use of quantitative export constraints in general, it allows countries to make exception under specific conditions, including when food prices change strongly.

The WTO distinguishes between various types of export restrictions, and have different rules for quantitative export restrictions (QERs), which restrict the volume of exports, and export taxes, which levy a tax on exports. The former group of measures includes export quotas and

export bans. The second category of export restrictions is export taxes. Export taxes are not explicitly forbidden in the context of the WTO, and a review by Kim (2010) concluded that many WTO member countries had used them at some point.

QERs are in principle forbidden under WTO rules, but there are exceptions that allow QERs to be used in exceptional conditions—of which food security threats, including food price rises, is one (Korinek and Bartos 2012).

Export restrictions are governed by Article XI of the 1994 General Agreement on Tariffs and Trade (GATT). Article XI:1 imposes a general ban on quantitative restrictions, but Article XI:2(a) makes an exception to the general ban by allowing “export prohibitions or restrictions temporarily applied to prevent or relieve critical shortages of foodstuffs or other products essential to the exporting contracting party”. Article XI:2(a) applies not only in the case of shortages in volumes of foodstuffs but also in the case of increases in prices, and it allows for the exception to be country specific and vary depending on which goods are most important to the country in question. When a country uses the GATT Article XI:2(a) shortage exception to justify an export restriction on foodstuffs it must give due consideration to the effect of such restrictions on the food security of food importing countries. Moreover, members must notify the Committee on Agriculture of new export restrictions on foodstuffs and consult with affected member states when implementing them.

Korinek and Bartos (2012) compare RTA provisions on quantitative export restrictions with those of the WTO. Out of the sample of ninety-three RTAs, fifteen agreements contain stronger language than the WTO quantitative export restriction disciplines, while thirty-eight are equal and twenty-two are weaker. Eighteen agreements do not mention quantitative export restrictions at all.

Among the African TRAs, the COMESA as well as the ECOWAS agreement contain no extra regulation regarding export taxes and are therefore considered “WTO-equal” in this respect. At the same time, neither COMESA nor ECOWAS contain anything on quantitative export restrictions. The SADC agreement is considered a “WTO-plus” agreement regarding export taxes, but a “WTO-minus” agreement regarding quantitative export restrictions.

In summary, while the African RTAs do not constrain the introduction of QERs, this is not exceptional. The restrictions on interventions such as QERs in other RTAs and in the WTO are not effective neither—or allow them explicitly.

<sup>13</sup> A related argument is made by Grossman and Helpman (1995) when they explain how a trade agreement may be politically feasible if a few politically sensitive sectors can be excluded from the agreement, or give extra time to be integrated.

## 5. Liberalization, Value Chains, Prices, and Agricultural Performance in Africa

Before drawing conclusions on the political economy of RTAs and trade policies, it may be useful to point at some of the potential effects, which may not always be as expected. There are a mixture of findings in the literature on the net effects of RTAs on trade (e.g., Hoekman and Kostecki 2013). Our arguments go beyond the traditional critiques of RTAs as being both trade creating and trade diverting. Our arguments relate to how trade liberalization may have unexpected effects due to the institutional organization of the value chains.

### 5.1 Liberalization and Performance in SSA Agriculture

Assessment of the effects of earlier liberalization episodes in sub-Saharan Africa typically concluded that the impacts were disappointing. While there was some progress, the consensus appears to be that market reforms did not meet expectations (Kherallah et al. 2002; Barrett 1997; Jayne et al. 2003). In an international comparison of liberalization effects on performance, Swinnen, Olper,

and Vandemoortele (2011) conclude that agricultural liberalization falls between that of liberalizing countries in East Asia and Eastern Europe. In sub-Saharan African output was 35 percent above its pre-reform level after a decade of reform. While this was considerably slower than East Asia, it was much better than in Eastern European and former Soviet Union countries in the early years of liberalization.

However, the picture is less rosy if we look at the evolution of output per capita or output per worker in agriculture. Swinnen, Olper, and Vandemoortele (2011) show that there was hardly any growth in these indicators. Moreover, the steady, but slow, growth of agriculture in sub-Saharan Africa hides important variations among specific crops and sub-sectors. Using the disaggregation we used for the NRA analysis, one finds substantial differences in performance among these groups (see Table 1). Fruits and vegetables and roots, tubers, and pulses have performed better than industrial crops and cereals. Swinnen, Olper, and Vandemoortele (2011) conclude that the lagging performance in cereals and industrial crops reduced average growth in sub-Saharan African agriculture.

These findings are consistent with the indicators over the past two decades—and in particular the period before 2007. While GAO growth averaged 3.7% per year over

**TABLE 1: Growth of Gross Agricultural Output (GAO) between 1990 and 2012 for SSA as a Whole and for the 4 Different RTAs**

#### Growth GAO (total) (%) 1990–2012

|                           | SSA   | EAC   | APEI  | ECOWAS | SADC  |
|---------------------------|-------|-------|-------|--------|-------|
| Roots, Tubers, and Pulses | 150.4 | 63.3  | 141.7 | 251.7  | 85.3  |
| Cereals                   | 106.9 | 94.3  | 154.7 | 158.1  | 86.8  |
| Industrial Crops          | 91.8  | 171.8 | 385.9 | 88.5   | 223.1 |
| Fruits and Vegetables     | 117.5 | 198.2 | 87.7  | 137.4  | 92.9  |
| All crops                 | 116.7 | 131.9 | 192.5 | 158.9  | 122.0 |

\*Yearly Average Index

#### Average Yearly Growth GAO (%) 1990–2012

|                           | SSA | EAC | APEI | ECOWAS | SADC |
|---------------------------|-----|-----|------|--------|------|
| Roots, Tubers, and Pulses | 6.8 | 2.8 | 6.4  | 11.4   | 3.8  |
| Cereals                   | 4.8 | 4.2 | 7.0  | 7.1    | 3.9  |
| Industrial Crops          | 4.1 | 7.8 | 17.5 | 4.0    | 10.1 |
| Fruits and Vegetables     | 5.3 | 9.0 | 3.9  | 6.2    | 4.2  |
| All crops                 | 5.3 | 6.0 | 8.7  | 7.2    | 5.5  |

Source: Authors' calculation based on FAO data

the 1990–2006 period, GAO per capita grew only by 0.4% and agricultural labor productivity (ALP) grew by 1.5%. The numbers in Table 2 also show that growth was much slower in cereals (0.4% growth of production per capita) and industrial crops (0.1%) than for the other commodities: 1.2% for F&V and 1.9 for roots, tubers, and pulses.

These output variations are remarkable given the impact of liberalization on NRAs. If anything, they would predict the opposite in terms of relative performance. More specifically, with significant reduction of taxation of ICs one would expect these crops to have grown fastest.

## 5.2 A Value Chain Perspective on Staple Food Performance

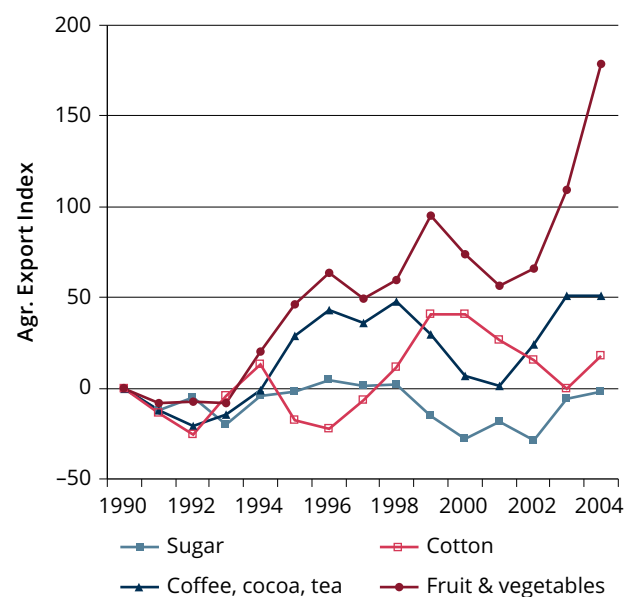
The differences in performance are, however, consistent with a more complex model of value chains, as developed by Swinnen and Vandeplas (2011) and used by Swinnen, Olper, and Vandemoortele (2011) to explain the differences in African agriculture's reaction to trade and market liberalization.

The different reactions may be due to varying institutional organizations within the value chains, partly reflecting differences in the commodity characteristics. For example, industrial crops were strongly dependent on interlinked input arrangements both before and after the liberalizations. In many cases, these production systems rely on extensive outgrower contracting schemes, with processors or traders providing inputs to smallholders in return for their crop output later (see Kherallah et al. 2002; Poulton, Kydd, and Dorward 2006).

However, contract enforcement is problematic in liberalized markets because these are typically medium-value commodities (limiting the amount of surplus to be shared in the system) and because side-selling is relatively easy (compared to the case with high-value export crops), with many traders involved, introduction of competition, and associated collapse in state-controlled vertical coordination have caused disruptions in input provision to farmers and led to below average output and productivity growth, despite a much stronger reduction in taxation than in other commodity groups.

The fruits and vegetables group includes both low-value products for the local market and high-value products for export, for which the impact of the reforms is likely to be quite different. Low-value fruits and vegetables for the local market are produced with little or no external inputs, and the main input is often labor. In contrast, high-value fruits and vegetables for export typically require important

**FIGURE 9: Agricultural Exports from SSA, 1990–2005**



Source: WTO

external inputs (including pesticides and fertilizer). This sector grew very rapidly after the reforms (Figure 9).

The high value in these chains sustained post-reform private investments in the sector and encouraged private vertical coordination with quality upgrading, interlinking (with both large and small farms), and input provision to farmers. Several recent studies show how the vertical coordination mechanisms and their spillovers and productivity growth effects are similar to the growth mechanisms in Central and Eastern Europe (Dries and Swinnen 2004; Minten, Randrianarison, and Swinnen 2009; Maertens, Colen, and Swinnen 2011).

Interlinked contracts in cereal production are typically difficult to enforce because cereals are low-value commodities, with relatively easy sales opportunities to multiple buyers (and thus high competition). Moreover, cereals are typically more easy to store than are more perishable commodities such as fruits and vegetables or some of the roots and tubers. This increases the options for opportunistic behavior for cereal farmers. This has constrained growth in the cereal sector since the reforms. Marketing activities have been taken over by many small private traders and are based on spot market transactions (Coulter and Poulton 2001; Fafchamps and Minten 2001).



In summary, the different experiences of these four subsectors in sub-Saharan Africa—which are masked by the average growth rates—are consistent with the general arguments presented here that reliance on external inputs and value in the supply chains—which affect the endogenous emergence of exchange institutions in a liberalized environment—are crucially important for understanding the impact of trade liberalization in sub-Saharan Africa—and thus far understanding the preferences for trade liberalization in the political economy.

In other words, with extensive interlinking between input and output markets it is difficult to enforce contracts (and thus growth) in input-intensive value chains for low and medium value commodities (unlike in high-value fruits and vegetables).

### 5.3 Food Price Increases, Trade, and Performance

In this value chain perspective, the recent price increases in food prices, and in particular in cereals, may have caused a “double whammy” effect in African cereals markets: it

increases the profitability of investing in cereals production and it enhances the capacity to enforce contracts—and thus access to inputs—in the cereal value chain. This appears consistent with recent data on food production in Africa, which suggest that the price increases have caused important adjustments in food production in SSA with differences between commodity groups.

First, output and productivity have clearly increased since 2007. This is documented by several indicators. The average annual growth of gross agricultural output (GAO) in SSA increased from 3.7% in 1990–2006 to 5.2% in 2007–2012 (see Table 2). In per capita terms, the effect comes out stronger: GAO/capita was close to zero (0.4% average) over the 1990–2006 period, but increased to 2.3% after 2007. If one looks at agricultural labor productivity (ALP) (i.e., the ratio of GAO over labor used in agriculture), the effect is similar: it increased from an average of 1.5% before 2007 to 3.4% after.

Second, the growth response has been particularly sharp in the subsectors of cereal and industrial crops, the sectors which were lagging behind in the 1990–2006 period. The three indicators in Table 3 all show that the

**TABLE 2: Agricultural Output and Labor Productivity (Average Annual Growth %)**

#### Gross Agricultural Output (GAO)

| SSA                       | 1990–2012 | 1990–2006 | 2007–2012 |
|---------------------------|-----------|-----------|-----------|
| Roots, Tubers, and Pulses | 6.8       | 5.8       | 4.5       |
| Cereals                   | 4.9       | 3.8       | 7.3       |
| Industrial Crops          | 4.2       | 3.4       | 3.9       |
| Fruits and Vegetables     | 5.3       | 4.7       | 4.0       |
| All Crops                 | 4.6       | 3.7       | 5.2       |

#### Gross Agricultural Output/Capita (GAO/capita)

|                           |     |     |     |
|---------------------------|-----|-----|-----|
| Roots, Tubers, and Pulses | 2.2 | 1.9 | 2.2 |
| Cereals                   | 0.9 | 0.4 | 4.7 |
| Industrial Crops          | 0.4 | 0.1 | 1.6 |
| Fruits and Vegetables     | 1.3 | 1.2 | 1.6 |
| All Crops                 | 0.7 | 0.4 | 2.3 |

#### Agricultural Labor Productivity (ALP)

|                           |     |     |     |
|---------------------------|-----|-----|-----|
| Roots, Tubers, and Pulses | 3.7 | 3.1 | 3.3 |
| Cereals                   | 2.5 | 1.7 | 5.9 |
| Industrial Crops          | 1.6 | 1.2 | 2.6 |
| Fruits and Vegetables     | 2.9 | 2.5 | 2.7 |
| All Crops                 | 2.0 | 1.5 | 3.4 |

Source: Authors' calculation based on FAO data

Sub-sector ALP growth is an approximation since there are no subsector labor data. It is calculated as the change of the sub-sector output relative to the change of labor use in all of agriculture.



poor aggregate performance in SSA agriculture before 2006 was hiding important heterogeneity among sectors. As the GAO/capita and the ALP<sup>14</sup> indicators clearly show, the average growth rates were much lower in the cereals and the industrial crops sectors (IC). However Table 3 also shows that these differences have been reversed since 2007. The average growth rate in IC is now close to that of fruits and vegetables (F&V) (GAO/capita 1.6% and ALP 2.6% compared to 0.1% and 1.2% before 2006). The turnaround is most dramatic for cereals: output/capita growth increased from 0.4% to 4.7% per year and ALP growth from 1.7% to 5.9%.

Third, if we look further into the cereal sector—the staple food that has received much attention during the food crisis and which has witnessed the strongest turnaround—we can identify some further changes (Table 3).

- a. Both imports and domestic production have increased significantly in recent years. Over the 1990–2006 period imports of cereals increased rapidly, while growth of domestic production was slow: growth of per capita imports grew at 7.6% per year while per capita production was almost stagnant (0.3% annual growth).

<sup>14</sup> Note that subsector ALP is an approximation since we do not have subsector labor data. It is the growth of subsector output compared to the growth of labor use in all of agriculture.

However, since 2007 growth of imports has slowed down to 7.4% (4.6% per capita) while growth of domestic production increased dramatically to 7.4% (4.6% per capita)—all average annual numbers over the 2007–2011 period. Hence, they now grow at approximately the same rate. Per capita cereal production in the mid-2000s was around 99 kg per capita (average 2003–2005), approximately the same as in the early 1990s, but since the food price spikes of 2007 has increased to 116 kg per capita (average 2009–2011).

- b. Domestic growth has come from expansion of area, but mostly from productivity increases. The expansion of cultivation area for cereals actually slowed down, on average, if one compares the 2007–2012 period with the 1990–2006 period (0.8% per year versus 2.2% before). However, a closer look at the trends in area use shows that there are three distinct periods over the past twenty-five years: there was a period of rapid cereal area expansion in the early 1990s (5% annual growth from 1990 to 1994) followed by a period of no expansion (–0.06% annual growth from 1994 to 2002) and a period of moderate expansion since 2002 (1.7% annual growth since 2002). Hence cereal area has expanded since 2002 without a clear structural break in 2007. However, there is a clear increase in productivity after 2007. Cereal yields have increased on average

**TABLE 3: Growth of Imports, Production, Area, and Productivity of Cereals, 1990–2011 (%)**

|  | 1990–2011 | 1990–2006 | 2007–2011 |
|--|-----------|-----------|-----------|
| <b>Cereals Imports</b>                     |           |           |           |
| Total <sup>1</sup>                         | 13.9      | 14.9      | 7.4       |
| Per Capita <sup>2</sup>                    | 6.3       | 7.6       | 4.6       |
| <b>Cereals Production</b>                  |           |           |           |
| Total                                      | 4.8       | 3.7       | 7.4       |
| Per Capita                                 | 0.7       | 0.3       | 4.6       |
| <b>Cereals Yields<sup>3</sup></b>          |           |           |           |
| Total                                      | 34.6      | 17.4      | 16.6      |
| Yearly                                     | 1.6       | 1.1       | 3.3       |
| <b>Cereals Cultivated Area<sup>4</sup></b> |           |           |           |
| Total                                      | 39.7      | 34.4      | 4.0       |
| Yearly                                     | 1.8       | 2.2       | 0.8       |

<sup>1</sup> In Millions of Tonnes

<sup>2</sup> Kg per Capita

<sup>3</sup> Kg per Ha of Harvested Land

<sup>4</sup> In 1000 ha

Source: Authors' calculation based on FAO data

by 3.3% since 2007, three times the growth rate of the pre-2007 period (1.1%).

In summary, the food price increases have induced significant growth in SSA agricultural production and in particular in cereal production and in industrial crops, sectors which were showing very slow growth in the decades before. Domestic production growth in cereals now equals import growth. Per capita cereal production has increased by more than 7% per year on average since 2007. The growth has come both from an increase in area and, mostly, from an increase in productivity. Cereal yield growth in recent years (3.3%) is three times higher than before the food price increases.

## 6. The Role of Non-Tariff Measures and Informal Trade

### 6.1 Non-Tariff Measures

In section 3, we have documented the general liberalization of agricultural and food policies over the past decade despite the recent introduction of export constraints. However, several studies emphasize an increase in the use and the impact of NTMs in recent years. It is difficult to assess the importance of these NTMs since there are major data constraints and interpretation problems in the reports on this. Major problems are (a) that NTMs are a mix of different policy instruments, (b) which may (not) affect different commodities, (c) which may have reinforcing or offsetting effects, and (d) the effects of which are hard to measure.

It is not always clear to what extent the NTM policy indicators that are being used capture the effects of actual “policies”—which are set (or changed) by governments, and possibly integrated in international trade agreements—and to what extent they capture the effect of various other factors (institutions, infrastructure, ...) which influence trade. While one can make a plausible argument that also the “non-policy effects” can be addressed by policies, it is clear that these are very different policies, and should be analyzed differently; both in terms of their economic effects, and in terms of the political economy mechanisms. (For example: the economics and politics of building a road is quite different from one imposing export licenses, both in terms of the process and the implementation.)

Consider the case of SPS and other standards. Cadot and Gourdon (2012), using within-product regressions with country effects, conclude that on average SPS measures raise domestic prices of foodstuff by about 13% in

SSA. However, Karugia et al. (2009) find that standards and certification accounts for 0.5% to 5% of total transfer costs and thus even less of the production price. They carefully distinguish between different “transfer costs” and find that trade permits and certifications amount to 4.93% of total transfer costs in Kenya, 0.41% in Tanzania and 2.63 in Uganda (see Table 4) (Karugia et al. 2009).

According to Kalaba (2012), the most important growth comes from a five-fold increase in SPS measures between 2000 and 2010. However, this does not seem to be supported by empirical evidence. For example, the tripartite SADC-EAC-COMESA agreement has set up an on-line based system for reporting and monitoring NTMs which finds that SPS issues are on fifth place in terms of trade complaints.<sup>15</sup>

As we already documented, there is significant evidence for the introduction of quantitative export restrictions (export bans and restrictions on export licenses, etc). As mentioned above, according to Wodon and Zaman (2008), 22 percent of African countries introduced export constraints in response to the food price spike in 2007. From various studies it appears that they have been introduced mostly in cereals, and less so in other commodities, although there is little systematic information on this.

It is unclear to what extent other NTMs did increase (strongly). Most other measures are a mixture of SPS, other types of trade standards and infrastructural and institutional deficiencies that hamper trade. Moreover, it is not quite clear from the studies how much and in what way SPS have affected trade. For example, some studies indicate that a significant part of these SPS measures were introduced before 2008, which was a period of significant trade liberalization, reflected in a convergence of RRAs and NRAs toward very low numbers.

Also, if these SPS measures were intended as (producer) protectionist instruments and were/are intended to protect domestic producers, it is unlikely that their implementation would have continued after 2008 when governments tried to lower food prices for consumers. This

<sup>15</sup> More precisely, complaints can be filed on <http://www.trade-barriers.org/> and the process of elimination can be followed up online, making the entire process more transparent. To date, 466 complaints have been registered of which 381 are reported to have been resolved. Most complaints concern lengthy and costly customs clearance procedures (55) followed by Issues related to the rules of origin (44), Costly Road user charges /fees (32), Inadequate trade related infrastructure (23) and Issues related to sanitary and phyto-sanitary measures (22).

**TABLE 4: Non-Tariff Barriers (NTBs) as a Percentage of Total Transfer Costs**

|   | Kenya | Tanzania | Uganda |
|---|-------|----------|--------|
| Weighbridges  | 2.41  | 0.97     | 4.25   |
| Security  | 0.45  | 0.73     | 0.26   |
| Transiting <sup>1</sup>   | 0.49  | 0        | 33.87  |
| Municipal permits   | 3.61  | 2.39     | 2.21   |
| Council permits   | 3.74  | 4.31     | 1.79   |
| Licenses  | 2.75  | 0.37     | 4.46   |
| Customs clearance   | 12.83 | 0.75     | 2.75   |
| Immigration   | 0     | 0.13     | 0.31   |
| Standards and certification   | 4.92  | 0.41     | 2.63   |
| Road toll stations  | 1.42  | 0.35     | 0.63   |
| Bribes  | 1.94  | 1.27     | 1.41   |
| Transfer costs taken up by NTBs (percent)                           | 34.56 | 11.68    | 54.57  |
| <b>Other transfer Costs as a percentage of total transfer costs</b> |       |          |        |
| Vehicle hire and maintenance  | 46.08 | 69.19    | 21.75  |
| Loading   | 3.8   | 5.45     | 1.51   |
| Off-loading   | 2.19  | 4.51     | 2.01   |
| Transporter's allowance   | 3.38  | 5.51     | 1.38   |
| Other costs   | 10.03 | 3.71     | 18.81  |
| Total transfer costs  | 100   | 100      | 100    |

Source: Karugia et al. 2009

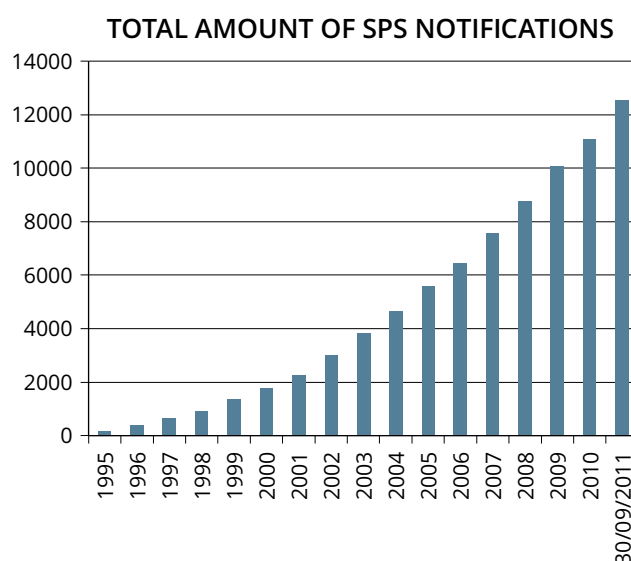
1 Transiting procedures that are cumbersome, unstandardized, and costly

would be inconsistent with all the other observations that we see—and they would have the opposite effects of other policy measures that are introduced.

If the SPS were not affecting domestic consumers (maybe they were not used in locally consumed products—that is not clear) then they do not appear to have affected trade much since the RRAs and NRAs for industrial commodities, mostly exported, have continued to converge to low numbers, thus little intervention effects.

Again, it seems important to take into account that the increase in SPS measures reflects a global phenomenon, not just an African development. For example, Figure 10 shows the rapid increase in SPS measures at the WTO over the past twenty years. The growing trend reflects a changed world of agricultural trade, one in which quality and safety standards of products and the enhanced regulations (including but not only SPS) are crucial components (Swinen and Maertens 2014).

Moreover, in this perspective, various studies have argued and documented that standards, such as SPS, can just as well stimulate trade instead of hamper it (Jaffee and

**FIGURE 10: SPS Notifications at the WTO (1995–2011)**

Source: WTO

Henson 2004). In other words, they can be a “catalyst” for trade, instead of a “barrier” (Maertens and Swinnen 2007). In any case, just arguing that an increase in SPS is an indicator of increasing trade obstacles is not convincing.

## 6.2 Informal Trade

An important issue in understanding the effects and the political economy of trade (agreements) is the role of informal trade. Trade barriers may have a stronger constraining effect on the officially recorded trade than on effective trade. In fact, several studies conclude that income bans, export bans, and cumbersome custom procedures increase the formal transaction costs and therefore encourages the value chain's stakeholders to reorganize in the informal sector (Engel, Jouanjean, and Awal 2013).<sup>16</sup>

The Economic Commission for Africa (2010) argues that informal trade is significant, in particular in some staple commodities. However, these (potential) effects are hard to measure since informal trade is (mostly) unrecorded—by definition.

## 6.3 Trade Constraints for Inputs

Another concern is that with tariff reductions on outputs, policies may have shifted to some extent to influencing trade in inputs. From a political economy view, control over inputs can be important. One reason is that the results of the provision of fertilizer manifest themselves within one crop season while results of investment in roads can

take years to be visible. This is important for politicians that seek to be reelected. Another is that inputs can be targeted to specific groups of interest (Mason, Jayne, and Mofya-Mukuka 2013). There is a lack of representative and comparative data (both across countries and over time) regarding policies that affect trade in inputs. The RRA and NRA policy indicators are zero for almost all inputs in SSA. As we explained earlier (see section 3), this is probably due to lack of official data.

It is not clear how much (and even in which direction) the input NRA (and the total NRA/RRA) are biased since it appears that input markets are affected not just by input subsidy programs but also by other government policies (regulations), and some of these have opposite effects.

In recent years, fertilizer and seed subsidies have been used in many SSA countries (Jayne and Rashid 2013; NEPAD 2013) and these are benefitting farmers (increasing NRAs). However, studies such as the World Bank's 2012 report on “Africa Can Help Feed Africa” and Keyser (2013; 2015) provide clear evidence on how regulations and input distribution costs (including taxes) are hurting farmers (decreasing NRAs). The net effect is not clear.

Most, but not all (e.g., temporary export bans), of the NTBs affecting trade in foodstuff (e.g., roadblocks, cumbersome border formalities, corruption, dangerous borders, low quality roads, etc.) affect international trade in inputs in the same way. Also, specific NTBs seem to hamper trade of inputs.

Cross-border movement of seeds and fertilizer is hampered by SPS and other regulations, differences in certification and standards between countries, and the resulting issues at the borders (World Bank 2012). Infrastructural related issues drive up the price of fertilizer (UNCTAD 2010). Bumb (2009) estimates that transport and distribution costs (including taxes) represents up to 50 percent of the final fertilizer retail price in SSA while this is only 20 percent in Asian countries. Needless to say, this discourages fertilizer use.

Another important factor restricting the movement of fertilizer and driving up its price is the fact that most African countries insist on using their own fertilizer mix and therefore buy directly from the world market. However, markets in most African countries are too small to exploit economies of scale and the countries therefore end up paying a higher price (World Bank 2012). Cost associates with seed registration are high and additional fees apply for reregistering. However, infrastructure and institutional constraints appear at least as problematic.

While one could argue that trade and markets in inputs seem to suffer both from too few (enforced) standards as

<sup>16</sup> For example, the Economic Commission for Africa (2010) and Lesser and Mois-Leeman (2009) listed several reasons for the large share of informal trade in SSA:

*Flexibility:* Many operators in informal trade find it easy to do business compared to formal trade as they are not tied to various rules and regulations as it is the case in formal trade. One of the predominant features in informal trade is the flexibility of doing business.

*Transaction costs,* which are typically higher in formal trade than informal trade, arising from the following, among others: high charges in obtaining a business license, regularized employment of workers; compliance with government laws and regulations, and government taxes.

*High domestic taxes, tariffs, non-tariff barriers, and border checks* where customs officials and police at roadblocks cause long delays.

*Payment systems* are complex and may imply long delays in formal trading, including additional charges such as interest and service charges. Operators in informal trade are often operating with small amounts of capital.

from too many, with institutional constraints limiting implementation and enforcement, by far the most important problem appears to be performance testing requirements. These regulations create unnecessary and very significant constraints on trade on inputs such as seeds (Byerlee, et al. 2013).

For example, Keyser (2013) describes the procedures for seed release in SSA. In short, the introduction of new seeds is controlled through official tests to evaluate the variety's performance. Next, the results are discussed by variety release committees. These committees normally meet once a year but in some countries limited resources do not allow for yearly meetings. At the same time, most African countries prohibit companies to multiply or bulk seeds until the entire registration process has been completed.

Consequently, it often takes up to three additional seasons after a variety has been approved, to build up the necessary stocks before the seed in question can be sold to farmers. But even during the phase of bringing the seeds into the commercial market, strict rules apply in order for a company to receive a certificate or license. In some cases, these procedures have become more about raising revenue by certification bodies than about serving local farmers. In a case study of Uganda's seed industry Joughin (2014) finds that impediments to developing a more competitive market can be attributed to the lack of political benefits for political elites as well as to the risk of significant losses for large farmers and domestic seed producers.

As a result, many seed companies choose to register only a limited number of varieties in each country. These varieties are not necessarily the ones that are most suited for the country in question but are often the ones that are generally suited for each market. In other words, the cost and the time that it takes to get new varieties registered directly affects agricultural production.

To illustrate this, available data from five sub-Saharan countries shows that between 1998 and 2010, a median of 0.62 new varieties across eight major food crops per country per year were released. Compare this to South Africa that does not require VCU performance tests but only "asks for one season of official DUS tests to describe the seed's characteristics thereby making registration an automatic formality." Here, a median of "45 new varieties of maize per year, 10 new varieties of beans per year, and six to eight new varieties per year each of potatoes, sorghum, sunflower, and wheat."

A lack of agreement on standards between countries as well as a mistrust in other countries' testing and

certification capabilities often translates into duplicate procedures, associated with high costs. These duplicate procedures also raise revenue for certifying bodies, which creates an additional obstacle for removing them (Keyser 2015). In addition, these complex regulations cause additional delays at the borders because border customs do not always understand the regulations. In summary, it is clear that input market regulations distort trade and hurt farmers, but there is not enough data or estimates to compare these costs for farmers with the benefits of input subsidies which have gone up in recent years.

## 7. Conclusions and Implications

Various studies have come up with a series of recommendations to enhance the functioning of the RTAs (e.g., Engel, Jouanjean, and Awal 2013; Meyer et al. 2010; UNECA and AU 2013). These include:

- the need for better implementation of the regional integration agreements;
- the need to prioritize and mainstream agreed programs;
- to engage private sector, civil society, etc.... in a dialogue to ensure their cooperation and to strengthen their commitment in the process;
- enhancing monitoring and evaluating of the integration process;
- sharing best practices through some kind of platform;
- include stronger TBT provisions;
- amending the RTAs to meet the basic requirements of standards systems and implementation of current obligations to support expanded trade opportunities;

These are all useful recommendations. However, while some of these recommendations are primarily technical, several of them face the same political constraints that the current situation has delivered, so it appears crucial to understand how these political constraints are likely to develop in the future.

Our argument here is consistent with the more broader argument made by Dercon and Gollin (2014) who argue that it is striking that the policy debates have drawn so little on the growing empirical literature that addresses the political economy of agricultural policy in developing countries. Since the work of Bates (1981), it has been clear that agricultural development strategies in Africa are closely tied to larger goals of achieving political stability, mobilizing

revenues for the state, and controlling urban food prices. They argue that the political landscape may have changed for agriculture in Africa. With emerging growth, it is important to revisit the political economy drivers of agricultural policies in sub-Saharan Africa.

### **A Coalition for Agriculture for the Future?**

These arguments are in line with our own findings, and have important implications for possible political coalitions for agricultural trade. However, the implications of our analysis are not straightforward in terms of putting together coalitions for regional trade liberalization.

There are two key dimensions to the political economy, much in line with our analysis in section 5. One is the long-run dimension of economic growth and structural changes in infrastructure and institutions. The second is what will happen with food prices in the future.

As we explained in section 5, the reduction of anti-agricultural and food policies in developing countries during the past decade has been caused by a combination of factors, including the structural adjustment programs, economic growth, and the shift in the political-economic equilibria induced by such growth, and by changes in governance and information structures. Reduced taxation of agriculture in many African countries that experienced income growth during recent decades is consistent with the identified forces.

In terms of organization of political pressure, as rural infrastructure improves and communications costs fall, farmers become more aligned and politically more effective. This development again contributes to a shift in the power balance in favor of rural interests. The reduction of anti-agricultural and food policies over the last two decades has been reinforced by changes in media structure and political institutions. In several cases, income growth has coincided with political reforms (democratization) and with the growth of commercial media. Democratic reforms have, on average, motivated increases in RRAs. The impact of the change in political institutions on agricultural distortions is complex, but empirical evidence suggests that democratization and the growth of commercial media may have contributed to the reduction of taxation of agriculture in African countries.

As African economies develop further, the “agricultural lobby” may expand with a growing importance/role of agribusiness and food companies—whose interests may be aligned with those of farmers—expands. These more concentrated and better capitalized organizations often form powerful lobby coalitions with farmers’ interest groups.

### **A Coalition for Regional Trade Liberalization in Agriculture for the Future?**

All these factors are likely to continue in the future, and this should make the opposition to export constraints stronger in (potentially) agri-food exporting countries. However, this should not necessarily lead to more trade liberalization overall, as there may also be other effects in a regional framework. The same forces that make export agriculture more powerful, may also make import-competing farmers stronger in lobbying governments to protect them against imports. The net effect is not obvious.

Historical evidence from other regions confirms these complex political economy developments. Forces which first contributed to removing trade obstacles (by removing taxes on agriculture), may later lead to pressure for more trade constraints—as they did historically in more developed countries, and more recently in emerging countries as China (Anderson 2009; Gardner 1987).

Moreover, it is important to emphasize that the most successful RTAs were importantly driven by non-economic considerations. For example, regional economic integration process in Europe (be it after World War II, or after the fall of the Berlin Wall more recently) were strongly driven by geo-political strategies (Manoli 2013). Such broadly shared regional political drive seems absent in most African RTAs. In fact, in RTAs such as the SADC where South Africa is the dominant country, the potential hegemonic ambitions of this RTA member appears to weaken, rather than strengthen, strong integration in the RTA (Soko 2007). Thus, in the absence of a shared political mission for a unified economic region, domestic pressure for reforms will likely remain the main driver (Hoekman and Kostecki 2013). Hence, one should have realistic aspirations in what one can expect from RTAs.

Still, the literature (and economic reasoning) points at some reasons for optimism. First, there is significant investment taking place in African agriculture, both through private investments and through public funding—and both supported by increased foreign transfers (Guariso et al. 2014). These investments should have some impact on trade costs.

There seems to be a consensus that (non-policy) trade costs remain very high due to institutional and infrastructural constraints. Reducing these constraints, either through public investments or institutional reforms, should have important direct economic gains but could also have important indirect gains as it would change the political economy of the RTA bargaining. Since both the gains and the losses from regional integration would be



strengthened with lower trade costs, the political economic equilibrium would shift.

While this may initially increase opposition to trade liberalization, it should ultimately contribute to more opening since the overall gains from trade would be much bigger—allowing also “losers” from trade in the short run to benefit either through compensation, or through reallocation of production factors.

For similar reasons countries with larger differences in factor endowments are likely to be the biggest gainers from RTAs and should therefore be considered the potential drivers for stronger integration (Liu 2008).

Second, economic growth could stimulate deeper integration (stronger RTAs) if it contributes to enhanced labor and capital mobility between sectors. Enhanced factor mobility reduces the sector specific interests and allows workers and capital to flow from sectors hurt by liberalization to sectors benefiting. This will reduce the anti-RTA lobbying (Maggi and Rodriguez-Clare 2007).<sup>17</sup>

Third, democracy movements in Africa may also enhance the strength of RTAs. Mansfield and Milner (2012) argue that autocratic governments are less likely to join RTAs (or implement them) since it constraints their ability to dole out rents (from protectionist trade policies). They argue that governments in democracies have greater incentives to conclude trade agreements because it may enhance their political support base.

Fourth, just as structural adjustment programs had direct and indirect impacts via the impact on changes in perceptions and ideological “beliefs” on the functioning of markets and trade, so may RTAs, when implemented, cause opponents to (gradually) recognize the benefits of RTAs, and therefore lead to a gradual strengthening of pro-RTA political support (Rogowski 1989; Mansfield and Milner 2012).

Fifth, there is disagreement in the literature on whether the participation in multiple RTAs is a good or a bad thing for trade and economic development. One perspective is that it leads to conflicting regulatory requirements and unnecessary costs (Khadiagalla 2011), and that, paradoxically, it creates more policy space for governments, which makes it more difficult for them to resist pressure from interest groups to protect them from trade competition

(Busch and Mansfield, SD). However, others, such as Afe-sorgbor and van BERGEIJK (2011) argue that multiple RTA memberships may reinforce the regional integration process. Their argument is an example of the “spaghetti bowl as building blocks” political economy argument of Baldwin (2006).

### Value Chains in Economics and Politics

It is also important to consider the role of agricultural value chains. Value chains play a role in the performance of specific commodities (“the economics”)—as we have documented in section 5 of the chapter. The performance of specific commodities may be strongly influenced by the institutional organization of the value chains, including the extent of vertical coordination and of interlinked markets. This may also contribute to explaining the strong performance of the cereal sector in recent years.

However, value chains may also play an important role in influencing policies (“the politics”) as different partners in the chain may reinforce each other in the political process to support agriculture. The effect of this is likely to depend on the nature of the policy intervention. Their interests may be aligned or contrary to those of farmers depending on at what level the government intervenes (agricultural products or processed food products). For example, interests along the value chain may conflict on price interventions as farmers benefit from high prices and processing companies may benefit from low farm prices. These companies may be in favor of trade liberalization, in particular in RTAs so that they can source from different suppliers across regional borders. However, while processing companies are likely in favor of lower agricultural prices, they may prefer government policies that protect the markets for their processed products. In this case their interests may be aligned with farmers.

Hence, the interest in favor of trade liberalization may differ significantly across RTAs, across countries, and even along the commodities value chains. This, of course, makes it difficult and complex to design strategies for political coalitions for regional trade liberalization. The most useful strategy therefore appears to be one which recognizes these complexities and takes this as a starting point for a strategy which will inherently need to be region-specific.

It is also important to recognize that the political economy of trade integration is fundamentally different when it concerns products where countries have very different production and consumption patterns than when they are relatively similar. Anti-trade lobbying is likely to be much stronger in the second case—which probably reflects the

<sup>17</sup> And it may also enhance the benefits for governments in committing themselves to an RTA if they value long-term economic gains (Maggi and Rodriguez-Clare 1998).



food staple markets in Africa; while the first case probably represents better the exports of high value F&V—where trade works well.

Finally, the interaction between value chains and RTAs are bi-directional. The emergence and restructuring of value chains themselves will be influenced by the nature of the RTA as it influences the potential market and supply base for companies in the value chain (Vandemoortele et al. 2012).

### Food Prices and RTAs

The extent to which these fundamental changes in African societies will affect agricultural trade policies and regional trade agreements will also depend on what will happen with food prices in the future. By the mid-2000s the aggregate effect had caused the RRA to be close to zero, but since then new measures have been introduced to protect consumers. If food prices continue to be volatile there is a good chance that this will contribute to continued significant interventions in markets for products such as cereals.

However, one should also expect that the chaotic policy experiences following the first price spikes may subside and be integrated in a more predictable set of policies, as there should be some “learning by doing” by the African governments, and a better anticipating of some of these policy changes by the private sector. (A more pessimistic view of this is that the ad hoc policy interventions have undermined private sector activities and made the private sector more reluctant to invest.)

It may be important to make the balance between commitments and flexibility more specific, to accommodate for these (temporary) exceptions to the RTAs, and to enhance transparency within the RTAs. This could be done by refining exceptions to the general export restrictions, either by defining product specific exceptions or by refining situational exceptions.

Korinek and Bartos’ (2012) recommendations regarding the WTO process can be useful also for the African RTAs. They argue that several measures could limit the disruptions caused by the exceptional trade interventions, and provide more transparency and thereby enhance the functioning and credibility of the trade agreements. These measures include:

- Specifying positive lists of specific goods exempted from the QER regulations rather than vague categories of goods that are exempted and limiting the scope of situational exceptions. For example, RTAs could agree to allow situational exceptions only for a certain product or product type (e.g. foodstuff).

- Another measure could be to fix the time period for which the situational exception is granted.
- RTAs could opt to make the use of situational exceptions subject to certain procedures. This would guarantee that countries that want to impose trade restrictions based on situational exceptions have to consult other member countries. Furthermore, this allows for an organization of the periodic review of the restrictions. This is important because often, measures outlive the circumstances that gave rise to the need for this measure in the first place. However, in order to keep track of these procedures, a relatively high level of institutional development is needed, which not every RTA has achieved as yet.
- The formulation of conditions on the use of exceptions to the general prohibition on export restrictions. More precisely, if a country wishes to use certain restrictions, it will have to meet predefined conditions. One example could be that the restriction cannot lead to a disruption of the normal channels of supply.

In summary, rather than trying to prevent political leaders from reacting to price volatility in markets of staple food, it seems more useful to develop a strategy to make such reactions more predictable, more transparent, based on less ad hoc instruments and to integrate this explicitly in RTAs.

Finally, it is important to point out that there has not only been an impact on the volatility of food prices but also on their average level, and that this seems to have had major implications already. With agricultural and food prices much higher since 2007, both trade and domestic production have increased and most strongly so for some of the lagging sectors, in particular cereals. In fact, annual growth rates of cereal production are now three times higher than before 2007; and they now match growth in cereal imports—on average across SSA. Hence both trade and domestic production (and productivity) have been enhanced by higher food prices.

### Need for Better Information on SSA RTAs and Trade (Policies)

Finally, there is a clear need to enhance information and data in this area. Information problems play a role at different levels. Overall, our study has revealed a need for much better and more representative and comparative information on the RTAs, the policies that the member countries have implemented and their effects on trade. As we have documented at several places in this chapter, it is

very difficult to draw conclusions on cause and effects and to have an idea of the size of some of the policy and RTA effects because of lack of (precise) data.

Engel, Jouanjean, and Awal (2013) also point out that information asymmetries between the private sector and policy-makers, as well as insufficient or incorrect data further compounds the difficulty for governments in addressing trade barriers. They refer to the lack of information on informal trade, in many countries there seems to be a lack of awareness of the fact that a large part of cross-border trade is informal and only a few countries collect data on informal trade flows. However, even basic information such as how much trade is taking place within and outside RTAs at a disaggregated level is not easily available.

The availability of such data is not only important from an analytical perspective, but can be very important also from a political perspective, both for enhancing the trade and domestic political negotiations and for improving policy targeting and enforcement. In the same way that various agricultural policy indicators (such as PSEs, trade distortion indicators, other subsidy measures...) have contributed to multilateral trade negotiations, such data and indicators could do this at the regional level. Engel, Jouanjean, and Awal (2013) point out that The COMESA-EAC-SADC online NTB database ([www.tradebarriers.org](http://www.tradebarriers.org)) has been useful in drawing policy-makers' attention to the scale of these barriers, with each complaint at minimum discussed in tripartite forums.

There is certainly an area where organizations like the World Bank could play an important role. There is need for a careful reflection on the type and the nature of data that is needed, and on the institutions to process the data into useful indicators which could enhance transparency in policy designs and trade negotiations.

If future studies are to complement this chapter, there should be an attempt to structure the information collection in order to make the data comparative for countries within RTAs and possibly across RTAs, and develop useful and easily accessible indicators.

### **Need for Better Information on NTBs and Prices**

It would probably be useful to attempt to capture more accurately the extent and effects of NTBs in both input and output markets. It is generally accepted that today, many NTBs persist. However, it is not clear to what extent these barriers are the result of policy measures aiming at restricting trade rather than impediments resulting from infrastructural and institutional limitations. Even when explicitly distinguishing NTMs from NTBs, the different

types of NTMs (e.g., SPS measures) still hide a range of different measures with different policy implications. Furthermore, it is far from clear how these NTBs have evolved over time, let alone what happened to specific NTBs. This is further complicated by the vast number of different NTBs that exist. Although lifting them might have the same effect in the form of reducing trade costs, tackling them will require different approaches.

Recently, attempts have been made to increase the availability of data on NTBs. One example is the combined effort between the World Bank and other agents, including UNCTAD and the African Development Bank to collect data on NTMs, coded according to the 2009 MAST nomenclature, for 30 different countries and 5,000 product lines. However, when trying to estimate the price raising effects of these NTMs for different product lines, accurate price data for each product line is also needed. Today, this is not yet the case. For example, Cadot and Gourdon (2012) find themselves limited in their analysis due to the fact that no disaggregated price data is available for different cereals.

In other words, there seem to be a need for more disaggregated data on prices and on a wider range of NTBs in order to get a more accurate idea of what is actually happening. Note that not only the availability of the data is important, but that the quality should equally be guaranteed.

### **Increasing Transparency and Harmonizing Trade Regulations**

Based on several case studies and a review of other studies, Keyser (2015) identifies several "clear-cut areas where policy improvements or other institutional change could help African countries enhance benefits of trade," both in output and input markets. Four key recommendations of Keyser are:

1. Better awareness and understanding of trade rules would reduce the confusion that exists over the requirements to move food staples from one country to another.
2. Dissemination of product standards by official agencies could make trade conditions more transparent.
3. Adoption of rules and regulations based on the principle of mutual recognition and equivalence.<sup>18</sup> Given the

<sup>18</sup> One especially notable barrier in agriculture is that none of the regional trade blocks has a fully developed regional approach to SPS. Discussions are under way on establishing SPS protocols for each region but none of these agreements is complete (Keyser 2015).



large amounts of food that presently go around the formal system without any inspection at all, regional approaches based on equivalence and mutual recognition of each other's systems may be more meaningful than harmonization with developed-country norms.

4. Adoption of a regulatory system that provides for acceptance of fertilizer compounds that have been approved and inspected by other countries of the RTA. Harmonized regional policies would reduce transaction costs, and the resulting larger common market would yield larger economies of scale, and possibly investments in local manufacture of fertilizer.

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# Chapter 3: Political Economy of Financial Sector Integration in the East Africa Community

## 1. Introduction

The members of the East African Community (EAC)—Burundi, Kenya, Rwanda, Tanzania, and Uganda—are currently pursuing the regional integration of their financial systems with the aim of accelerating economic growth.<sup>1</sup> Like many other developing countries, particularly across sub-Saharan Africa, the EAC countries have long had small financial systems marked by low levels of intermediation, concentrated banking sectors, and limited access to finance.<sup>2</sup> Greater financial integration is expected to help these countries stimulate growth by enabling their banks and non-banking institutions to increase the scale of their operations across borders, leading to greater competition, lower costs, and broader access of financial services.<sup>3</sup> An integrated regional financial system is expected to further stimulate growth by facilitating intra-regional trade and positioning the EAC as a single investment destination for foreign direct investment.

But the manner in which the EAC has moved toward regional financial integration raises questions about the role of regional institutions and government policies in shaping the expansion strategies of banks—the principal financial institutions of the region. Such questions are especially salient because the EAC's regional financial integration has followed a markedly different trajectory from the West African Economic and Monetary Union (*Union Economique et Monétaire Ouest Africaine*, UEMOA), the

regional grouping that has achieved the highest degree of financial integration in sub-Saharan Africa. The regionalization of the UEMOA financial system was shaped by the early creation of supranational institutions such as a single regional central bank to conduct monetary policy and a single banking commission and bank licensing regime.<sup>4</sup>

Financial integration in the EAC, by contrast, has largely been driven by market incentives. Rather than responding to government-led integration initiatives, banks in the EAC have pursued cross-border investments for over the last two decades to pursue higher returns promised by the liberalizing reforms adopted in individual countries and the expansion of regional operations by non-financial firms. The EAC's market-driven financial integration has evolved asymmetrically: Kenyan banks have established subsidiaries in all EAC countries, but banks from other EAC countries have not yet entered Kenya or any other country in the region in a meaningful way.

The benefits of the regional financial integration emerging within the EAC have yet to be fully realized, in part, because policy coordination has lagged considerably behind evolving market realities. In 2013, EAC members committed themselves to a monetary union protocol that calls for the establishment of a regional central bank and single currency by 2024. However, while EAC members have accepted explicit convergence criteria for their monetary union in the near term, there are important development and regulatory differences that may slow their progress toward that union. Although several large Kenyan banks have been able to enter other markets, there are considerable barriers to greater competition, permitting the banking sector in most countries to remain highly concentrated and continue charging high mark-ups on

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<sup>1</sup> South Sudan has also applied to join the EAC.

<sup>2</sup> Patrick Honohan and Thorsten Beck. *Making Finance Work for Africa*. Washington, DC: World Bank, 2007.

<sup>3</sup> *Financial Sector Integration in Three Regions of Africa: How Regional Financial Integration Can Support Growth, Development, and Poverty Reduction*. Tunis: African Development Bank, 2010; *Kenya: Economic Update—Edition No. 6*. Washington, DC: World Bank, 2012.

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<sup>4</sup> Amadou N. R. Sy, "Financial Integration in the West African Economic and Monetary Union," *IMF Working Paper* WP/06/214, Washington, D.C: International Monetary Fund, 2006; "Financial Sector Integration in Two Regions of Sub-Saharan Africa," Washington, DC: World Bank, 2007.

financial services. And while EAC members have sought to coordinate their finance sector laws, individual governments continue to enforce regulations that impede greater cross-border investment.<sup>5</sup>

This chapter proceeds by examining the evolving dynamics of regional financial integration in the EAC. It begins by providing essential background on regional institutions and macroeconomic conditions. The chapter broadly outlines the structure of the financial system, describing in particular how Kenyan-led banking has driven regional financial integration. We then examine whether the current EAC framework is creating conditions for greater cross-border banking expansion as well as the challenges likely to be faced by EAC members in meeting the convergence criteria for monetary union. We also examine the political factors that may slow further progress toward regional financial integration.

## 2. Background

### 2.1 Regional Institutions

The EAC is an inter-governmental organization that aims to promote the development of its member states through progressive integration, leading eventually to the formation of a single market and political federation.<sup>6</sup> The EAC's current five members are Burundi, Kenya, Rwanda, Tanzania, and Uganda. The EAC entered into force in 2000 after its three original members—Kenya, Tanzania, and Uganda—negotiated throughout the 1990s to revive an earlier regional organization that had linked their governments and economies between 1967 and 1977.<sup>7</sup> Burundi and Rwanda joined in 2007.

To accelerate growth and promote trade within the region, the EAC first created a customs union in 2005 that established duty-free trade, a common external tariff, and common customs procedures.<sup>8</sup> The EAC formed a common market in 2010 to attain the benefits of a single market regulated through coordinated economic policies coupled with the free movement of people, services, labor, and capital.<sup>9</sup> The EAC agreed to a monetary union protocol in 2013, initiating a ten-year process of fiscal and monetary harmonization that will culminate in the establishment of a regional central bank and single currency.<sup>10</sup>

The EAC's political institutions determine regional development policies. The Summit of Heads of State functions as the EAC's executive branch by setting goals and approving policies through consensus among the leaders representing member states.<sup>11</sup> The Council of Ministers—comprising the minister for East African Community affairs, the attorney general, and any other minister delegated by the government of each member state—acts as the EAC's principal policymaking body by issuing directives, approving regulations, and overseeing policy implementation.<sup>12</sup> The work of the Council of Ministers is divided and carried out by sectoral councils composed of ministers responsible for policy formulation in areas such as agriculture, education, energy, finance, and health among others.

The EAC Treaty further provides for legislative and judicial oversight of the policymaking. The East African Legislative Assembly serves as the EAC's legislative branch. Its representatives are selected by the national assemblies of member states to debate policy, enact legislation, and exercise oversight over other EAC bodies.<sup>13</sup> The East African Court of Justice functions as the EAC's judicial branch with jurisdiction over the interpretation and application of the EAC Treaty.<sup>14</sup> However, on the whole,

<sup>5</sup> *East African Common Market Scorecard 2014: Tracking EAC Compliance in the Movement of Capital, Services and Goods*. Washington, DC: World Bank, 2014. <https://www.wbginvestmentclimate.org/publications/eac-market-scorecard-2014.cfm>

<sup>6</sup> Preamble, Article 5, and Article 11 of the Treaty for the Establishment of the East African Community.

<sup>7</sup> According to the preamble of the Treaty for the Establishment of the East African Community, signed in 1999 and amended in 2006 and 2007, the first regional organization was dissolved due to a “lack of strong political will, lack of strong participation of the private sector and civil society in the cooperation activities, the continued disproportionate sharing of benefits of the Community among Partner States due to their differences in their levels of development and lack of adequate policies to address this situation.”

<sup>8</sup> The Protocol for the Establishment of the East African Community Customs Union was signed in March 2004.

<sup>9</sup> The Protocol for the Establishment of the East African Community Common Market was signed in November 2009.

<sup>10</sup> The Protocol for the Establishment of the East African Community Monetary Union was signed in November 2013.

<sup>11</sup> Articles 9–12 of the Treaty for the Establishment of the East African Community.

<sup>12</sup> Articles 13–16 of the Treaty for the Establishment of the East African Community.

<sup>13</sup> Articles 48–65 of the Treaty for the Establishment of the East African Community.

<sup>14</sup> Articles 23–47 of the Treaty for the Establishment of the East African Community.

these institutions exercise marginal influence over EAC policy formulation, which is primarily shaped through inter-governmental negotiations among the governments represented within the Summit of Heads of State and the Council of Ministers.<sup>15</sup>

## 2.2 Macroeconomic Conditions

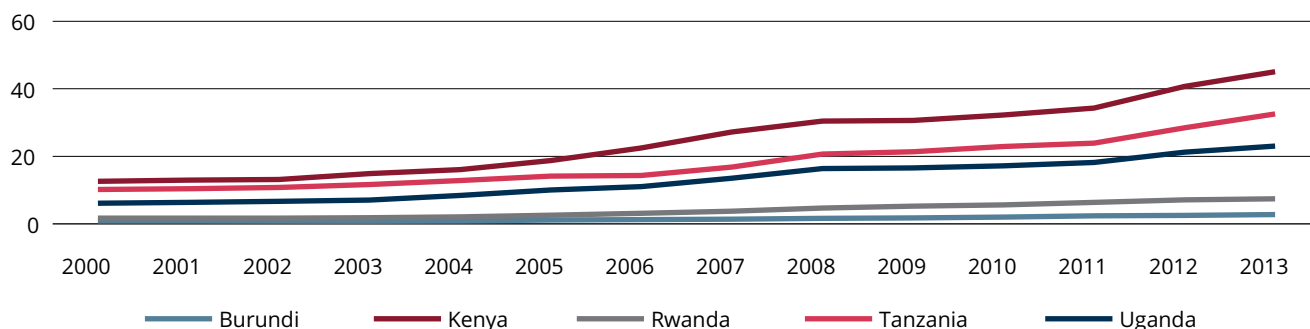
The five EAC members are small, open economies with a combined nominal GDP of US\$110 billion in 2013—about

one-quarter the size of the South African economy, the largest in Africa. The EAC members have several common economic characteristics, particularly as price takers in the world economy and being largely dependent on the export of primary commodities (e.g., coffee, tea), precious metals, and other natural resources. Nevertheless, there are considerable differences in the economic structures and performance of EAC members. The EAC economy is dominated by Kenya, which is the region's most complex and accounts for 41% of the region's combined GDP, as shown in Figure 11. The respective share of the region's GDP of the other economies for 2013 is as follows: Tanzania (30%), Uganda (21%), Rwanda (7%), and Burundi (2%).

Real GDP growth has varied considerably among EAC members. As Figure 12 illustrates, Rwanda and Tanzania have attained the region's highest growth rates since 2000, while Kenya and Burundi have posted the slowest. Uganda's mean growth rate has slowed by nearly one percentage point between 2000–2006 and 2013–2007. Figure 13

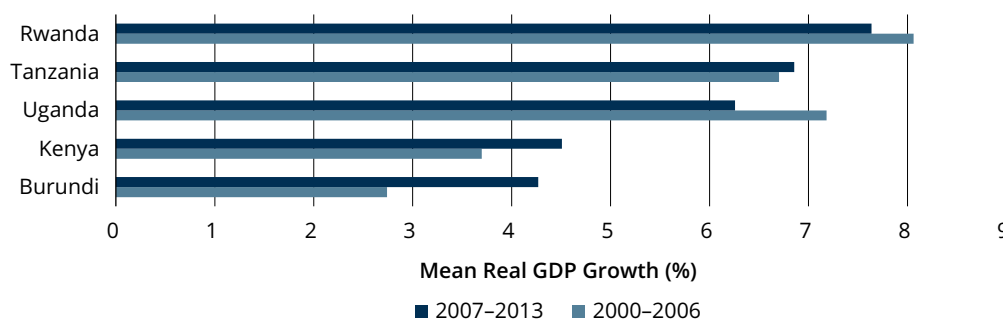
<sup>15</sup> Henry Onoria, "Botched-Up Elections, Treaty Amendments and Judicial Independence in the East African Community," *Journal of African Law*, vol. 54, no. 1, 2010, pp. 74–94; M. A. Mohamed Salih, "African Regional Parliaments: Legislatures without Legislative Powers," in *Parliamentary Dimensions of Regionalization and Globalization: The Role of Inter-parliamentary Institutions*, eds., O. Costa, C. Dri, and S. Stavridis, Hampshire: Palgrave Macmillan, 2013, pp. 149–165.

**FIGURE 11: Nominal GDP in the East African Community**



Source: IMF World Economic Outlook Database.

**FIGURE 12: Real GDP Growth in the East African Community**



Source: IMF World Economic Outlook Database.

shows that consistently high growth rates in Rwanda, Tanzania, and Uganda have raised their mean per capita incomes, at purchasing power parity, to close the gap with Kenya, the region's wealthiest economy. Burundi's anemic growth has raised its mean per capita income only marginally. Figure 14 further indicates that macroeconomic stability has varied across the five EAC economies, which have experienced unsynchronized episodes of inflationary spikes and troughs. Mean annual inflation has doubled in Tanzania and Uganda between 2000–2006 and 2007–2013, but has increased less severely in Kenya and Rwanda during the same periods.

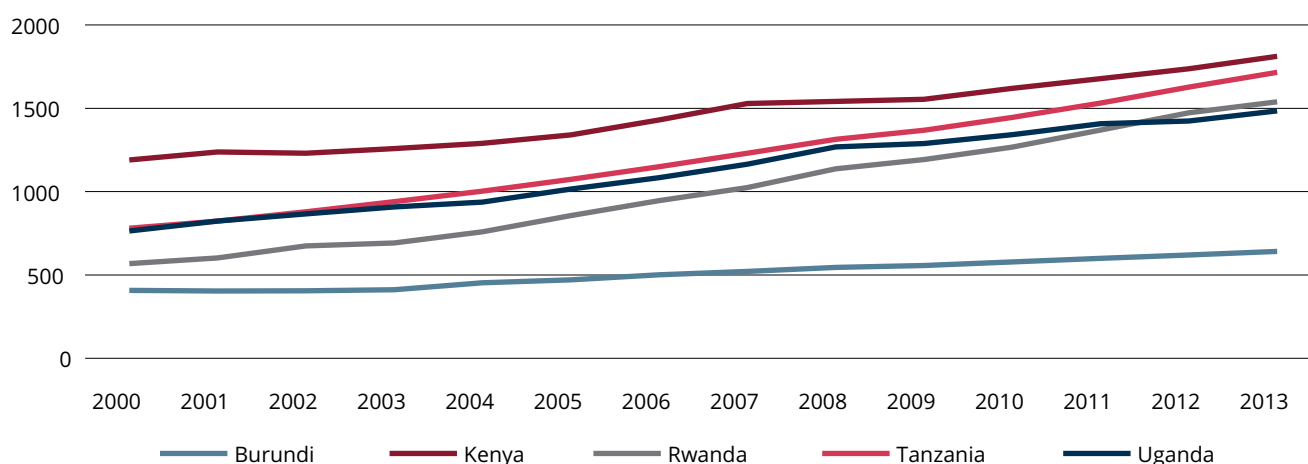
The EAC economies share two characteristics in their external position. First, all five countries generally maintain a negative current account position. Figure 15 shows that this deficit has widened over the past decade across the EAC. Second, the five countries have a savings gap arising from the fact that their total investment levels exceed

their gross national savings, as illustrated in Figure 16. This savings gap reflects the extent to which the countries rely on external savings for domestic investment. The gap also reflects the external dimensions of domestic macroeconomic stability arising from exchange rate pass-through effects on prices and inflation.

Foreign direct investment (FDI) flows to the region have more than doubled in recent years. Figure 17 shows that FDI flows have favored Tanzania and Uganda. Investment in these countries has been stimulated by extractive industries such as minerals and petroleum. While Kenya has received considerably less FDI than Tanzania and Uganda, it has become a significant investor in neighboring countries across several economic sectors, particularly in the finance.

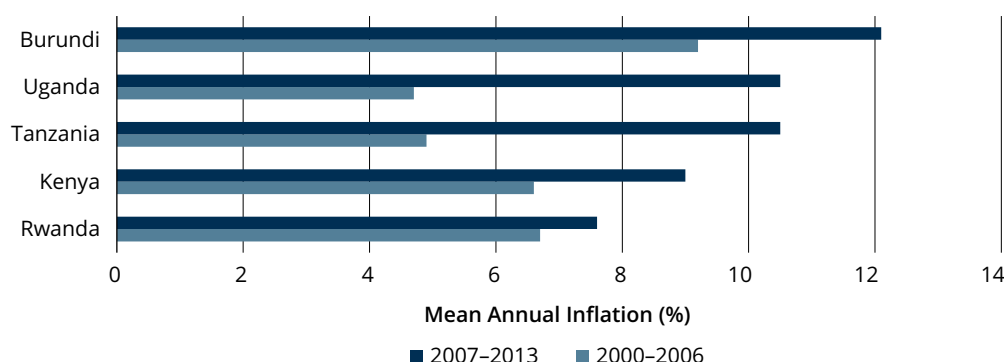
Trade among EAC members is also increasing. For example, the value of exports to Kenya from the other four economies has been steadily growing, as shown in

**FIGURE 13: GDP Per Capita in the East African Community**

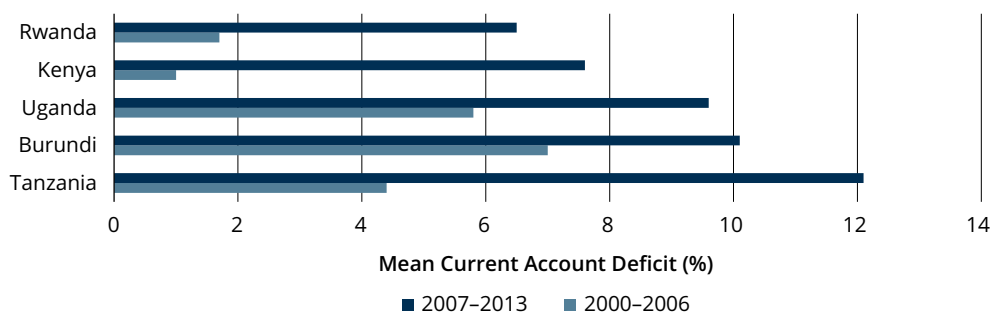


Source: IMF World Economic Outlook Database.

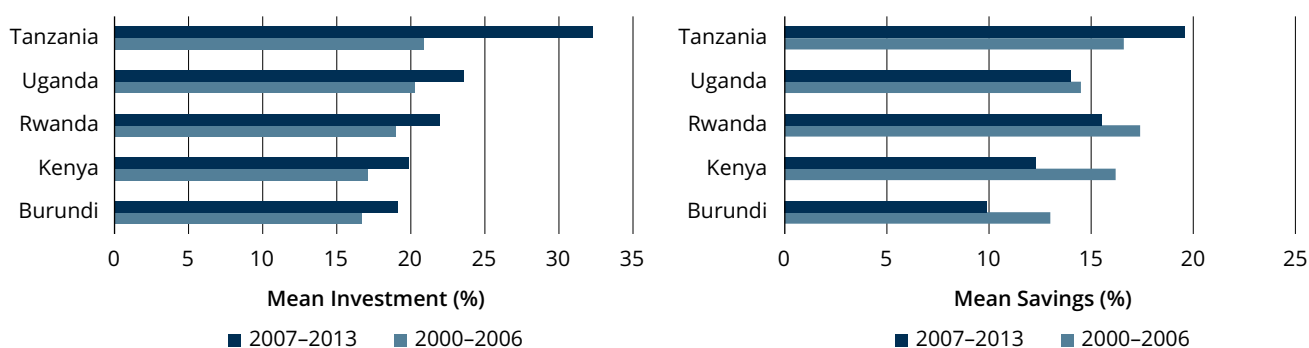
**FIGURE 14: Inflation in the East African Community**



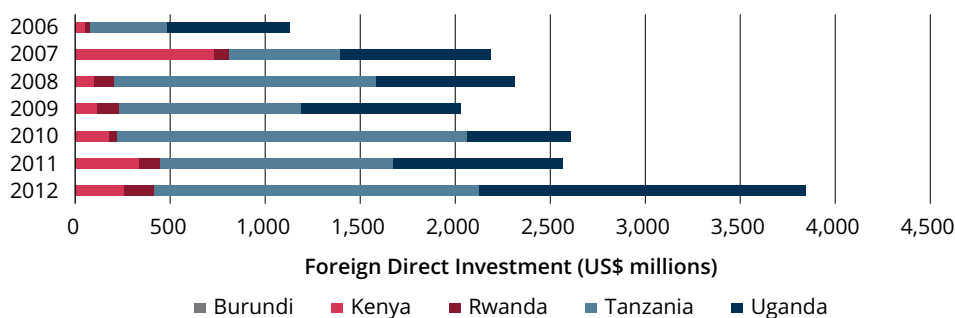
Source: IMF World Economic Outlook Database.

**FIGURE 15: Current Account Deficit in the East African Community**

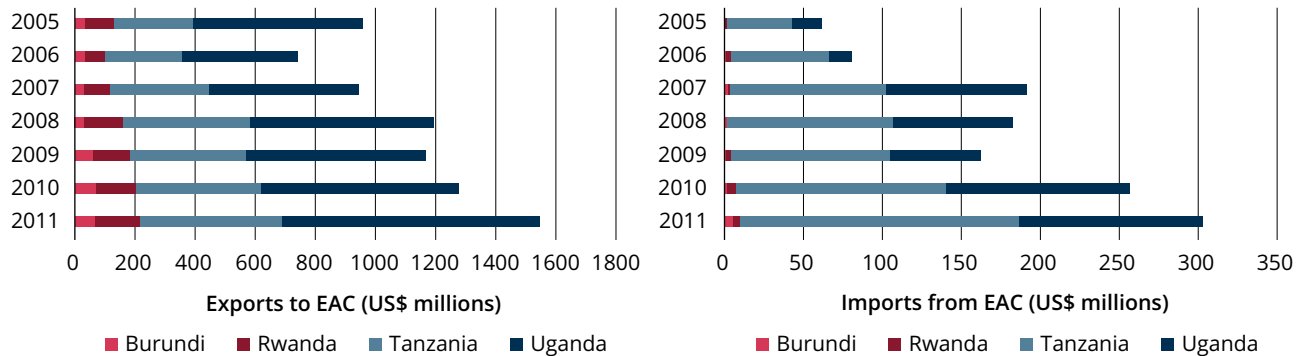
Source: IMF World Economic Outlook Database.

**FIGURE 16: Investment and Savings in the East African Community**

Source: IMF World Economic Outlook Database.

**FIGURE 17: Foreign Direct Investment in the East African Community**

Source: World Bank World Development Indicators.

**FIGURE 18: Kenya's Trade with the East African Community**

Source: EAC Secretariat.

Figure 18. Kenya's exports to the rest of the EAC are concentrated in industrial materials, light manufacturing, and food processing. Given Kenya's dominant position in the region, the value of its exports to the other four economies has been growing faster, hence the widening positive trade balance in its favor.

### 3. The Financial System in the EAC

#### 3.1 Financial Development

The EAC economies have widely differing levels of financial development. The size and depth of the sector varies considerably across countries due to country-specific macroeconomic conditions and the legacies of previous banking policies. Kenya, for example, is the EAC member with the most developed financial system because it has maintained less statist policies than most of its neighbors, permitting both domestic private firms and foreign-owned banks to operate continuously for far longer than either Tanzania or Uganda.

Figure 19 reflects the divergence in financial system development between Kenya and the other EAC members. The figure illustrates the size of each country's financial sector as measured by the ratio of broad money (M2) to GDP, a conventional indicator of the financial system's monetization. Kenya's financial sector has greater depth than the sub-Saharan African average.<sup>16</sup> By contrast, Burundi,

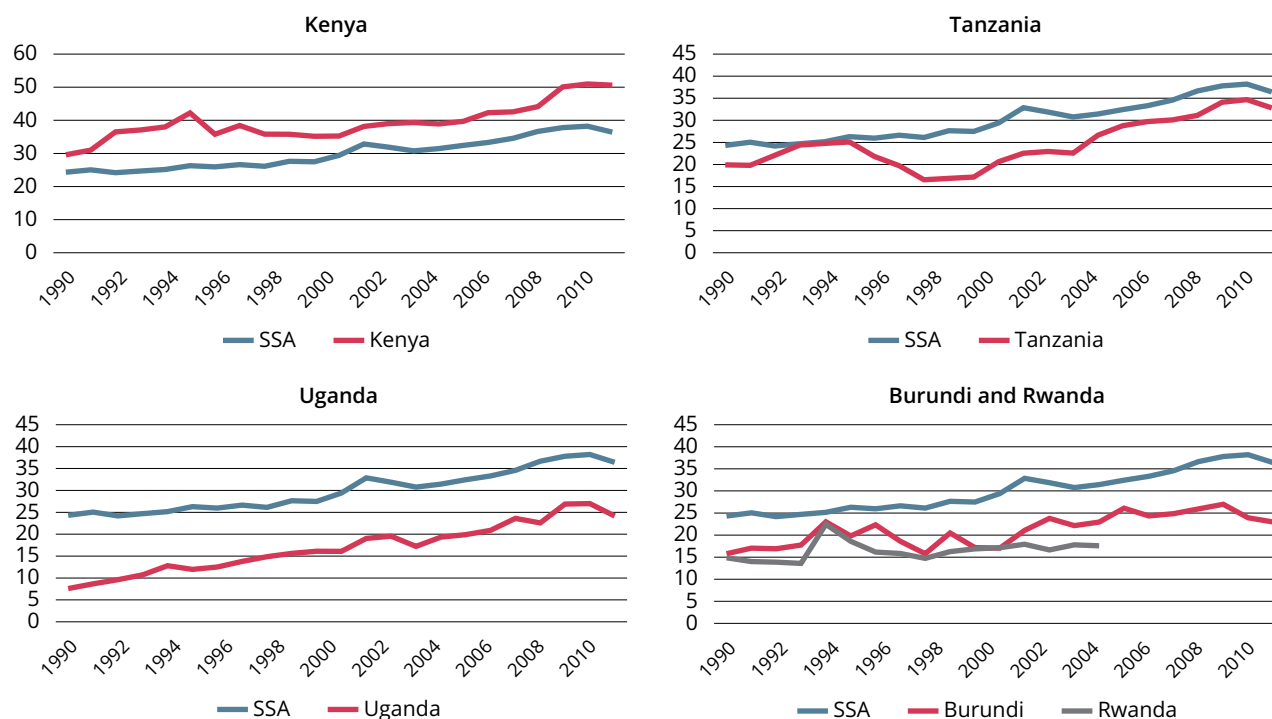
Rwanda, and Uganda have appreciably smaller financial systems when compared to the regional average, though most of these countries have experienced steady progress in financial development since 2000. Tanzania's financial system has grown to nearly approximate the regional average in that time period. Moreover, Figure 19 highlights one additional noteworthy pattern: the deepening of Tanzania and Uganda's financial systems precedes the implementation of the EAC customs union in 2005 or the EAC common market in 2010. Accelerated financial development in those countries is thus likely to have been initially stimulated by country-level macroeconomic or policy reforms rather than regional integration.

The divergence in financial system development between Kenya and other EAC members is similarly visible in Figure 20, which shows the ratio of private credit to GDP as an indicator of financial intermediation. Kenya's financial institutions play a greater role in extending credit to the private sector, relative to total economic activity, when compared to the African average. The other four EAC countries have ratios that fall below the regional average, though most have made progress over the past decade in closing the gap with Kenya. Tanzania and Uganda's financial systems have nearly attained levels comparable to the regional average. Additionally, Figure 20 suggests that financial deepening in Tanzania and Uganda began well before the implementation of the EAC customs union in 2005 or the EAC common market in 2010.

#### 3.2 Banking Sector

EAC members may have varying levels of financial development, but finance in all these countries is dominated by banking. The banking sector in each country is relatively

<sup>16</sup> Chuling Chen, "Bank Efficiency in Sub-Saharan African Middle-Income Countries," IMF Working Paper WP/09/14, Washington, D.C: International Monetary Fund, 2009.

**FIGURE 19: Financial Depth in the East African Community: M2/GDP**

Source: World Development Indicators.

small when compared to other developing regions.<sup>17</sup> Nevertheless, banking institutions are responsible for most of the financial intermediation that occurs in the EAC. Figure 21 shows bank assets—including loans, reserves, securities, and other assets—as a share of GDP. The bank asset patterns seen in Figure 21 are virtually identical to the credit provision patterns shown in Figure 20 precisely because banks are largely responsible for whatever credit services are available in the region.

The banking sector has become less concentrated in most EAC countries over the past decade. Following earlier reforms aimed at financial liberalization and banking privatization, privately owned domestic banks now operate in all countries alongside foreign-owned and state-owned banks. The number of commercial banks operating in each country varies widely in line with financial depth, ranging from more than forty banks in Kenya to fewer than ten in Burundi. The entry of new banks has appreciably lessened concentration, as is evident in the declining market share of the

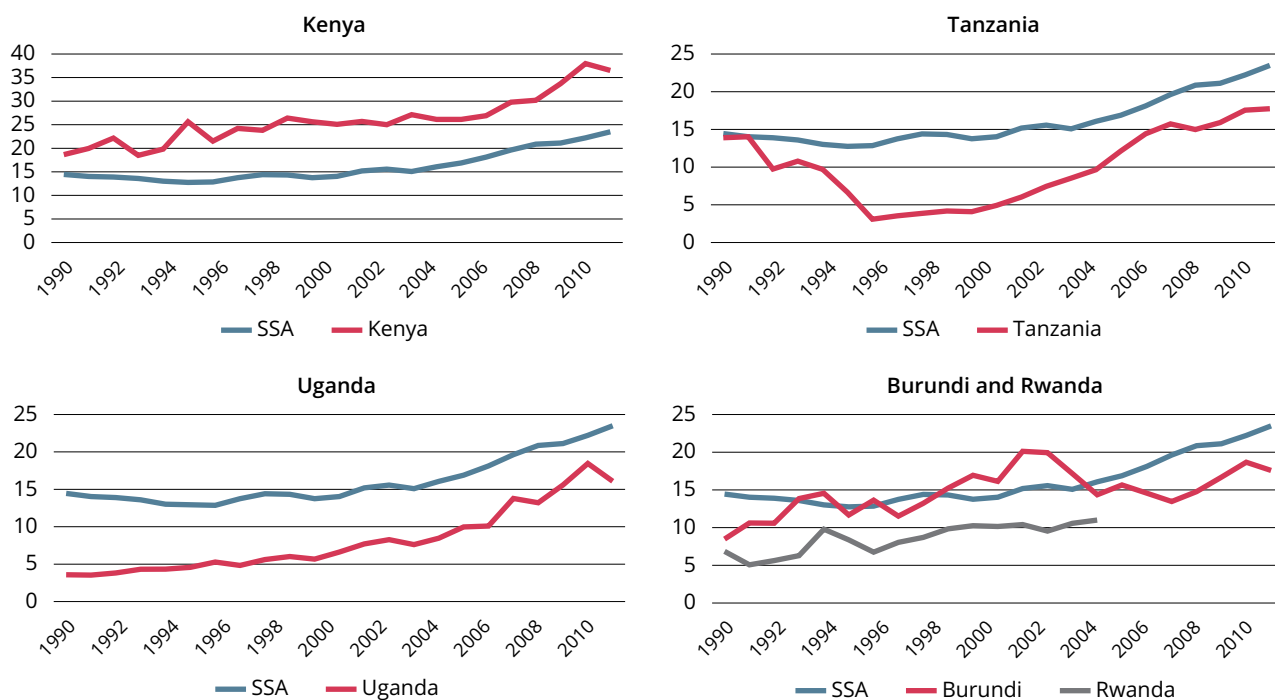
largest three banks shown in Figure 22. A few large banks typically dominate banking in most of Africa's small financial markets, where the average market share of the three largest banks was 75% in 2011. Four of five EAC members now fall well below the regional average, though most remain above 50%. Kenya has among the least concentrated banking sectors in sub-Saharan Africa; its three largest banks held 40% of banking assets in 2011. Tanzania's banking concentration declined from over 95% in the early 2000s to 51% in 2011. Banking concentration in Rwanda declined in the same time period from 100% to 68%. Burundi is the only EAC member where banking concentration, at 89% in 2010, remains above the regional average.

Although the banking sector has become less concentrated across much of the EAC, the entry of new banks has not necessarily increased competition.<sup>18</sup> This is evident in the Lerner index scores of EAC countries shown in Figure 23. The Lerner index measures the pricing power of

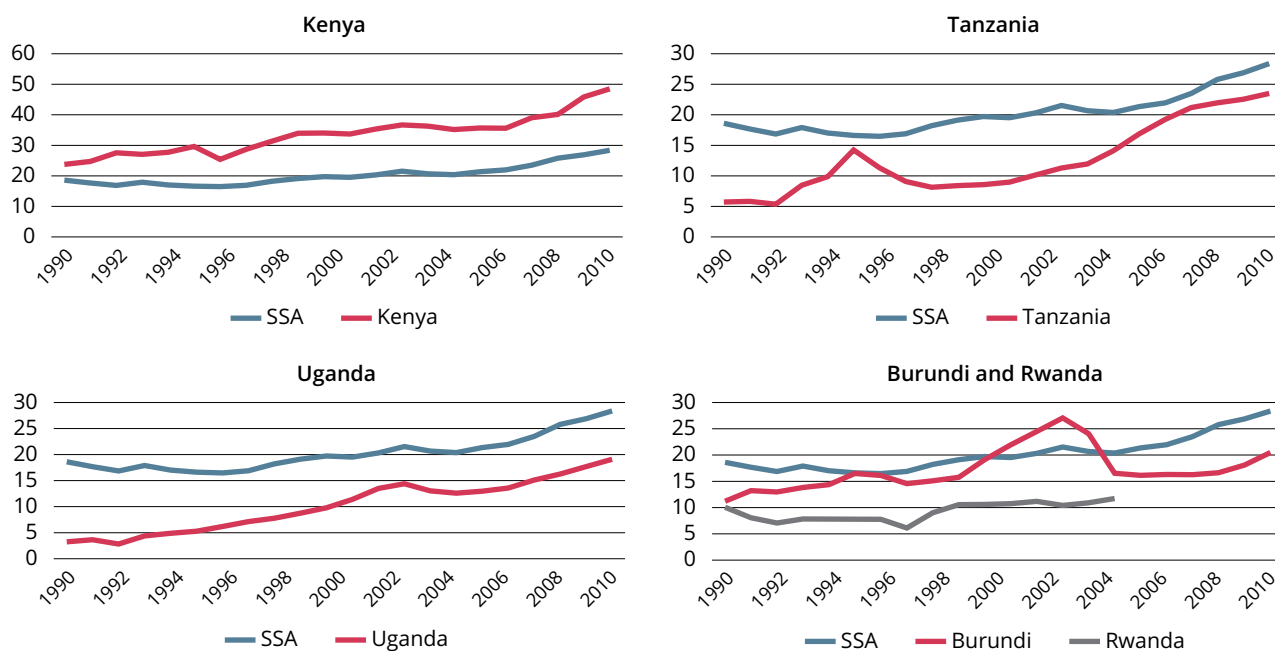
<sup>17</sup> Honohan and Beck 2007.

<sup>18</sup> Sarah Sanya and Matthew Gaertner, "Assessing Bank Competition within the East African Community," *IMF Working Paper*, WP/12/32, Washington, D.C.: International Monetary Fund, 2012.

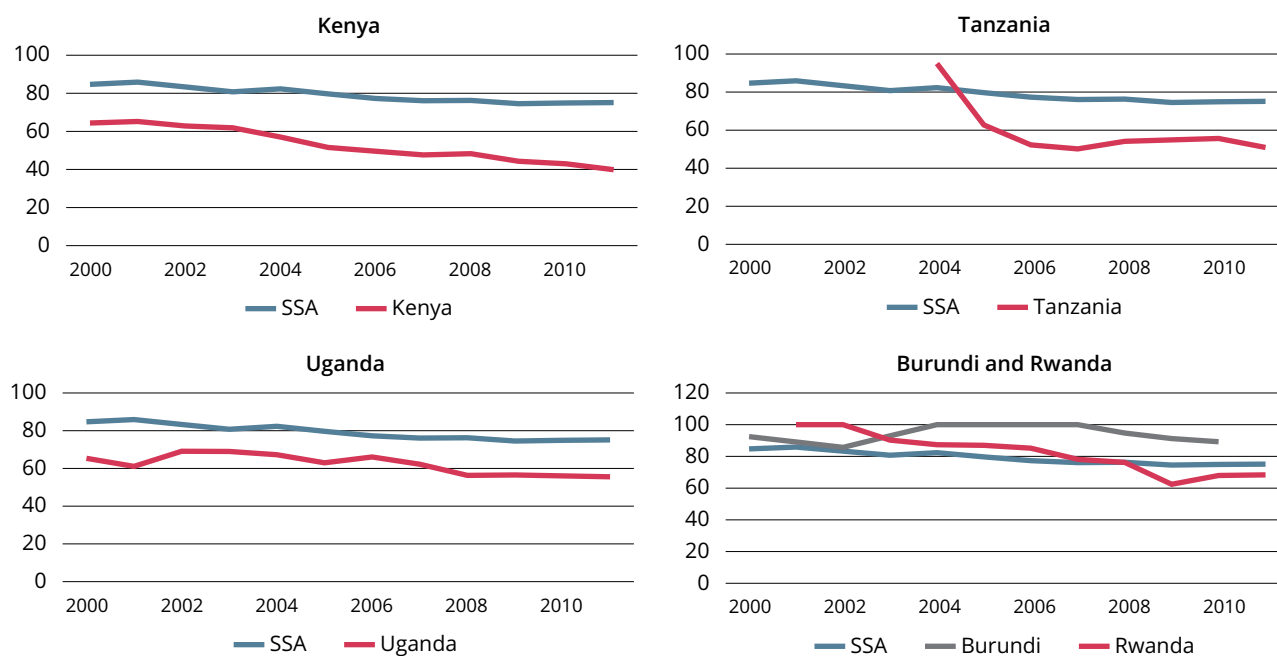


**FIGURE 20: Financial Intermediation in the East African Community: Private Credit/GDP**

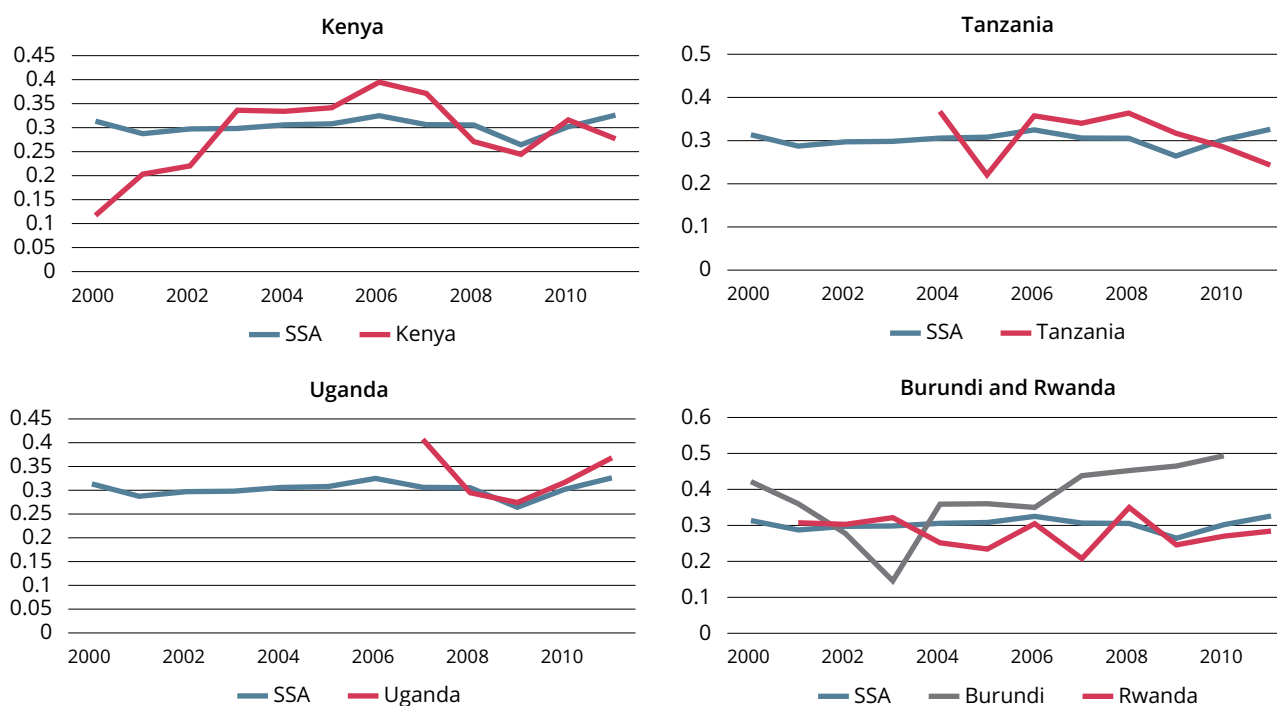
Source: World Development Indicators.

**FIGURE 21: Bank Assets in the East African Community**

Source: World Bank Global Financial Database.

**FIGURE 22: Banking Sector Concentration in the East African Community**

Source: World Bank Global Financial Database.

**FIGURE 23: Lerner Index in the East African Community**

Source: World Bank Global Financial Database.

banks as the mark-up on financial services above marginal costs. Higher index scores, which range from 0 to 1, reflect less competition. Figure 23 shows that the market power of banks in EAC countries has generally trended with the regional average for sub-Saharan Africa, which is notable given the decline in banking concentration that simultaneously occurred among EAC countries. The average Lerner score for African countries was 0.33 in 2011, suggesting that banks priced their services 33% above marginal costs. The Lerner index score for Burundi, which has the most concentrated banking sector in the EAC, was 0.56 in 2011. Uganda's index score for the same year was 0.37. Kenya's index score of 0.28 was identical to Rwanda's (0.28) and similar to Tanzania's (0.24) in 2011 despite its greater financial depth.

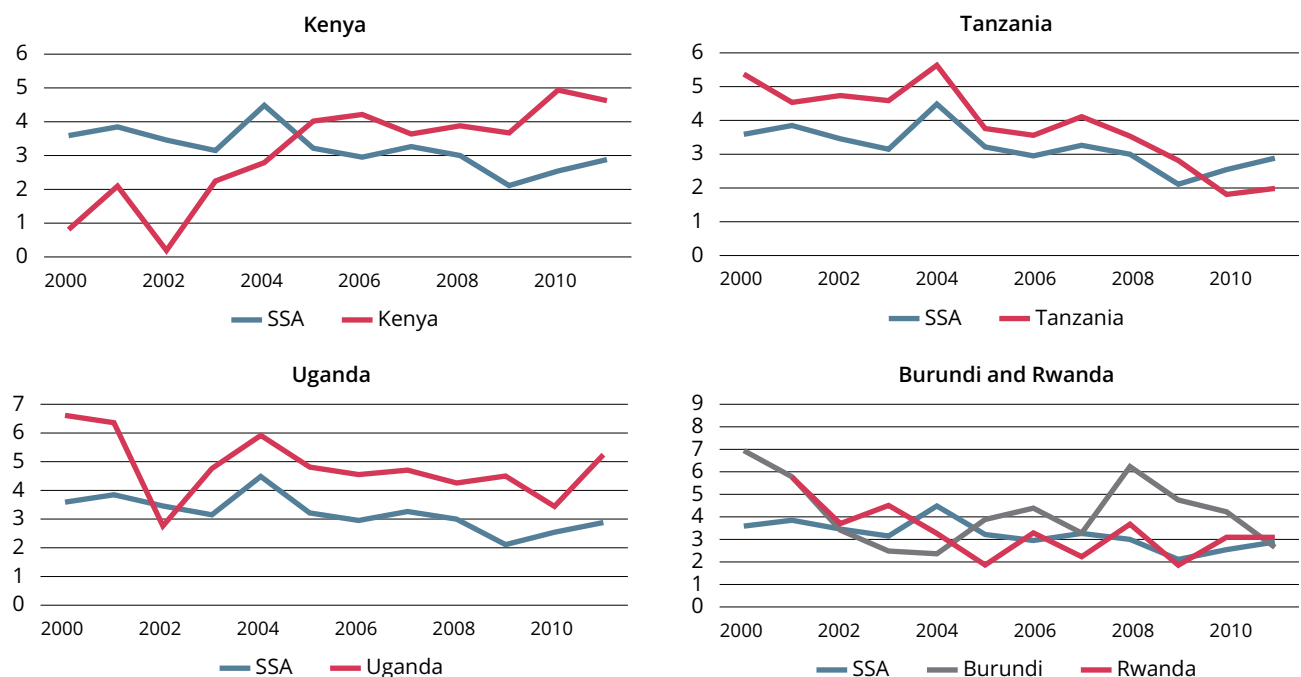
The ability of banks in EAC countries to continue charging a mark-up on financial services has enabled them to remain highly profitable despite the entry of new banks. As Figure 24 shows, for much of the period since 2000 the average return on assets in the larger EAC markets has generally exceeded the African average, which is already among the highest in the world.<sup>19</sup> In 2011, the

regional average return on assets was 2.88%. In the same year, banks in Kenya (4.63%) and Uganda (5.24%) posted among the highest average rates in the region. The rates in Burundi (2.65%) and Rwanda (3.09%) nearly approximated the regional average in 2011, while Tanzania (1.99%) fell below. In this respect, there is no evident convergence among EAC members: average rates of return on assets in Kenya and Uganda appear to be rising over time, but have been steadily declining in Tanzania. Rwanda's rates have trended with the African average, while Burundi's have exhibited the greatest variability. Overall, the average return on equity, as another measure of profitability, reflects similar national trends with all EAC banking sectors showing highly attractive rates in 2011: Uganda (37.11%), Kenya (30.54%), Burundi (20.69%), Tanzania (19.63%), and Rwanda (18.81%).

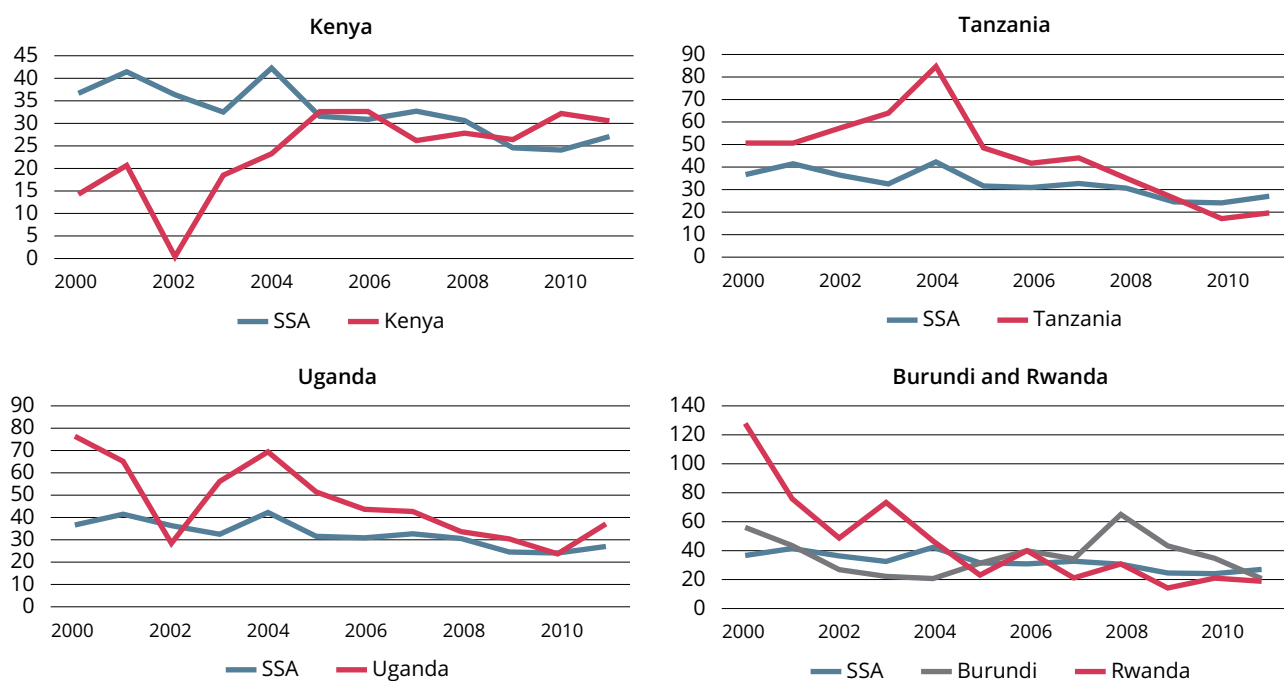
One manifestation of the market power of banks in the EAC is reflected in the interest rate spread between lending and deposit rates. Figure 26 shows that the interest rate spread in EAC countries has generally been lower than the regional average since 2000, but the entry of new banks has not necessarily put downward pressure on spreads. While the country trend lines shown in Figure 22 suggest a nearly secular decline in banking concentration in much of

<sup>19</sup> Honohan and Beck 2007.

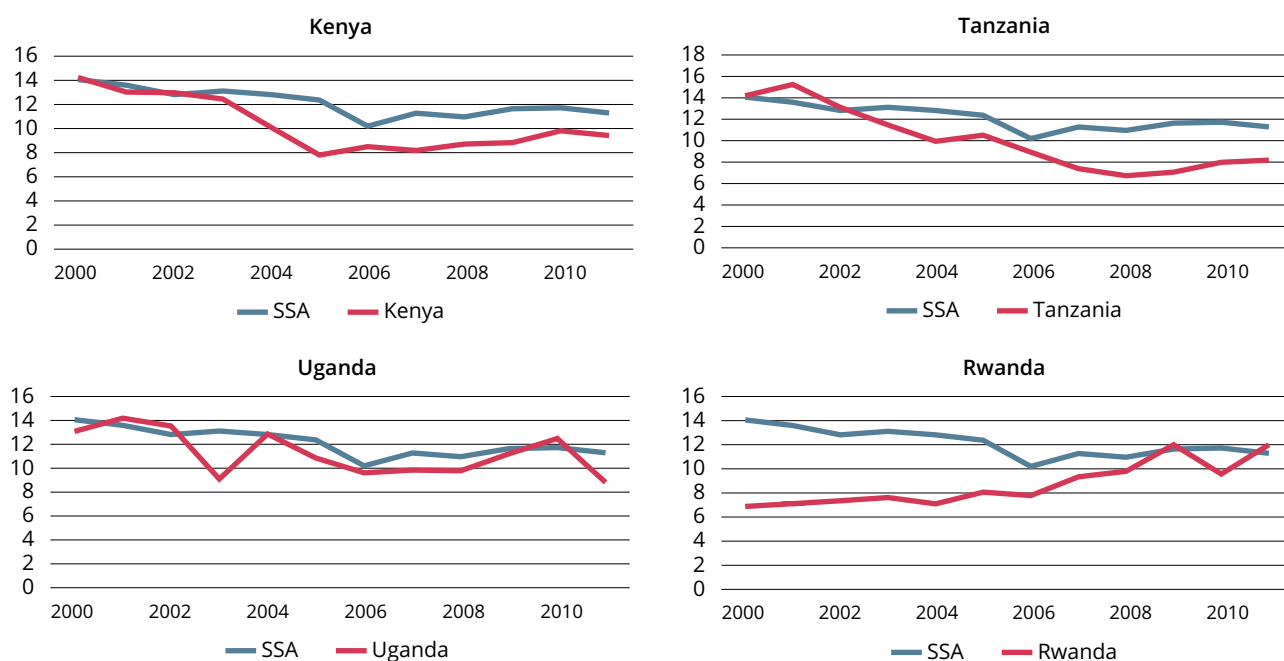
**FIGURE 24: Return on Assets in the East African Community**



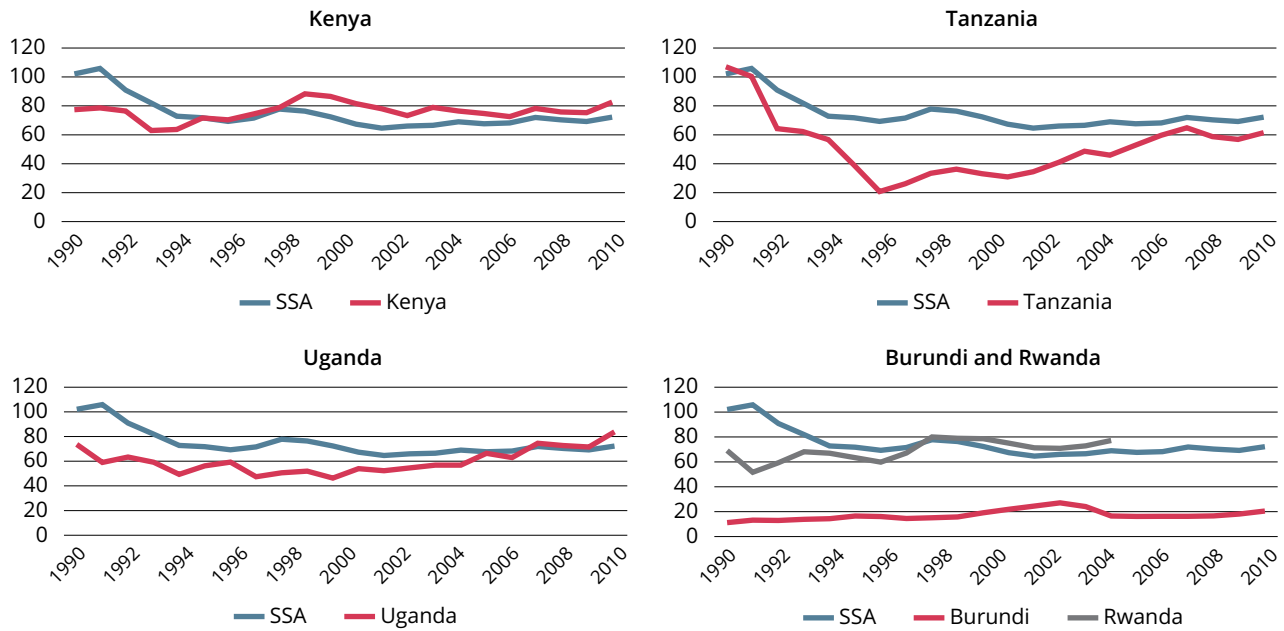
Source: World Bank Global Financial Database.

**FIGURE 25: Return on Equity in the East African Community**

Source: World Bank Global Financial Database.

**FIGURE 26: Bank Lending-Deposit Spread in the East African Community**

Source: World Bank Global Financial Database.

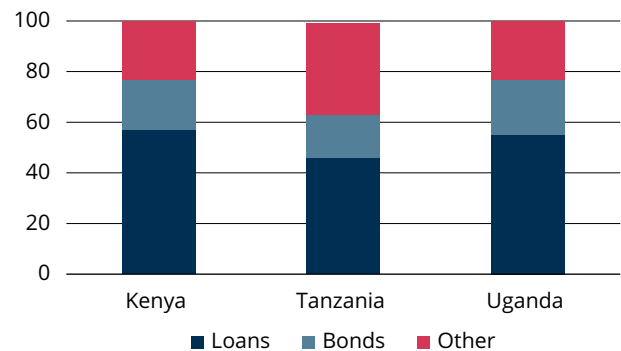
**FIGURE 27: Intermediation in the East African Community**

Source: World Bank Global Financial Database.

the EAC, Figure 26 shows that the larger number of banks operating in the EAC has not consistently affected interest rate spreads. The spreads across the EAC appear to be converging among the largest financial markets despite their varied levels of development and regulatory conditions. In 2011, the spread was 9.42 in Kenya, 8.19 in Tanzania, and 8.82 in Uganda.

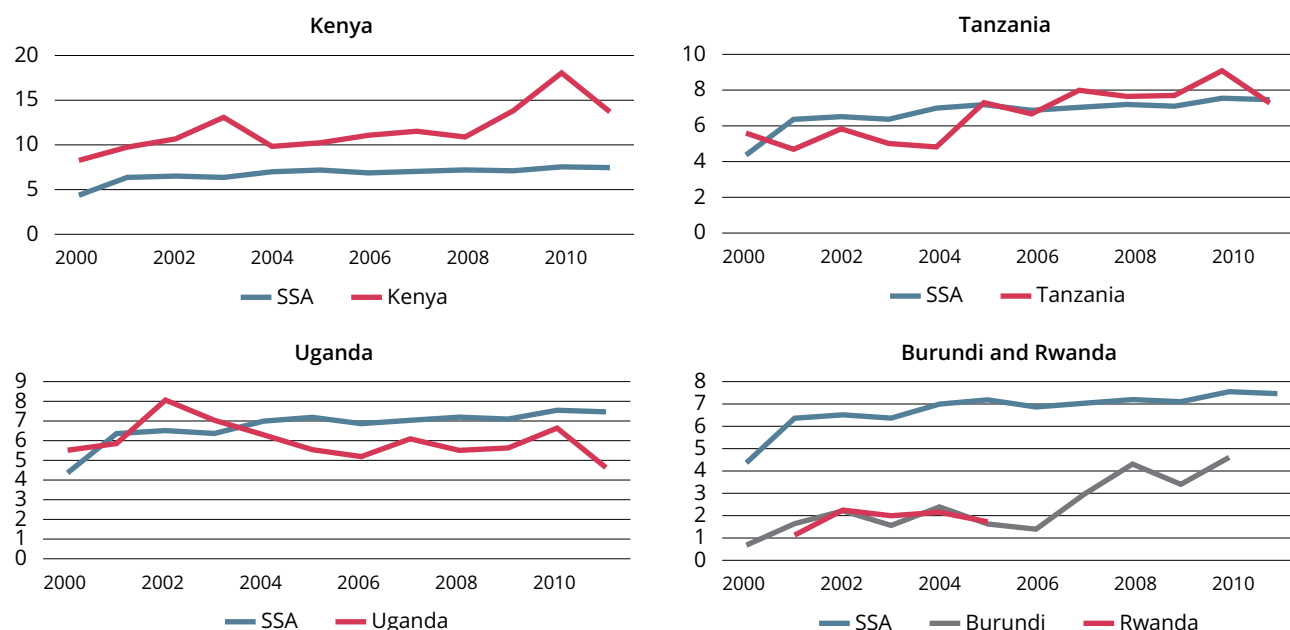
The banking sector may be able to sustain higher interest rate spreads partly because the proportion of deposits employed in intermediation has not appreciably increased in most EAC countries. Figure 27 shows the share of total bank deposits extended as credit to the private sector. In Kenya, the level of financial intermediation has remained relatively flat since 2000 despite otherwise improving indicators of financial depth. Between 2000 and 2011, Kenya's credit-deposit ratio experienced more year-on-year decreases than increases. In Tanzania, financial liberalization and banking privatization led to an improving credit-deposit ratio; it nearly doubled from 33.12% in 2000 to 61.5% in 2011. Similarly, in Uganda, the credit-deposit ratio has jumped from 46.3% in 2000 to 83.81% in 2011.

The limited efficiency of financial intermediation in the EAC is related to the preference of many banks to hold a large share of their assets as non-private sector loans,

**FIGURE 28: Composition of Commercial Banking Assets in the EAC, 2008–2012**

Source: Business Monitor International.

which is typical of the broader Africa region. Figure 28 shows, for example, that banks in the EAC continue to invest a significant proportion of their resources in government bonds. Figure 29 further indicates that credit from banks to the government and state-owned enterprises (SOEs), as a share of GDP, remained relatively unchanged between 2000 and 2011 in Burundi, Tanzania, and Uganda. Banks in Kenya have accelerated their lending to government

**FIGURE 29: Credit to Government and State Enterprises in the East African Community**

Source: World Bank Global Financial Database.

and SOEs in the same time period that government has become less directly involved in banking. Between 1990 and 2000, credit to government and SOEs in Kenya grew by 26% from 6.55% in 1990 to 8.27% in 2000; it grew by 41% from 9.75% in 2001 to 13.7% in 2011.

### 3.3 Banking Access

While EAC members have achieved greater levels of overall financial depth over the past decade, access to banking remains limited to a small sector of the population even when compared to the rest of sub-Saharan Africa. As Figure 30 indicates, relatively few adults in EAC countries have bank accounts. In Uganda, less than 19% of adults have accounts, as do 17% in Rwanda and 3% in Burundi. The exception is Kenya, where bank accounts among the adult population has grown from 10% in 2004 to 65% in 2011.

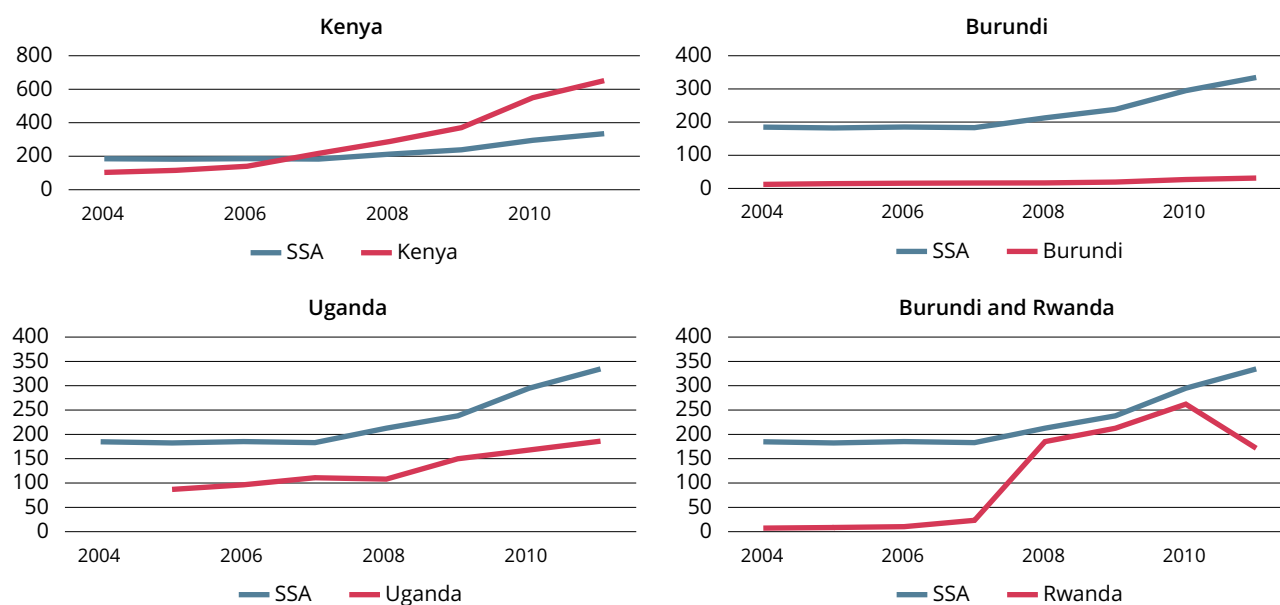
Figures 31 and 32 further indicate that the physical infrastructure of banking has expanded more slowly across the EAC than in the rest of Africa. In 2011, there were approximately two bank branches per 100,000 adults in Burundi, Tanzania, and Uganda, and about five branches per 100,000 in Kenya and Rwanda. Possibly related to

broader patterns of economic development, the number of ATMs per 100,000 adults in 2011 varied widely among EAC members, reflecting their divergent levels of financial depth: nearly ten in Kenya, five in Tanzania, four in Uganda, three in Rwanda, and one in Burundi.

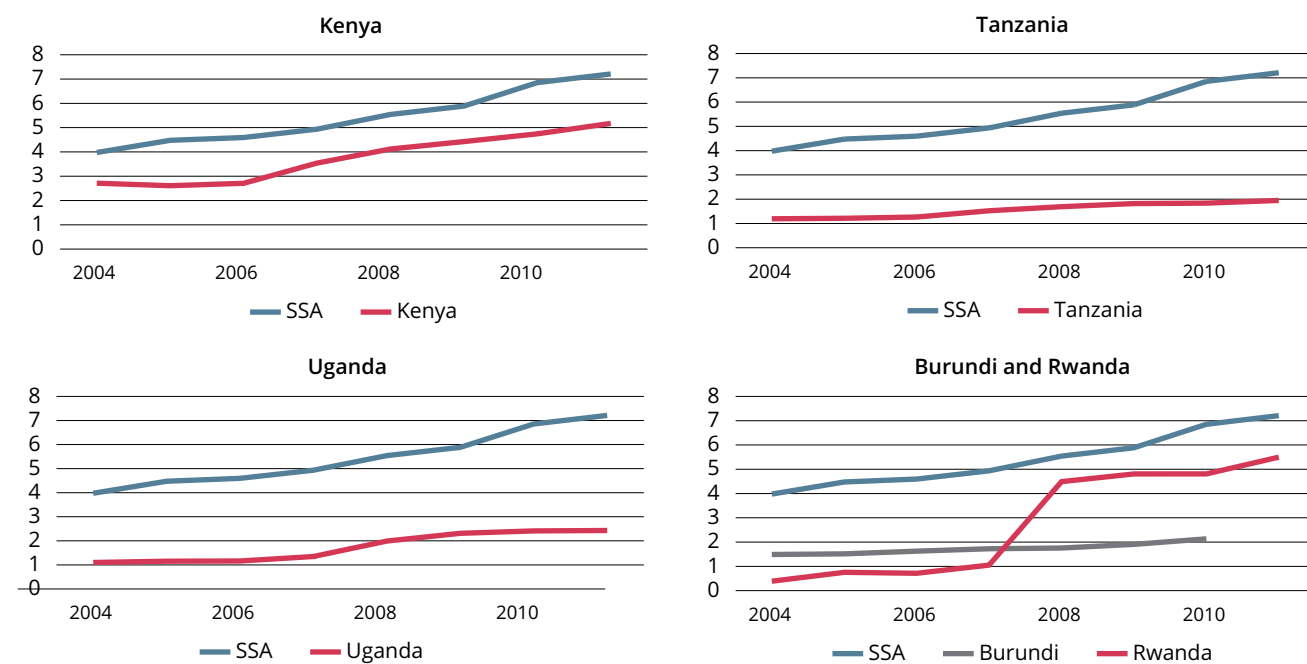
### 3.4 Nonbank Financing

Capital markets in the EAC reflect the relative underdevelopment of long-term financing options outside the banking sector. As Table 5 shows, the debt and equity markets' aggregate capitalization is about \$29 billion, which is equivalent to 29% of the region's total GDP in 2012. By comparison, the South African capital market, the largest and most sophisticated in Africa, is equivalent to nearly 201% of its GDP.

The support of other financial sector players in the intermediation process within the EAC remains limited. The penetration of the insurance sector remains low while the pensions sector—which has potential to play a larger role in expanding the availability of long-term funding for regional investments—is similarly small. These sectors could complement banking in accelerating the growth of finance across the EAC if the governments of smaller

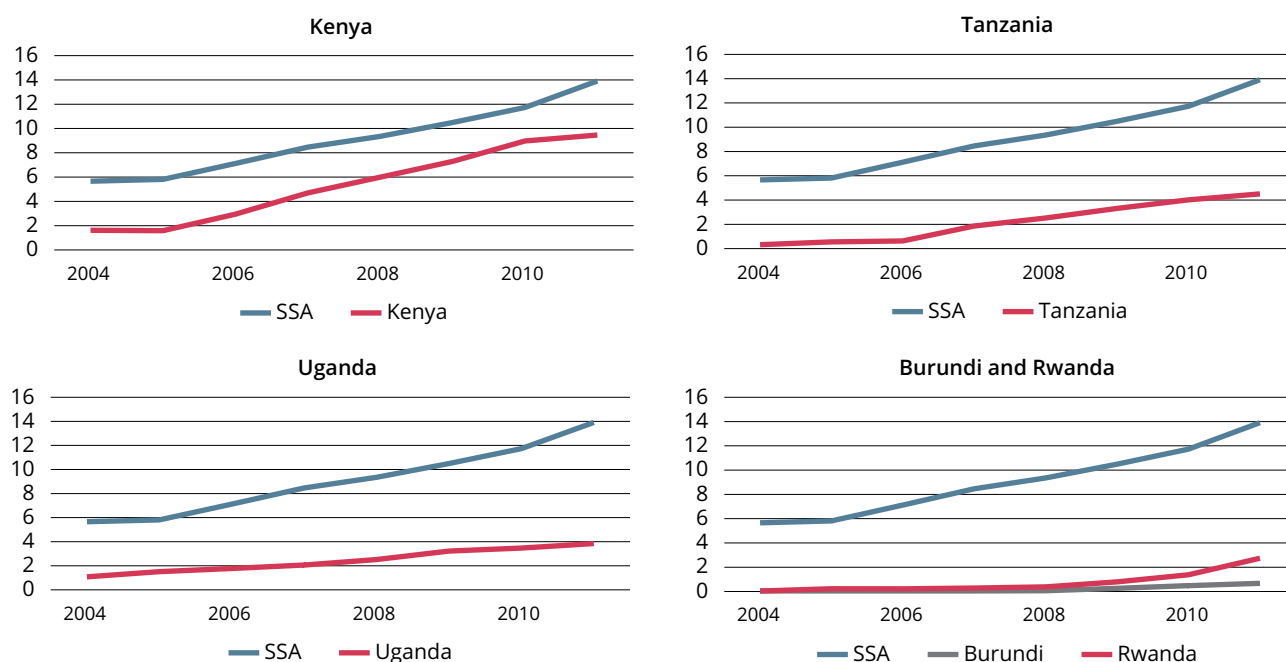
**FIGURE 30: Access to Banking: Bank Accounts per 1,000**

Source: World Bank Global Financial Database.

**FIGURE 31: Access to Banking: Bank Branches per 100,000**

Source: World Bank Global Financial Database.



**FIGURE 32: Access to Banking: ATMs per 100,000**

Source: World Bank Global Financial Database.

**TABLE 5: Selected Capital Markets Indicators in East Africa (December 2012)**

|  | Burundi | Kenya  | Rwanda | Tanzania | Uganda | Total  |
|--|---------|--------|--------|----------|--------|--------|
| Listed Companies                             |         | 61     | 4      | 17       | 15     | 97     |
| Domestic                                     |         | 61     | 2      | 11       | 8      | 82     |
| Cross Listed                                 |         |        | 2      | 6        | 7      | 15     |
| Corporate Bonds                              |         | 13     | 1      | 5        | 6      | 25     |
| <b>Market Capitalization (US\$ millions)</b> |         |        |        |          |        |        |
| Equities                                     |         | 14,800 | 1,696  | 8,326    | 6,218  | 31,040 |
| Domestic                                     |         | 14,800 | 230    | 1,896    | 815    | 17,741 |
| Cross Listed                                 |         |        | 1,466  | 6,430    | 5,403  | 13,299 |
| Bonds  | 10      | 9,080  | 41     | 1,754    | 816    | 11,701 |
| Government                                   | 10      | 8,330  | 39     | 1,660    | 758    | 10,797 |
| Corporate Bonds                              |         | 750    | 2      | 94       | 58     | 904    |

Source: Stock exchanges and central banks in respective markets.

markets removed restrictions on the investment of Kenyan capital in their economies.

Although small by international standards and constrained by limited new issues, Kenya constitutes the core of the EAC's nonbank financing. It accounts for 81% of the

EAC's capital market and two-thirds of all listed companies. However, existing disparities in market size and levels of development seem to impede rather than encourage beneficial integration among EAC members. Kenya has no investment restrictions and investors from the rest of the

EAC are accorded similar status as domestic investors, but it is unclear whether investors from the rest of the EAC are taking advantage of this unrestricted access. It remains unclear when other capital markets might be opened to offer similar status to investors from EAC members. In fact, the policies of some EAC members inadvertently restrict market access. For instance, Tanzania's capital market is marginalized by the fact that the country's capital account is not fully liberalized. Not only is it the only market in the EAC that is largely inaccessible to other regional investors, but Tanzanian investors are also restricted from investing in other regional markets.

## 4. Cross-Border Banking Expansion

### 4.1 Expansion Patterns and Incentives

The cross-border expansion of banks in East Africa has largely been shaped by market dynamics associated with financial liberalization—a process that predates EAC market integration. Beginning in the 1990s, governments across the region began to undertake financial reforms encouraged by the World Bank as part of the broader process of structural adjustment. This liberalization reform package included measures such as the privatization of commercial banks, the strengthening banking regulation, and the elimination of controls on credit, interest rates, and foreign exchange. As these reforms were adopted across East Africa, the role of the state in the financial sector receded in favor of allowing the market to allocate capital in response to prices.

The implementation of liberalizing reforms generally made East African markets more amenable to the entry of foreign banks. Banks based in the Middle East, India, South Africa, and Nigeria have since established subsidiaries in Kenya and neighboring countries. Many foreign banks have been drawn to Kenya in particular because it is the largest of all markets in the EAC; it also serves these banks as a base for regional management coordination. By the end of 2013, the Central Bank of Kenya (CBK) had licensed seven representative offices of foreign banks from India (2), China (1), South Africa (2), the United Kingdom (1), and Rwanda (1). Representative offices of foreign banks only serve as marketing and liaison offices for their foreign parent banks and affiliates and are not permitted to undertake banking business. The opening of a representative office by the Bank of Kigali, a Rwandan bank, is notable in that it is the first

foreign bank from an EAC member to be granted authority to operate in Kenya.

Among EAC financial institutions, Kenyan banks dominate cross-border banking. The CBK is presently the home supervisor of eleven Kenyan banks with cross-border banking interests in the EAC and beyond. Table 6 shows that the subsidiaries of Kenyan banks had a total of 282 branches across the East African region as of December 2012. This represents an increase of 26.5% over the 223 branches counted in December 2011. The largest number of Kenyan branches is found in Uganda (125) and Tanzania (70). But Rwanda has registered the highest growth with the number of Kenyan bank branches rising from twenty-seven in 2011 to fifty-one in 2012. Altogether, Kenyan subsidiaries had a total of 4,780 employees in the rest of the EAC along with total assets valued at about KES 266.5 billion (USD 3.10 billion) of which KES 125.5 billion (USD 1.46 billion) were loans to customers. Total deposits amounted to KES 202.6 billion or USD 2.36 billion.

Table 6 shows that Kenyan subsidiaries account for as low as 9% of the total number of banks in South Sudan (3 of 34 banks) to as high as 36% in Uganda (9 of 25 banks). Nine of the eleven Kenyan banks operating regionally have a presence in at least two other East African countries. Larger banks such as Kenya Commercial Bank (KCB) are present in all four EAC economies as well as South Sudan. Kenyan banks have also begun to expand their interests beyond the boundaries of the EAC. I&M Bank, Kenya's tenth largest bank, has subsidiaries in Tanzania and Rwanda as well as an interest in Bank One in Mauritius and First Merchant Bank in Malawi. Cooperative Bank of Kenya, the country's third largest bank, first ventured into the South Sudan market before entering the rest of EAC. It has recently signaled its intention to enter the Uganda market.

Banks like KCB explicitly state that their motivation to expand operations within the EAC has been primarily driven by their client base. According to KCB chief executive Martin Oduor-Otieno, "Our customers had seen business opportunities in trade and investment outside Kenya and they needed banking services to help facilitate all that and we were the bank that provided the solution, through our regional reach."<sup>20</sup> On 1 July 2010, the first day the EAC Common Market took effect, KCB became the first firm to launch a new rights issue simultaneously on the four stock markets of Kenya, Tanzania, Rwanda, and Uganda.<sup>21</sup>

<sup>20</sup> Jeff Otieno, "Rights Issue Will Provide KCB with Internal Capital," *The East African*, 14 June 2010.

<sup>21</sup> "Rights Issue Gives KCB First Bite of EAC Common Market," *Daily Nation*, 1 July 2010.

**TABLE 6: Kenyan Commercial Banks Operating Across East Africa (December 2012)**

|                               | Uganda     | Tanzania  | Rwanda    | Burundi   | South Sudan | Total      |
|-------------------------------|------------|-----------|-----------|-----------|-------------|------------|
| Equity Bank                   | 38         | 6         | 8         |           | 9           | 61         |
| Kenya Commercial Bank         | 14         | 11        | 13        | 1         | 21          | 60         |
| Bank of Africa                | 32         | 18        |           | 1         |             | 50         |
| Diamond Trust Bank            | 27         | 16        |           | 4         |             | 47         |
| Fina Bank <sup>6</sup>        | 7          |           | 15        |           |             | 22         |
| I&M Bank                      |            | 6         | 15        |           |             | 21         |
| Commercial Bank of Africa     | 1          | 8         |           |           |             | 9          |
| NIC Bank                      | 1          | 5         |           |           |             | 6          |
| Imperial Bank                 | 3          |           |           |           |             | 3          |
| ABC Bank                      | 2          |           |           |           |             | 2          |
| Cooperative Bank              |            |           |           |           | 1           | 1          |
| <b>Total Kenyan Branches</b>  | <b>125</b> | <b>70</b> | <b>51</b> | <b>6</b>  | <b>31</b>   | <b>282</b> |
| <b>Total Kenyan Banks</b>     | <b>9</b>   | <b>7</b>  | <b>4</b>  | <b>3</b>  | <b>3</b>    |            |
| <b>Total Banks in Economy</b> | <b>25</b>  | <b>32</b> | <b>15</b> | <b>10</b> | <b>34</b>   |            |

Source: CBK 2012 Annual Bank Supervision Report and respective Central Banks

Similarly, African banks from outside East Africa have expanded their operations within the EAC to take advantage of business opportunities created by regional integration. In 2010, the Nigeria-based United Bank for Africa expanded its network in Kenya, Tanzania, and Uganda, noting business opportunities for the bank in financing infrastructure projects and issuing letters of credit for local businesses engaged in regional trade.<sup>22</sup> Also in 2010, Togo-based Ecobank announced expansion plans for the EAC motivated by serving regional corporations, international organizations, and small- and medium-sized firms. Once the EAC permitted the free movement of goods and services, Ecobank introduced a money transfer system that could conduct transactions across the region instantly.

Recent empirical studies undertaken by the Kenya Bankers Association provide insights on the regional expansion of Kenyan banking. In "The Drivers of Cross-Border Banking Expansion," Kodongo and Natto (2014) examine the entry of Kenyan banks in Rwanda, Tanzania, and Uganda.<sup>23</sup> Their results indicate that entry decisions are shaped by a follow-the-customer logic in which Kenyan

banks can pursue greater profits by crossing borders to service clients who themselves are exploiting investment opportunities created by progressive EAC integration. Kenyan banks also appear more likely to engage in cross-border operations as competition in their home market intensifies, as measured by domestic bank concentration, and regulatory conditions improve in neighboring EAC markets.

In a follow-up study, "Determinants of Banks Expansion in the East African Community," Njoroge and Ouma (2014) similarly study the entry of Kenyan banks in other EAC countries.<sup>24</sup> Their findings corroborate the follow-the-customer logic: Kenyan banks are significantly more likely to expand across the EAC in tandem with growing intra-regional investment and trade. They further show that bank size and efficiency, as measured by profits, are significant determinants of cross-border expansion. Larger, more efficient Kenyan banks appear to be better positioned to pursue higher profits in faster growing EAC economies like Rwanda, Tanzania, and Uganda. And they are more likely to enter such countries as they achieve macroeconomic stability along with higher growth rates and lower inflation.

<sup>22</sup> Victor Juma, "Hold Your Horses, Analysts Tell Banks on EAC Expansion," *Business Daily*, 7 July 2010.

<sup>23</sup> O. Kodongo and D. Natto, "The Drivers of Cross-Border Banking Expansion: Evidence from East Africa," KBA Centre for Research on Financial Markets and Policy Working Paper Series, WPS/03/14, Nairobi: Kenya Bankers Association, 2014.

<sup>24</sup> L. Njoroge and S. Ouma, "Determinants of Banks Expansion in the East African Community: An Empirical Analysis of Kenyan Banks," KBA Centre for Research on Financial Markets and Policy Working Paper Series, WPS/04/14, Nairobi: Kenya Bankers Association, 2014.

Despite rapid expansion of Kenyan banks across East Africa, the regionalization of the EAC financial sector remains asymmetric. Ongoing market integration has opened new markets and lowered the risks associated with cross-border expansion, but banks domiciled in other East African countries have not yet entered Kenya or other markets in a meaningful way. For example, banks from the two other large regional economies, Uganda and Tanzania, have failed to establish a regional presence. To date, among the non-Kenyan banks in the EAC, only two Tanzanian banks, the CRDB Bank and Export Import Bank, have established subsidiaries in Burundi and Comoros, respectively. At this stage, the Rwandan Bank of Kigali's representative office in Kenya is only evaluating the prospects for a long-term presence in the country.

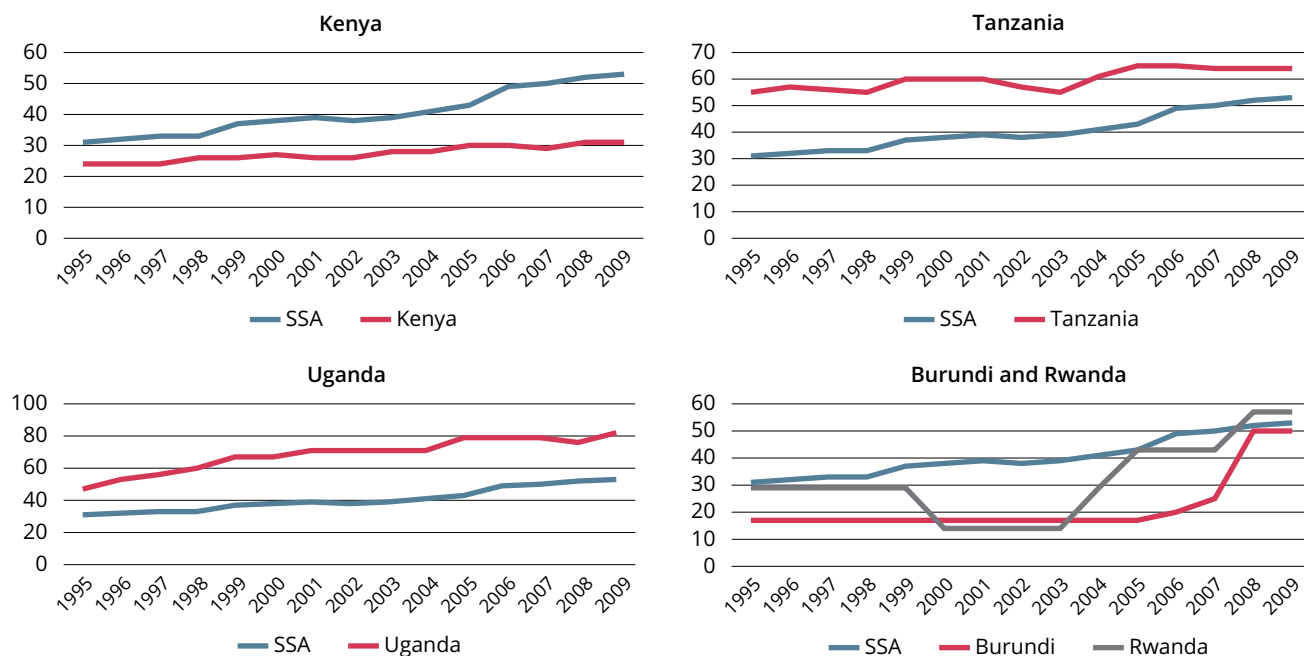
## 4.2 Host Country Impact

Foreign-owned banks have long had a presence in East Africa due to economic relationships forged during the colonial era. While progressive market integration among

EAC members may have facilitated cross-border expansion since 2005, foreign bank penetration began to accelerate a decade earlier as countries in the region began to undertake financial liberalization, including the acquisition of formerly state-owned banks by foreign banks. Figure 33 shows that foreign banks have dominated the banking sectors in Tanzania and Uganda since the 1990s. The presence of foreign banks, as percentage of all banks, has doubled in Burundi and Rwanda since the mid-2000s to approximate the regional average for sub-Saharan Africa. The relative position of foreign banks in Kenya, by contrast, has remained relatively constant and persistently below the regional average. The Kenyan pattern may reflect, in part, the competitive position of established domestic banks.

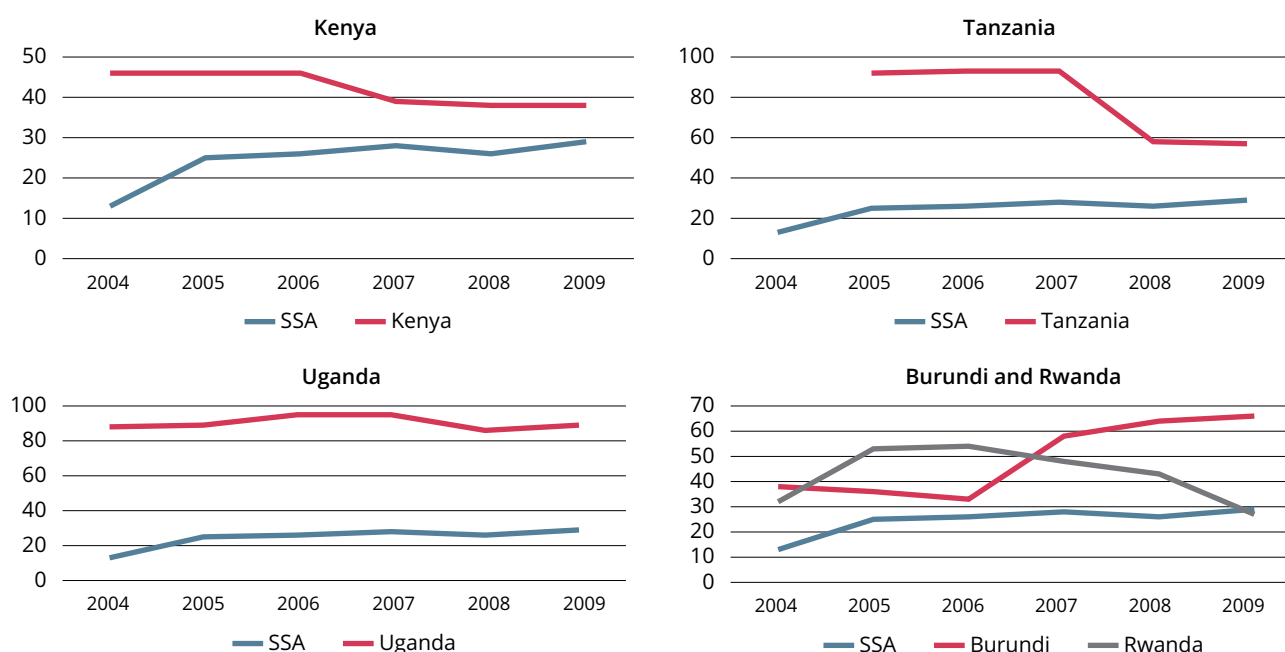
Figure 34 shows that foreign banks control a large proportion of bank assets throughout the region. The share of assets owned by foreign banks in all EAC economies generally exceeds the regional average. While foreign banks owned an average of 29% of total bank assets across sub-Saharan Africa in 2009, they controlled the majority

**FIGURE 33: Foreign Banks in the EAC**



Source: Claessens and Van Horen (2014).<sup>1</sup>

1 S. Claessens and N. V. Horen. 2014. "Foreign Banks: Trends and Impact," *Journal of Money, Credit and Banking*, Supplement to 46(1): 295–326. The database is available at <http://www.dnb.nl/en/onderzoek-2/databases/index.jsp>

**FIGURE 34: Foreign Bank Assets (% Total Bank Assets)**

Source: Claessens and Van Horen (2014).

of assets in Uganda (89%), Burundi (66%), and Tanzania (57%). While these figures partly reflect the entry of large, better-capitalized foreign banks into EAC economies, they also reflect the persistently small size of domestic banks. Recent trends in Rwanda and Tanzania suggest, however, that some local banks are expanding after being effectively recapitalized.

The net impact of foreign banks on the EAC banking sector remains unclear. On the one hand, foreign banks are expected to increase the provision of financial services. As opposed to small banks that often tend to serve niche segments of a market, foreign banks that maintain large operations in host countries may be more willing to lend to small and medium enterprises (Presbitero, Udell, and Zazzaro 2014).<sup>25</sup> Rwandan central bank officials, for example, have attributed to extension of banking services directly to the increased number of commercial banks that have expanded branch networks in their country.<sup>26</sup>

On the other hand, foreign banks have also been found to negatively affect private credit access in low-income developing countries as well as countries where contract enforcement is costly and credit information is limited (Claessens and Horen 2014).<sup>27</sup> Foreign banks may undermine overall access to financial services by “cherry picking” borrowers, worsening the credit pool for local banks (Detragiache, Gupta, and Tressel 2008).<sup>28</sup> In countries like Tanzania, for example, foreign banks often concentrate on their activities in servicing multinational corporations and international organizations along with the wholesale market for government securities. Moreover, although foreign banks are often assumed to promote financial stability by strengthening their local affiliates with improved management and greater capital, it is also possible for foreign banks to transmit funding shocks to their local affiliates (Popov and Udell 2012).<sup>29</sup>

<sup>27</sup> Claessens and Horen 2014.

<sup>28</sup> E. Detragiache, P. Gupta, and T. Tressel, “Foreign Banks in Poor Countries: Theory and Evidence,” *Journal of Finance*, 63, 2008, pp. 2123–2160.

<sup>29</sup> A. Popov and G. Udell, “Cross-Border Banking, Credit Access and the Financial Crisis,” *Journal of International Economics*, 87, 2012, pp. 147–161.

<sup>25</sup> A. F. Presbitero, G. F. Udell, and A. Zazzaro, “Home Bias and Credit Crunch: A Regional Perspective,” *Journal of Money, Credit and Banking*, Supplement to vol. 46, no.1, 2014, pp. 53–866.

<sup>26</sup> Saul Butera, “Banked Population Rise By 20 Percent,” *The New Times*, 5 February 2010.

Kenyan banks operating in other EAC markets may encourage greater financial stability by combining the best attributes of foreign and local banks. The entry of Kenyan banks not only adds to domestic competition—possibly increasing the quality of intermediation—but the close proximity of Kenyan subsidiaries to their headquarters may also facilitate greater access to financial services in host countries, especially as credit information and contract enforcement improve.

## 5. Toward Greater Financial Integration in the EAC

### 5.1 The EAC Monetary Union

The signing of the EAC's Monetary Union Protocol in 2013 marked an important milestone for the regional integration agenda. While previous efforts aimed at promoting economic integration among EAC members focused primarily on trade and investment, the role of finance in the integration process largely remained on the margin of inter-governmental negotiations. In accepting to form a monetary union, EAC members have recognized that an integrated financial system may be necessary to fully realize the benefits of their customs union and common market (e.g., increased competition, economies of scale, lower transaction costs) and thereby attain sustainable development.<sup>30</sup> The East African Central Bank (EACB), for example, is envisaged in the EAC Monetary Union Protocol as a supranational independent central bank that will acquire the sole right to issue currency and conduct monetary policy on behalf of its members.

The EAC Monetary Union Protocol stipulates a set of convergence criteria that at least three members must meet at least three years before the monetary union comes into effect by 2024. The three economies can then establish a single currency and a common monetary policy conducted by the EACB; others will join when they meet the criteria.<sup>31</sup> The primary convergence criteria are: a

ceiling on headline inflation of 8 percent; a ceiling on the fiscal deficit, including grants, of 3 percent of GDP; a ceiling on gross public debt of 50 percent of GDP in net present value terms; and a foreign currency reserve cover equivalent to 4.5 months of import cover. Other indicative criteria include a ceiling on core inflation of 5 percent, a ceiling on the fiscal deficit, excluding grants, of 6 percent of GDP; and a floor on the tax-to-GDP ratio of 25 percent.

The EAC Monetary Affairs Committee (MAC), which is comprised of the central bank governors from EAC members, is tasked with ensuring full integration of the region's financial system. The MAC has developed convergence criteria for harmonizing central bank legal and prudential supervisory rules and practices. It has also developed a bank-specific supervisory college framework to coordinate oversight for banks that maintain a significant regional presence. For example, in October 2012, the inaugural supervisory college meeting for Kenya Commercial Bank (KCB) included all six central banks where KCB operates. The purpose of the meeting was to share supervisory experience, exchange analytical intelligence, and create a collaborative supervisory framework.

### 5.2 The Optimal Currency Area Argument

Despite earlier protocols ensuring greater labor and capital mobility within the EAC—important pre-conditions for monetary union—it remains uncertain whether the region's members would constitute an optimal currency area.<sup>32</sup> The pursuit of a monetary union among EAC members would be worthwhile if a single currency permits national economies to adjust smoothly and return quickly to stability after experiencing symmetrical shocks. Even if such shocks were asymmetrical, but relatively manageable, the benefits of a single currency would still outweigh the costs.

A monetary union will be a costly arrangement for the EAC if shocks affect the real economy asymmetrically across members and each requires a different monetary policy response. Supply-side shocks are particularly important given that their effect on the real economy could shift an economy's potential output. But the EAC has yet to fully develop mechanisms (e.g., fiscal transfers, bailout clauses, etc.) that would enable its members to coordinate responses to asymmetrical shocks.

<sup>30</sup> See, for example, H. R. Davoodi, S. Dixit, and G. Pinter, "Monetary Transmission Mechanism in the East African Community: An Empirical Investigation," IMF Working Paper WP/13/39, 2013; H.R. Davoodi, ed, *The East African Community after Ten Years: Deepening Integration*, EAC Secretariat, 2012; D. Duverall, "East African Community: Preconditions for an Effective Monetary Union," University of Gothenburg School of Business, Economics and Law, Working Papers in Economics, No. 520, 2011.

<sup>31</sup> The EAC Treaty provides for the principle of variable geometry whereby some community members can move faster than others on some matters.

<sup>32</sup> R. Mundell, "A Theory of Optimum Currency Areas," *The American Economic Review*, Vol. 51, No. 4, 1961, pp. 657–665.

The EAC's move toward monetary union is undoubtedly informed by the European Union's experience in forming the Eurozone. The creation and maintenance of the Eurozone, especially since the global financial crisis that began in 2008, can provide the EAC with valuable lessons concerning the challenges likely to be faced in moving toward and then sustaining convergence. For example, the convergence criteria for establishing the EAC monetary union follows the basic parameters agreed to by EU members for their own criteria to form the euro, that is, requiring members to meet targets in areas like price stability and government debt. Nevertheless, recent analyses indicate the Eurozone economies have not been able to sustain their convergence: all were in violation of their own convergence criteria by October 2012.<sup>33</sup> It thus appears that Eurozone members, while ostensibly meeting explicit convergence targets in the short run, may not have given sufficient consideration to whether individual governments could maintain those targets in the long run, particularly under crisis. This has direct relevance for the EAC monetary union. Although EAC members have accepted explicit convergence targets, little attention has been paid to whether they will be able to attain those targets through sustainable processes or reforms. Indeed, given the evident variation in the external balances of EAC members, one serious concern is that countries with weak fundamentals may resort to meeting their target for foreign exchange reserves by having their monetary authorities intervene in the market.

Perhaps the most informative lesson the Eurozone case study could impart on the EAC process concerns Britain's decision not to join the euro. While the British economy was on strong footing to be among the first to qualify to form a single currency, the British Treasury spent the seven-year transition period leading up to the Eurozone's creation by applying five tests set out by the Chancellor of the Exchequer. These tests, which directly concern the formation of an optimal currency area, asked whether (a) business cycles and economic structures were sufficiently compatible so that Britain could live comfortably with euro interest rates on a permanent basis; (b) there was sufficient

flexibility to deal with problems if they emerged; (c) joining the euro would create better conditions for firms making long-term decisions to invest in Britain; (d) entry into the euro would impact the competitive position of Britain's financial services industry, particularly London's wholesale markets; and (e) joining the euro would promote higher growth, stability, and a lasting increase in jobs. In examining such questions, British policymakers were apparently concerned by two overriding issues that EAC members may want to keep in mind as they move toward their monetary union, namely, that meeting convergence criteria will entail significant transition costs that should not be ignored,<sup>34</sup> and that a monetary union may also require a fiscal union if it is to function optimally.<sup>35</sup>

### 5.3 The Institutional and Political Challenges to Regional Integration

Although the economic benefits anticipated from regional integration are regularly espoused by EAC members and their development partners, there has been little public discussion of how national governments plan to contend with or address the institutional challenges to be faced when implementing the regional integration agenda. Implementing the plans for monetary union, in particular, will ultimately require governments to relinquish some autonomy in key areas of policymaking. As they move from increasing levels of inter-governmental coordination to the actual execution of a single monetary policy and a single financial regulatory system, EAC members must not only forgo the ability to pursue unilateral policy choices, but they must also permit regional institutions to perform their functions across members' borders without political interference. Once the EACB begins to operate as a regional central bank, for example, EAC members will effectively lose the ability to adapt monetary policy in response to country-specific conditions.

Given their variable records of macroeconomic stability and monetary discipline, EAC members could profit from the integration process by willingly ceding a degree of economic sovereignty in exchange for greater policy credibility. But for EAC regional institutions to represent a credible commitment to sound policymaking, these institutions

<sup>33</sup> See the study by investment bankers Nordea [<http://research.nordeamarkets.com/en/2012/10/18/all-eur-countries-in-violation-of-their-own-convergence-criteria/>]. According to this study, of all the Eurozone economies, only the so-called peripheral economies of Finland, Luxembourg, and Estonia come closest to meeting the criteria at the time of assessment. Some studies suggest that the Eurozone was never an optimal currency area in the first place. See, for example, M. Furrutter, "The Eurozone: An Optimal Currency Area?" IIFER Papers, February 2012.

<sup>34</sup> Peter Westaway, "Modelling the transition to EMU: EMU Study," HM Treasury, 2003.

<sup>35</sup> HM Treasury, "The United States as a monetary union: EMU Study" HM Treasury 2003.



must be endowed with sufficient power to exercise independent authority and regulatory enforcement—without members being able to influence or reverse decisions at will.<sup>36</sup> The long-term sustainability of a monetary union will require institutions like the EACB to pursue policies that may occasionally conflict with the preferences of individual EAC members and may oblige them to take on commitments that they might not have made otherwise.

Toward that end, EAC members must do more to concretely specify how they plan to invest in regional institution building, that is, creating regional institutions capable of coordinating policies, obliging compliance by national authorities, and imposing sanctions when compliance is lacking. Existing EAC protocols do not address such issues in sufficient detail. The failure to do so in the near future could undermine the policy credibility of regional institutions because EAC members themselves have yet to develop the internal governance structures or institutional capacities necessary to ensure consistent voluntary compliance.<sup>37</sup> Delegating policymaking authority to regional institutions will prove inadequate unless accompanied by constraints that prevent EAC members from rewriting policies that prove to be politically inconvenient. Regional institutions must also be designed to resist pressure from individual members that may exercise considerable influence in particular domains (e.g., Kenya in the banking sector).

To date, however, EAC members have not undertaken the public debate necessary to legitimize a deepening integration process that will eventually constrain the ability of governments to pursue national preferences that may conflict with regional policies. In agreeing to the formation of a monetary union, EAC members have accepted convergence criteria that will eventually limit their ability to use fiscal policy to secure financing from the central bank or public debt to fund development projects. But the fiscal deficit convergence criterion may well pose the most significant challenge to EAC members. A fiscal union will not accompany the EAC monetary union, but it is now common practice for the budgets of the five EAC partners to be presented on the same day. This is an act beyond symbolism.

Fiscal coordination will ultimately be a key determinant of the success of the monetary union. As the experience of the Euro zone has shown, sovereign fiscal positions in a monetary union need to be taken into account. Individual members of a monetary union inevitably rely on fiscal policy as their primary macroeconomic lever to influence the economy, using expenditure and tax measures to respond to supply disturbances—as well as political concerns.

The case of Kenya underscores the potential political challenge that governments are likely to face in conforming to the fiscal constraints required by monetary union. While the EAC's monetary union protocol requires members to meet ceilings on fiscal deficits, Kenya's new 2010 Constitution has empowered county governments to make expenditures according to locally determined priorities. Subsequent legislation, such as the 2012 Public Finance Management Act, has clarified the national government's ability to impose discipline in the management of county resources. The national government, for example, must issue formal guarantees for loans taken on by counties, and it can suspend disbursements to counties that have taken on excessive debt.

Nevertheless, it remains unknown to what extent Kenya's national government will be able or willing to impose fiscal discipline on the counties when there are political incentives not to do so. The national government may fail to impose sanctions if the executive and legislative branches, controlled by different political parties, do not agree on what constitutes excessive debt. Alternatively, national politicians may choose not to rein in spending by their county-level counterparts if the latter can influence voter turnout in competitive elections.

Shoring up the policymaking credibility of the EAC's regional institutions is especially critical because individual EAC members are likely to continue facing political incentives either to deviate from the convergence criteria in the near term or to periodically ignore regional policies over the longer term. And relinquishing the option to do so may prove to be politically costly. Election-driven public debt in Uganda represents a case in point. During the 2011 national elections, for example, the Ugandan parliament approved a supplementary budget of approximately \$260 million that international observers and civil society representatives allege was mainly used to finance the ruling party's campaign.<sup>38</sup>

<sup>36</sup> Henrik Jensen, "Credibility of Optimal Monetary Delegation," *American Economic Review*, vol. 87, no. 5, 1997, pp. 911–920; Paul R. Masson and Catherine Pattillo, "Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?" *Journal of African Economies*, vol. 11, no. 3, 2002, pp. 387–412.

<sup>37</sup> Dominique M. Guillaume and David Stasavage, "Improving Policy Credibility: Is There a Case for African Monetary Unions?" *World Development*, vol. 28, no. 8, 1999, pp. 1391–1407.

<sup>38</sup> European Union Election Observation Mission, "Uganda 2011 Elections: Improvements Marred by Avoidable Failures," Preliminary Statement, 20 February 2011, Kampala.

Observers note that \$41 million of the supplementary budget allocated to the president's office, which is exempt from the legal prohibition on the use of public resources during elections, and that "nearly 330 [ruling party] candidates were each given UGS20 million (\$8,500) as campaign funding within days of Parliament endorsing the supplementary budget."<sup>39</sup> Subsequent public statements by Bank of Uganda Governor Emmanuel Tumusiime-Mutebile suggest that the central bank may have been pressured into issuing new treasury bills to finance the supplementary budget.<sup>40</sup> The Bank of Uganda's record suggests it may not have been the first time that it had engaged in politically motivated financing despite its constitutionally guaranteed independence.<sup>41</sup>

EAC members will be reluctant to relinquish their policy autonomy in favor of greater regional integration if the political costs (e.g., losing the power to use fiscal instruments to address political problems) are perceived to considerably outweigh the economic benefits. This is a possible scenario. The analysis of Debrun, Masson, and Pattillo (2011) suggests that the net benefits of monetary union are likely to vary across countries because greater monetary stability will not uniformly offset the costs derived from output shocks, yielding some gains for Burundi and Kenya, but smaller gains for Rwanda and Uganda and even small losses for Tanzania.<sup>42</sup> It thus remains to be seen whether national authorities will be able to overcome the strong domestic political incentives to delay full implementation of the EAC regional framework.

## 5.4 Empowering the EAC Secretariat

EAC members have sought to meet the challenge of deepening regional integration by increasing their coordination at the executive level. Besides the Summit of

heads of government where policy goals are issued, there is a Council of Ministers made up of ministers for regional cooperation from each member and a Coordinating Committee comprising permanent secretaries from each member. However, since these bodies meet on average only twice per year, the executive organ primarily responsible for policy management is the EAC Secretariat. It not only oversees the day-to-day administration of regional affairs; it is also mandated to undertake policy coordination and resource mobilization.

But the Secretariat cannot successfully manage the accelerating integration process under current conditions. Since its establishment under the terms of the EAC Treaty in 2000, the Secretariat has taken on additional responsibilities associated with the implementation of the customs union in 2004, the common market in 2010, and the monetary union in 2013. For example, according to the 4th EAC Development Strategy (2011/12—2015/16), the Secretariat is responsible for helping to implement all ten strategic interventions in customs administration, all nine strategic interventions in trade facilitation, and nine of twelve strategic interventions for realizing the monetary union. The Secretariat also provides essential functions for the East African Legislative Assembly and the East African Court of Justice.

The Secretariat's capacities have not been enhanced or its resources increased to keep pace with its growing mandate. This is a longstanding problem. The 3rd EAC Development Strategy (2006–2010) specifically noted: "The Secretariat has not been adequately staffed in terms of professional staff to undertake research, management and monitoring and evaluation of the tasks outlined in the Second EAC Development Strategy. Most of the staff is overstretched and not able to be as productive as is required for the implementation of all areas of the Strategy" (p. 20). While the Secretariat has since been able to expand and train up its staff, it continues to lack the capacity to efficiently carry out the multiple operations demanded by EAC members. As one example, the Secretariat does not have the analytical or institutional capacities necessary to adequately support the MAC in verifying whether members are meeting the convergence criteria for monetary union.

To fully realize the Secretariat's potential as a regional institution, EAC members should empower it with greater centralized policymaking authority. Its main function at present is to coordinate the policies of national governments and carry out the collective decisions of EAC members. Yet, in practice, the Secretariat has little power to compel implementation by national authorities. Endowing the Secretariat with the legal power to make certain decisions and enforce

<sup>39</sup> Roger Tangri and Andrew M. Mwenda, *The Politics of Elite Corruption in Africa: Uganda in Comparative African Perspective*. New York: Routledge, 2013, p. 117.

<sup>40</sup> Isaac Imaka and Stephen Otago, "I was misled into funding 2011 polls, says Mutebile," *Daily Monitor* (Kampala), 13 November 2014; Andrew M. Mwenda, "Mutebile's Revelations about 2011 Elections," *The Independent* (Kampala), 24 November 2014.

<sup>41</sup> Tangri and Mwenda 2013; Daniel K. Kalinaki, "Mutebile lifts the lid on patronage and electoral financing in Uganda," *The East African*, 15 November 2014.

<sup>42</sup> Xavier Debrun, Paul R. Masson, and Catherine Pattillo, "Should African Monetary Unions Be Expanded? An Empirical Investigation of the Scope for Monetary Integration in Sub-Saharan Africa," *Journal of African Economies*, vol. 20, AERC Supplement 2, 2011, pp. ii104–ii144.

regulations would enable it to overcome cumbersome procedures now associated with decentralized monitoring and implementation which have unnecessarily slowed the integration process. Strengthening the Secretariat in this respect would further reinforce the credibility of the broader integration process, especially if the Secretariat were to acquire the capacity to represent EAC-wide interests in international negotiations concerning issues such as trade and investment.

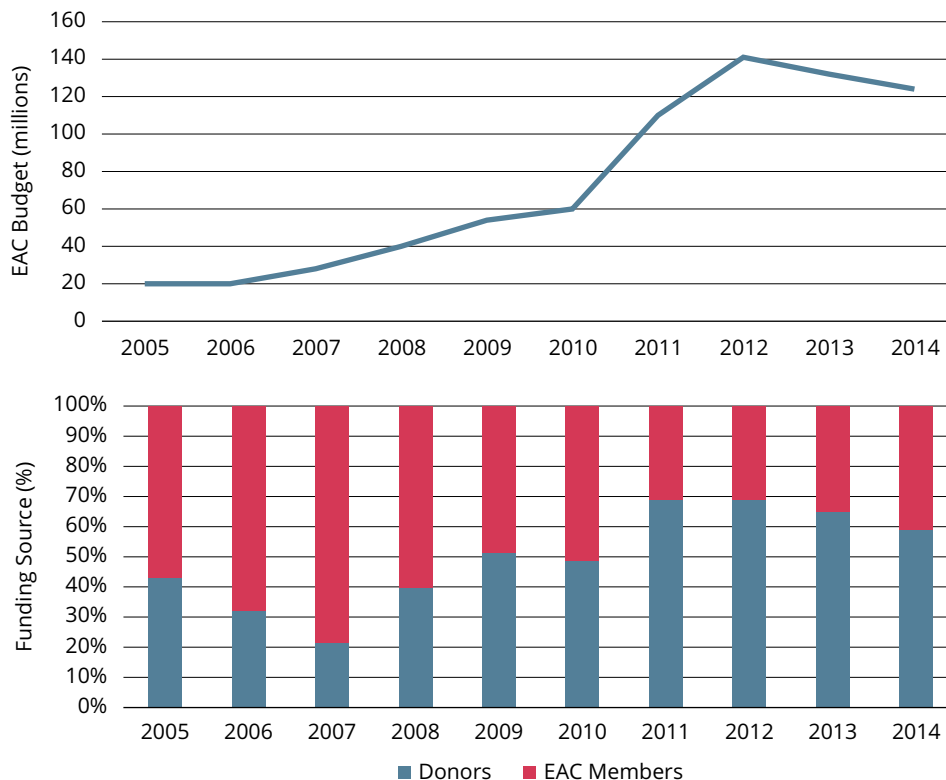
EAC members should empower the Secretariat by securing more sustainable funding for its operations. The EAC as a whole has become progressively dependent on donor resources to undertake regional integration. As Figure 35 shows, the EAC budget has grown from less than \$20 million in 2005 to more than \$124 million in 2014. At the same time, donor funding for the EAC budget has grown faster than funds provided by EAC members themselves. By 2011–2014, donors provided an average of two-thirds of the total EAC budget.

The EAC's reliance on donor funding is problematic because an increasing proportion of those funds are required for the Secretariat's core operations. The Secretariat's budget has nearly tripled from about \$25 million

(47% of the EAC total budget) in 2009 to more than \$76 million (61% of the EAC total budget) in 2014. But the Secretariat cannot be expected to consistently carry out its operations when donor funding is inconsistent. Consider the Partnership Fund established by donors specifically to coordinate support for the Secretariat's operations. The pool of resources has grown from less than \$650,000 in 2006/07 to over \$6 million in 2012/13. Nevertheless, despite the Partnership Fund's growth over time, large year-to-year changes in funding levels can present the Secretariat with problems. The Partnership Fund provided the EAC with over \$8 million in 2010/11, but the funding dropped by over a third to nearly \$5 million the following year. Moreover, not all donors are committed to consistently replenishing the pool of funds. Among the Partnership Fund's ten donors, only one country—Germany—has contributed every single year between 2006/07 and 2012/13. In the last year, only five of ten members contributed to the pool.

EAC members must not only secure alternative mechanisms for funding the Secretariat, but they must also commit more of their own resources to the institution if they are to assure themselves complete ownership of its expanding

**FIGURE 35: EAC Budget and Funding Sources**



Source: East African Community Secretariat.

operations. The EAC's existing plans for resource mobilization continue to excessively depend on donor aid and external grants. For example, according to the minutes of the Partnership Fund Steering Committee meeting held in June 2013, EAC members planned to contribute only \$62,800 out of the \$1.6 million budgeted for implementation of the monetary union protocol in 2013/14; donors provided the remaining 96% of funds. Such arrangements will have to change if the Secretariat is to become a credible institution capable of managing the EAC's deepening integration.

## 6. Persistent Policy Divergence

The creation of a common market that provides for the free movement of capital and services, coupled with the implementation of a monetary union protocol, has enabled EAC members to make steady progress toward deepening regional financial integration. The EAC integration framework is facilitating the work of central bank officials from across the region in harmonizing banking regulations, sharing supervisory information, and participating in joint examinations of banks that operate in multiple countries. The most recent example of progress made toward the creation of a single market in financial services is the successful 2013 launch of the East African Payment System (EAPS) for cross-border payments in real time. The EAPS stems from a decision taken by the EAC's Monetary Affairs Committee (MAC) requiring central bank officials to establish a mechanism for connecting otherwise fragmented payment and settlement systems. The EAPS is now facilitating payments between Kenya, Tanzania, and Uganda and will eventually be joined by Burundi and Rwanda.

The EAC integration framework is also having a direct impact on the policy decisions taken by coordinating the reforms undertaken by individual governments. For example, at a 2005 meeting of the MAC, the central bank governors of Kenya, Tanzania, and Uganda agreed to coordinate plans for deepening financial sector development and integration. After that 2005 MAC meeting, Uganda moved to lift its temporary moratorium on the licensing of new banks in 2007 and then launched a five-year financial development plan that included the licensing of new banks to encourage greater competition in the sector as well as greater access to services.<sup>43</sup> The Bank of Uganda established a Financial Markets Development Committee (FMDC)

that included representatives from the banking sector to design and implement its financial development plan. And in 2010 the Ugandan government increased capital requirements in order to remain in line with other EAC members.<sup>44</sup>

But even as regional financial integration accelerates within the EAC, there remain considerable challenges that may stall the integration process at later stages. There are obvious challenges to coordinating policy reforms among countries with widely varying levels of macroeconomic stability and financial development. Yet, unless EAC members begin to address the institutional and policy gaps among them in a coordinated fashion—rather than relying on market incentives to sustain the momentum of integration—they are likely to lose out on future business opportunities made possible through greater integration.

Consider, for instance, the market for mobile money services. Kenya and Tanzania are two of the global frontrunners in the use of mobile money transfers, but cross-border mobile money services currently only occur on a small, unregulated scale. Service providers are aware of the potential revenues to be made from tapping the growing volume of trade between people living on both sides of the border, but they are reluctant to expand in the absence of an integrated legal framework. Tapping this particular market points to the complexities that national authorities will confront as they try to forge a set of common regulations to be applied equally in all countries. Policies and regulations for mobile money services will not only be shaped by negotiations among central bank authorities, but also through negotiations between them and communication sector regulators as they consider technical issues such as system security as well as legal questions concerning anti-money laundering requirements.

Perhaps the most difficult challenge to future financial integration stems from the persistent policy differences within the EAC. While all members of the EAC participate in the common market and have agreed to move toward monetary union, each country faces internal political constraints that may impede the adoption of necessary sectoral reforms, especially as they perceive different trade-offs between the costs and benefits of further integration. According to Booth et al. (2014), reforms may lack sufficient political support if they threaten rents tied to the clientelistic networks that structure politics in most East African countries.<sup>45</sup>

<sup>43</sup> "Country Launches EAC Financial Markets Plan," *East African Business Week*, 14 September 2008.

<sup>44</sup> Sylvia Juuko, "Regional Banks in Critical Reforms," *The New Vision*, 19 May 2010.

<sup>45</sup> David Booth, Brian Cooksey, Frederick Golooba-Mutebi and Karuti Kanyinga. *East African prospects: An update on the political economy of Kenya, Rwanda, Tanzania and Uganda*. Overseas Development Institute. May 2014.

Kenya is the EAC member most likely to continue promoting the agenda of regional financial integration. Kenyan banks and insurance companies have already directly benefited from liberalized rules on the movement of capital and services, so the Kenyan government has an incentive to continue advocating for the continual elimination of other barriers to the cross-border expansion of financial services. Some analysts suggest that there is also a political basis for Kenya's proactive position on financial integration. Booth et al. (2014, 17) claim that the financial sector particularly benefited from improved government treatment after the country's regime transition in 2002.<sup>46</sup> Key investors in the private banking sector also happen to be business partners and political allies linked to former President Mwai Kibaki and his close associates.

Uganda has largely pursued a pro-integration position similar to Kenya's, as long-ruling President Yoweri Museveni has encouraged the development of the private sector along with greater foreign investment. However, the prevalence of clientelistic politics in the country has made the implementation of policy reforms inconsistent, as local entrepreneurs and their political allies vie for explicit preferential treatment by the state or implicit exemptions secured through corruption.<sup>47</sup> Under such conditions, even if Uganda accepts to undertake additional policy reforms to achieve greater financial integration, it remains in doubt whether those policies will be consistently implemented.

Tanzania is the country where further financial integration is most likely to be resisted. Juma Mwapachu, former EAC Secretary General, has publicly stated that Tanzania actively "blocks or delays decisions towards deepening or widening EAC integration."<sup>48</sup> Booth et al. (2014) suggest that consistent reform implementation in Tanzania has been hindered by a combination of factional competition within the ruling party, *Chama Cha Mapinduzi*, and continued ideological resistance to economic liberalization. The Tanzanian government's resistance to integration stems, in part, from one of the main causes that led to the collapse of the first East African Community in 1977—namely, the fear of economic dominance by Kenyan firms. While the Tanzanian government claims it remains committed to the EAC integration process, the government's relations with Kenya, Rwanda, and Uganda became strained in 2013 over plans to accelerate regional integration. Tanzania's representatives, for example, refused to attend certain EAC meetings in protest.<sup>49</sup> At the same time, Tanzania is perhaps the EAC member most actively seeking to diversify its economic ties, as it continues to pursue commitments through the Southern African Development Community (SADC).

The policy distance among the largest EAC members toward greater financial integration is most evident in their *de jure* capital controls. Figure 36 presents the financial

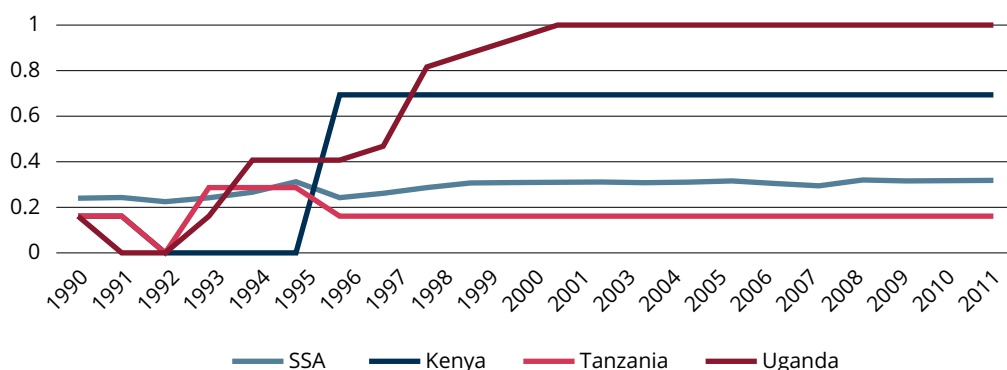
<sup>46</sup> Booth et al., 2014, p. 69.

<sup>47</sup> Aili Mari Tripp, *Museveni's Uganda: Paradoxes of Power in a Hybrid Regime*. Boulder, CO: Lynne Rienner, 2010.

<sup>48</sup> Quoted in Booth et al., 2014, p. 55.

<sup>49</sup> Muthoki Mumo, "EAC wobbles, but stays on its feet," *Daily Nation*, 30 December 2013; Daniel K. Kalinaki, "Members pull apart: Is this the beginning of the end of EAC?" *The East African*, 2 November 2013; "Tanzania officially renounces 'coalition of the willing,'" *The East African*, 21 October 2013.

**FIGURE 36: Financial Openness in EAC Countries**



Note: The Chinn-Ito index of capital account openness is normalized between zero and one. Higher values indicate greater openness in cross-border capital transactions.

Source: Chinn and Ito (2008).

openness index scores for Kenya, Uganda, and Tanzania along with the regional mean for sub-Saharan Africa. The Chinn-Ito financial openness index is based on information found in the International Monetary Fund's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), including restrictions on current account transactions and capital account transactions. The index thus serves as a proxy for policy intentions.<sup>50</sup> In this respect, two patterns are particularly noteworthy. First, there is a wide gap between the more liberal financial regimes of Kenya and Uganda and Tanzania's more restricted financial regime. Although not reported in Figure 36, both Burundi and Rwanda have more restricted financial regimes that are closer to the Tanzanian position. Second, despite the implementation of the EAC's customs union and common market, there is no evidence of movement toward greater financial openness in Tanzania.

The intra-EAC differences are similarly apparent in the steps taken by these countries to expand access to credit information. Figure 37 shows the depth of credit information index scores for Kenya, Tanzania, and Uganda along with the regional mean for sub-Saharan Africa. Produced by the World Bank's *Doing Business Survey*, the index measures access to credit information available through public credit registries or private credit bureaus. The cross-national pattern mirrors what was found in Figure 36, that is, while both Kenya and Uganda have made some progress in expanding the coverage of credit information by licensing private credit bureaus to facilitate the

screening of borrowers, Tanzania has made no progress in this respect. Burundi and Rwanda are not shown in Figure 37, but the trend line for the former follows the Tanzanian pattern, while the trend line for the latter shows considerable improvement on the scale seen in Uganda. Since the improvement in Rwanda and Uganda's credit information index scores coincide with the establishment of the EAC customs union, it is notable that no such development is seen in Tanzania.

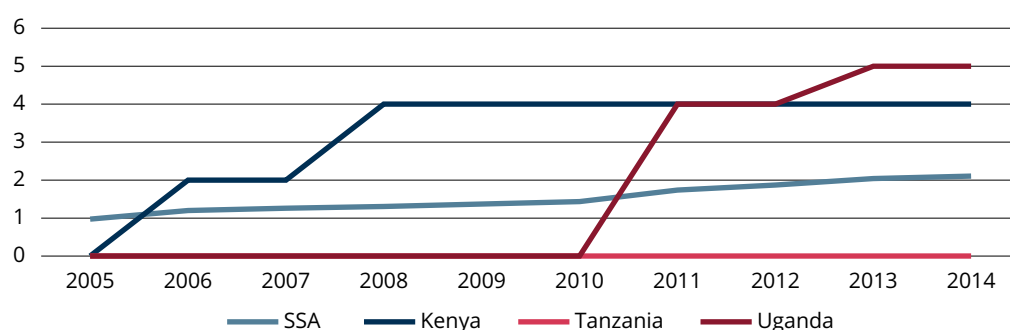
EAC members are not consistently implementing the policies required to make their customs union and common market a reality, let alone create the necessary conditions for establishing a monetary union. The World Bank's East African Common Market Scorecard has measured the degree of legal compliance with obligations undertaken by EAC members to liberalize the cross-border movement of capital, services, and goods.<sup>51</sup> In examining 683 laws and regulations relevant to the common market, including 124 focused on the movement of capital, Scorecard researchers find that, overall, EAC members continue to enforce laws and regulations that impede cross-border investment and trade.

Article 24 of the EAC Common Market Protocol specifically requires EAC members to eliminate restrictions on the free movement of capital. Annex VI of the protocol identifies twenty operations involving securities, credit, direct investment, and personal capital transactions that should be free from any legal restrictions. However, with

<sup>50</sup> M. D. Chinn and H. Ito, "A New Measure of Financial Openness," *Journal of Comparative Policy Analysis*, Vol. 10, No. 3, pp. 309–322, 2008.

<sup>51</sup> *East African Common Market Scorecard 2014: Tracking EAC Compliance in the Movement of Capital, Services and Goods*. Washington, DC: World Bank, 2014. <https://www.wbginvestmentclimate.org/publications/eac-market-scorecard-2014.cfm>

**FIGURE 37: Depth of Credit Information in EAC Countries**



Note: The depth of credit information index ranges from 0 to 6 with higher values indicating greater availability of credit information.

Source: World Bank Doing Business Survey.



reference to capital movement, the Scorecard researchers find that only two capital operations are free from restrictions in all five EAC countries: external borrowing by residents and repatriation of proceeds from sale of assets. Otherwise, many other capital operations, including those concerning securities and direct investment, continue to be hampered by legal restrictions. Capital controls are the most severe restriction on the movement of capital across the EAC, affecting the majority of transactions covered under the protocol. Indeed, while the EAC Common Market Protocol that went into force in 2010 prohibits new restrictions on capital movement, Rwanda, Tanzania, and Uganda have since adopted at least ten new restrictions.

All EAC countries maintain restrictions that affect investment from other EAC members, but the degree of restriction varies considerably across countries. Scorecard researchers find that capital movement is easiest under Kenya's legal framework: 17 of the 20 operations identified in Annex VI of the Common Market Protocol are unrestricted. In Rwanda and Uganda, 15 of the 20 operations are unrestricted. Capital movement is most difficult in Tanzania and Burundi, where only 4 of the 20 operations are unrestricted. And they are the only two EAC countries that restrict lending abroad by their residents.

Scorecard researchers further find that EAC members have yet to attain the coordination required for monitoring and enforcing the free movement of capital within the common market. With the exception of Burundi, EAC members have put in place exemptions to the protocol for the purposes of prudential supervision and public policy. Yet, they have failed to notify their partners or the EAC Secretariat along with evidence that the exemptions were justified, as required by the Common Market Protocol.

This failure to fully liberalize capital markets and financial services, as stipulated in the EAC protocols, may help to explain why the potential benefits of greater banking competition (e.g., lower intermediation spreads and broader banking access) have yet to be realized in most EAC countries. The large banks that dominate banking have been able to continue charging considerable mark-ups on financial services despite the entry of Kenyan and foreign banks in most EAC markets. Large banks can afford the costs associated with capitalizing subsidiaries in separate markets and meeting the requirements of multiple regulators, but such conditions make the cost of entry prohibitive for most small- to medium-sized banks. Concerted progress by EAC governments toward the regionalization of licensing, branching, and supervision would effectively remove barriers to greater competition in banking, which

would provide the most tangible benefits for the largely unbanked populations of countries such as Burundi, Uganda, and Tanzania.

## 7. Conclusions

This chapter has examined the evolving dynamics of regional financial integration in the EAC. The evidence suggests that regional initiatives and government policies continue to lag behind the market forces that stimulated the cross-border investments of banks over the past two decades. The integration process has also evolved asymmetrically, as Kenyan banks have aggressively pursued opportunities in neighboring markets with little to no cross-border participation from banks based other EAC countries. This asymmetry stems to a large degree from widely differing conditions in terms of financial development. Kenya's financial sector has long been the region's largest and most developed, while the financial sectors in countries like Uganda and Tanzania continue to recover from the legacies of previous statist banking policies.

All EAC members have agreed to establish a monetary union within ten years, and they have already taken positive steps to coordinate financial policies and regulatory activities. The creation of a supervisory college framework that brings together central bank representatives from all EAC members to examine banks that operate regionally is one such example. Nevertheless, the principal challenge to greater regional financial integration in the EAC remains the divergence between government policies and official attitudes. Financial firms and services have yet to receive equal treatment across borders because some EAC members have yet to fully implement commitments made under prior protocols. Some governments may fail to carry out necessary reforms, or even enact new barriers, because financial integration may threaten domestic interests linked to those who hold office. But, as a result, the benefits to be derived from greater regional financial integration—greater competition, lower costs, broader access—will not be fully realized.

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# Chapter 4: Political Economy of Trade in Professional Services in the EAC

## 1. Introduction

In East Africa, professional services are a small but growing sector that is important to industries including mining, manufacturing, and other service sectors. They aid growth through such benefits as higher productivity, lower transaction costs, and better production processes. On the basis of a survey of more than 500 firms, earlier studies have found that East African firms that use professional services (auditing/accounting, legal, and engineering) are 10 to 45 percent more productive than firms that do not use these services. Professional services are also an important avenue for both export diversification and increasing exports. However, at present professional services make a “meager” contribution in East Africa. There are relatively few professionals and the region is facing a “middle-level skills vacuum”—for example regarding paralegals—and a broad mismatch of skills and needs.

Policy makers in East African countries have recognized that weaknesses in their professional services sectors impede growth and are beginning to prioritize reform of these services, including by creating more integrated regional markets. In parallel with domestic reforms in these sectors, the five countries of the East African Community (Burundi, Kenya, Rwanda, Tanzania, and Uganda) are beginning to implement commitments on professional services included in the Common Market Protocol. Also, the development of mutual recognition agreements (MRAs) of professional qualifications to facilitate the movement of professionals supplying services in sub-Saharan Africa features high on the agenda of the EAC. In fact, the EAC countries have already signed agreements on the mutual recognition of professional qualifications and licensing requirements in accounting, engineering, and architectural services.<sup>1</sup>

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World Bank

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<sup>1</sup> The MRA for accounting services was signed in September 2011, the MRA on architectural services in July 2011, while the MRA in engineering services in December 2012.

In this context, this chapter attempts to support these reform efforts by identifying the key policy constraints affecting professional services and analyzing the regulatory experiences in accounting, engineering, and legal services in Eastern Africa. Section 2 summarizes the key findings of previous studies on professional services. These studies revealed a large cross-country and sectoral variance of the regulatory and trade environment and a significant diversity in the reform experience of the examined countries and sectors. An important lesson learned from the EAC regulatory experiences is that there is hardly ever a “quick fix solution” to regulatory problems. The sometimes slow and modest results of regulatory cooperation reflect the complex political economy processes that need to be addressed when implementing regulatory reforms. Sections 3 and 4 therefore extend the analysis on professional services to include conceptual and applied questions regarding the political economy of reform with the objective of providing concrete guidance for reforms and accelerating regional integration in East Africa. Section 5 concludes.

## 2. Professional Services in East Africa

The analysis of professional services sectors in Africa has been hampered by the lack of information on demand and supply, including data on market conditions and policies and regulations in professional services. To address this gap, a comprehensive data collection exercise including enterprise surveys covering users and providers of professional services, and regulatory surveys (covering entry and conduct regulation applied to domestic and foreign providers), was undertaken by the World Bank in Eastern Africa in 2009–10. The World Bank analysis highlighted the economic importance of professional services, the nature of restrictions that currently segment the regional market and prevent trade in professional services between sub-Saharan African countries, and the regulatory issues that must be addressed to allow for effective competition in

an integrated regional market (World Bank 2010a, 2010b, 2011a, and 2011b). Key findings included:

- The professional services sector is among the most dynamic in the region and, crucially, higher labor productivity is associated with greater use of professional services in Eastern African firms.
- There are striking differences in the level of development of professional services across countries in Eastern Africa suggesting that the potential for regional trade in professional services is significant.
- Regional integration could help address the underdevelopment of professional services markets, reduce the high costs of accessing professional services, and alleviate skills shortages and skills mismatches in professional services.
- At this stage, restrictive trade policies and regulatory heterogeneity have segmented regional markets for professional services in sub-Saharan Africa and have increased trade costs.
- To turn this sector around, the studies call for policy action in four areas: education, regulation of professional services, trade policy, and labor mobility at both the national and international levels.

In particular, the studies called for the following policy reforms:

### **Reforms at the National Level**

#### **Education reforms need to help students acquire market-relevant skills:**

- Financial constraints prevent individuals from acquiring a professional education, so *developing new and expanded means of financing higher education* (such as student loans schemes) is a priority.
- Weaknesses in African educational systems mean that students are poorly equipped to acquire professional skills, so *enhancing the quality and capacity of schools (especially in mathematics, sciences, and technical studies)* needs to be a key item on all countries' policy agendas.
- Given the capacity constraints and quality limitations of professional education institutions, *improving existing institutions and encouraging the creation of new ones is necessary*.
- Policy action to *encourage closer collaboration and consultation between employers, professional associations, and education institutions* could help professionals

acquire the job-market relevant skills and the crucial practical training.

#### **Regulatory reforms need to focus on incremental, qualitative improvements in domestic regulation:**

- *Disproportionate cumulative entry requirements need to be relaxed.* For example, narrowing the scope of exclusive tasks in certain professions would contribute to this goal. Exclusive rights can lead to increased specialization of professionals and guarantee a higher quality of service, but if they create monopolies they can have adverse price and allocation effects, especially when granted for services for which adequate quality can be provided at a lower cost by less-regulated middle-level professionals. Adequate regulations to ensure that professionals are equipped with market-relevant skills need to be put in place.
- *Disproportionate price restrictions that limit competition need to be eliminated.* Price regulations affecting legal services and public procurement contracts in engineering are supported and introduced by professional associations or the government, who claim that they are useful tools to prevent adverse selection problems. The EAC countries need to adopt less restrictive mechanisms, such as better access to information on services and services providers to accomplish the same goals at lower economic cost.
- *The countries need to allow advertising of professional services*, which facilitates competition by informing consumers about different products and which can be used as a competitive tool for new firms entering the market.
- *The key issue regarding regulatory reform is not less regulation but better regulation;* that is regulation that more effectively achieves public policy objectives while ensuring efficiently produced low cost services. Tools and procedures can be put in place to assist policy makers to assess whether existing or new regulation will achieve the sector-specific public policy objectives while contributing to market openness.

### **Reforms at the International Level**

The fragmentation of regional markets for professional services and professional education by restrictive policies and regulatory heterogeneity prevents countries from taking advantage of gains from trade based on comparative advantage, as well as gains from enhanced competition and economies of scale. Trade barriers would ideally be liberalized on a most favored nation (MFN) or non-preferential

basis, since this would generate the largest welfare gains, and complemented with regional cooperation to reduce regulatory differences.

***In education, the EAC countries should consider options to develop regional training hubs.***

The absence of institutions that offer specialized (post-graduate) courses (e.g., in legal and engineering services) was noted in several EAC countries, as was the absence of institutions offering academic and professional training courses for middle-level professionals. Where the market of a given country (e.g., Burundi or Rwanda) is too small to justify the creation of these missing institutions or courses, policies to facilitate access to foreign training are needed—including portability of course credits and scholarships.

Also, specialized courses for which a need was expressed in several EAC countries (e.g., legal courses focusing on e-commerce, technology transfer, etc.) could be designed and implemented at the regional level. In general, the fragmentation of the regional market for education by differences in regulation can prevent the emergence of regional hubs for higher education, so smoothing these regulatory differences can lead to a greater variety of higher education services becoming available at lower costs for students in sub-Saharan Africa. Regional institutions that are allowed to operate at the regional level and are accredited to deliver courses that are recognized by all countries could exploit economies of scale and recoup the large fixed costs of establishing training programs in order to produce students with the necessary specializations for the EAC region.

***In terms of trade reforms, steps need to be taken to relax the explicit trade barriers applied by EAC countries to the movement of natural persons and commercial presence of professional services.***

Examples of possible reforms are:

- Articulating the economic and social motivation for nationality and residency requirements;
- Minimizing restrictions on the forms of establishment allowed;
- Developing a transparent and consistent framework for accepting professionals with foreign qualifications.

***The reduction of explicit trade barriers also needs to be complemented with the reform of immigration laws and rules on the hiring of foreign workers.***

Trade liberalization needs to be coordinated with regulatory reform and cooperation at the regional level. Deeper

regional integration, through regulatory cooperation with neighboring partners who have similar regulatory preferences, can usefully complement non-preferential trade liberalization. Opening up regional boundaries and establishing Mutual Recognition Agreements (MRAs) would facilitate EAC integration in professional services. The EAC Common Market Protocol, adopted by the Multi Sector Council in 2009, includes an annex on a framework agreement on MRA of academic and professional qualifications. The five EAC countries have already signed an MRA in accounting services and implementation focuses on the following areas: requirements for education, examinations, experience, conduct and ethics, professional development and re-certification, scope of practice, and local knowledge. However, implementation of the negotiated MRAs remains a challenge across the region.

Policy measures in all four areas—education, domestic regulation, trade, and labor mobility—can affect the markets for professionals and professional services, including the exports of professional services to regional trading partners.

### 3. The Political Economy of Trade in Services: A Theoretical Approach

While a subset of the EAC group has made good progress with regional liberalization and regulatory cooperation, such developments have been much slower in the other member countries where a handful of regulatory restrictions and trade barriers still persist in professional services. This sort of disparity persists across sectors too. At the one end of the regulatory reform spectrum, we find that in legal services regulation has barely moved over the past ten years. At the other end extensive regulatory and trade reforms have been implemented in accountancy and engineering services. Most progress seems to be achieved in accountancy services where domestic reform has been complemented with regulatory cooperation at the regional level. According to stakeholders in several East African countries, one factor that explains the more rapid progress with both regulatory and trade reforms in accounting services is the increased exposure to foreign competitors.

To better understand the uneven progress with reform at the national level and help accelerate regional integration in professional services in the EAC region this section will address in detail the political economy constraints associated with professional services reform. The framework of our analysis is rooted in the recent political economy

literature of trade and regulatory reform. It applies a “problem-driven” political economy approach to better understand the potential roadblocks and frictions to reform and explain why progress in implementing these recommendations has been slow and uneven across countries and sectors (See Box 2).

There are a number of political economy approaches that could be used to analyze trade liberalization. For example, Gilpin (2001) analyzes the comparative drivers of economic integration, while Mansfield, Milner, and Pevehouse (2008) look at the political factors and relationships among countries to explain trade agreements results. Whenever possible, we will try to complement the structural, institutional,

sectoral, strategic, and international drivers covered by the “problem-driven” political economy approach with insights into the political framework to develop practical advice and guidance to policy makers who wish to implement reform. We will attempt to answer the following questions: What triggered regulatory changes in reforming countries? Why were some sectors reformed earlier and more deeply than others? What explains the more rapid progress in certain EAC countries? How can we explain the different degrees of resistance to change by country or sector? How can we advance the EAC integration process in professional services? How can we build on progress in the more advanced subset of countries?

## **BOX 2: Problem-Driven Political Economy**

While there are numerous political economy methodologies available, a particularly useful framework is offered by using a “problem-driven” governance and political economy (PGPE) approach, developed by the World Bank (Fritz, Kaiser, and Levy 2009). At the core of such an approach is a focus on a particular problem, opportunity, or vulnerability that needs to be addressed. Such a methodology allows for a better understanding of specific issues and challenges, rather than on developing broad overviews, in order to generate useful findings and implications (*ibid.*).

Once these individual issue areas are delineated, a second level of analysis will involve mapping out the governance and institutional arrangements as well as their weaknesses. This involves a thorough mapping of the relevant branches of government, ministries, SOEs and their interaction; existing laws and regulations; and *de jure* and *de facto* policy processes. The reasoning for mapping out these arrangements is to understand how they might relate to poor outcomes or the lack of progress on certain reforms. Once this analysis of the institutional structure is complete, a third level of analysis is applied to drill down to the political economy drivers to identify key obstacles and opportunities. Accordingly, this third level of analysis will seek to understand key stakeholders, rents and their distribution, historical legacies, prior experience with reforms, social trends and forces, in order to draw inference and gain insight into how these factors shape stakeholder actions and interests (*ibid.*).

A three-level, problem-driven approach as described above can be especially useful in understanding the underlying political economy determinants and constraints to the professional services sector. Given the nature of the sector, the trajectory of its development in the EAC region thus far, and the potential transformative effects it can have on both the regional and national economies of the member states, it is essential to tease out the key drivers that contribute to the development, regulation, and future prospects of trade in services. Accordingly, this analysis is not about identifying one major bottleneck, but rather, understanding the political economy decisions of a myriad of challenges and frictions, and perhaps suggesting which dimensions could be addressed. Such an approach will provide insight not only into challenges that result in necessary reforms not gaining traction, but also into potential opportunities that may unlock key roadblocks in the reform process.

As will be detailed below, the three domestic drivers will be further explained, and subsequently supplemented by incorporating an additional three regional drivers which can be extrapolated from the existing political economy literature on regional integration and regional services agreements. In doing so, this analysis hopes to present a customized framework through which trade in professional services can be conceptualized at the regional level, and to highlight specific issues that are relevant for developing the services sector in the EAC in particular.



### 3.1 Domestic Level Political Economy Drivers

The application of the PGPE approach will first consider three domestic political economy “drivers” through a detailed analysis of structural, institutional, and stakeholder issues.

**Structural Drivers** are those factors that are beyond the control of the government and reflect deeper features of the respective countries, such as resource endowments, geographic position, levels of development, or population dynamics, which may affect a country's institutional set-up. Such issues may additionally stem from the types of colonialisation and decolonisation that a particular country experienced, as well as other historical processes that have shaped the political, social, and cultural institutions that affect actors' incentives (Fritz, Kaiser, and Levy 2009, 10). In many cases these issues cannot be changed in the short- to medium-run, and define a country's *status quo* situation. At the same time, structural issues can have a large impact on the opportunities that a country has with respect to its bargaining position, as well as with respect to the exogenous risk that it faces in a global system. For example, structural issues may make an economy more exposed to commodity price shocks, currency fluctuations, or other macro-economic fragilities.

Given the nature of the professional services sector in the EAC, structural drivers could potentially have great importance on the political economy at the national levels across the five member countries. As noted by Byiers, Vanheukelom, and de Roquefeuil (2013) in their analysis of the political economy of regional integration, there are a number of divergent structural issues in the EAC countries which are particularly relevant. Kenya stands out as the regional hegemon, with a total of 37 percent of EAC GDP and the highest per-capita GDP in the region. Tanzania is the most populous country in the region with 48 million inhabitants, and, together with Kenya's 43 million inhabitants, accounts for 70 percent of the EAC economy. Uganda, Rwanda, and Burundi have a smaller economic footprint in terms of the EAC's overall economy, and their landlocked nature separates them from Kenya and Tanzania, who have direct coastal access through their large ports. Kenyan exports to the EAC represent approximately a quarter of its total exports, while export concentration to EAC markets by Tanzania is considerably smaller. Exports in EAC countries, regardless of their size, are generally concentrated in primary commodities. Aside from these economic, population-based, and geospatial differences, the five countries of the EAC have divergent colonial histories, with Rwanda and Burundi having Francophone

historical roots, as opposed to their Anglophone neighbors in the East (Byiers, Vanheukelom, and de Roquefeuil 2013, 13–14).

**Institutional Drivers**, which can be seen as the “rules of the game,” are a combination of the formal laws and regulations, as well as less formalized customs and institutions. Understanding both formal and informal institutions is essential, as they provide a clearer picture about the context in which actors operate, but also identify “levers of change” in existing systems (Fritz, Kaiser, and Levy 2009, 46). From an institutional level, mapping can be a valuable instrument in understanding structural political economy factors. As will be discussed subsequently, such an exercise includes analysis of informal institutions such as kinship structures, traditions and social norms, as well as formally codified institutions such as laws, regulations, and agencies. Importantly, as noted by the problem-driven literature, it is necessary to understand the relationship between formal and informal institutions and to ascertain if they have complementary, accommodating, substituting, or competing relationships.

Across EAC countries, however, there is a divergent degree of performance in terms of business climate, with Rwanda ranked as a top reformer (number 52) versus Burundi's performance (number 159). The most notable feature of the region as a whole is the Common Market Protocol, which entered into force in 2010 and guarantees the free movement of people, goods, services, and capital. Despite this agreement to implement these policies by 2015 (Rwanda remains the only country to have met the agreed deadlines), lack of implementation can have a great impact in how services are traded across the region (Byiers, Vanheukelom, and de Roquefeuil 2013, 15). As noted by the regional integration literature, informal cross-border trade is prevalent in the region, which can result in the evasion of import and export barriers, and undermine regional integration more generally (Brenton et al. 2014).

**Actor/Stakeholder Drivers** involves analyzing the divergent interests of government agencies, political parties, NGOs, business associations, traditional associations, and producers and traders of certain products, as well as external actors such as donors, foreign investors, and international organizations. From a stakeholder level, mapping can provide vital information on the various types of parties involved—whether they are individuals or specific groups such as government officials of a particular ministry, agency, CSO, business association or political party. Once key stakeholders are identified, the problem-driven literature suggests that they can be categorized in a number of



ways to be able to understand their interests in terms of demand side versus supply side actors, reform champions versus reform opponents, or winners versus losers from certain reforms. Taken together, the OECD suggests that such “games within the rules,” are concerned with the bargaining among social groups and the state over the use, production, and distribution of resources (VanGrasstek 2011). Moreover, while the OECD views these as issues related to political processes, these issues can also be viewed as those between elite strategies and state-society bargaining.

Analyzing trade in professional services in the EAC from a stakeholder/actor level is an important, yet especially complex, exercise. Given that the EAC comprises five countries, and professional services relate to three discrete sectors—accounting/auditing, engineering/architecture, and legal services—a total of fifteen stakeholder matrices can emerge. However, since this would merely result in a broad overview of stakeholders, some of which are irrelevant to the particular problems faced by the services sector, the subsequent analysis will approach these issues by focusing on four key areas for reform—education, regulations at the domestic level, trade barriers and liberalization efforts at the international level. Accordingly, the relevant stakeholder analysis will be based on information obtained from the World Bank’s Knowledge Platform on Professional Services in Eastern and Southern Africa as well as service provider/user surveys, and will only be applied to key “problems” in each of these reform areas, which will be defined subsequently.

### 3.2 Regional Political Economy Drivers

Since trade in services will be analyzed in a regional context—that of the East African Community—it is essential to draw on previous political economy work done on regional integration. A regional integration perspective provides an important lens for analyzing political economy issues as regional processes can create additional complexities and can be viewed as a “two level game” of regional diplomacy and domestic politics (Putnam 1988). Moreover, as noted by Byiers, Vanheukelom, and de Roquefeuil (2013, 6), “The regional protocols and treaties represent rules-based, formal agreements reflecting interstate interests and balances of power. Yet the implementation takes place at the national level, mediated through domestic political power relations and games, which reflect—among other things—the system and types of distribution of economic rents and on the other factors.”

Accounting for regional integration, political economy dynamics relies on many of the same “drivers” as presented in the problem-driven approach above. However, to provide a better understanding of the political economy drivers of trade in services, the problem-driven political economy framework presented above will be supplemented based on the regional integration political economy analysis developed by Byiers, Vanheukelom, and de Roquefeuil (2013), the OECD’s International Drivers of Corruption (2012), and the OECD’s political economy work on services trade in Regional Trade Agreements (VanGrasstek 2011). This analysis will thus adopt three additional drivers—sectoral, global/international, and strategic—to derive a customized and flexible framework through which to view the political economy of trade in services in the EAC.

**Sectoral Drivers:** A sectoral approach is necessary for several reasons. First, different sectors have differing levels of political salience and visibility at the national level, and accordingly, will incentivize politicians or service providers in different ways. Second, depending on information asymmetries, more visible policies make it easier to attribute credit or blame. Third, the balance of power between policy makers and other actors is important, as monopoly services can reduce state incentives for oversight and improved performance. Last, sector services that are frequent, predictable, or area-based may make it easier for citizens or other groups to mobilize collectively (Byiers, Vanheukelom, and de Roquefeuil 2013, 12).

While not all of these issues are salient to the political economy of trade in professional services in the EAC, it is nonetheless important to analyze sectors on an individual basis. In the context of professional services, the three main sectors—accounting/audit, engineering/architecture, and legal—will be analyzed separately to better understand why some sectors have been more successful in implementing reforms and why others have failed or are unable to do so. While sectors may share many of the same institutional actors (i.e., ministries of labor, trade, commerce, etc.) or be subject to the same formal/informal institutions (i.e., immigration laws, propensity for informal cross border trade, etc.), individual stakeholders may differ widely across the three sectors. The differences between actors are particularly salient with respect to their relative bargaining power, the ability to “capture” the policy process, and their ability to grant—or withhold—professional certifications. Accordingly, understanding how these actors function may highlight key sticking points as well as provide information on points of entry to unlocking reforms.

In addition to these considerations, at a sectoral level, modes of trade can have a large impact with respect to the particular political economy problems that emerge and the types of reforms that are pursued.<sup>2</sup> Moreover, additional sectoral issues may emerge as “countries’ willingness to make commitments in services are often inhibited by the *horizontal* fragmentation of power either between branches of government (executive vs. legislative) or within them (trade ministries versus other ministries or agencies), and in some countries the problem is further exacerbated by the *vertical* fragmentation of power (national governments versus subnational units of government) (VanGrasstek 2011, 6).

**Global Drivers:** Certain global dynamics or processes may shape domestic institutional and political incentives, which may have either positive or negative impacts on domestic institutions and governance arrangements (Byiers, Vanheukelom, and de Roquefeuil 2013, 12). The OECD approaches these drivers based on the effect that they have on corruption and governance at the state level. These could include: (1) sources of rents and unearned incomes; (2) opportunities and constraints to conceal and move illicit assets; (3) foreign investment; (4) global and regional security threats and responses; (5) international legal measures and sanctions against domestic elites; (6) reputation pressures on political elites from regional and international actors; and (7) external ideas and skills (OECD 2012). Importantly, these issues should not only take into account current exigencies, but their potential to affect governance in the future.

Clearly, several global/international drivers can have a particular impact on the domestic political economy of trade in services, including: (1) foreign investment, which can provide evidence on the intentions and interests of external investors and firms—especially those facing external competition—which affect how they lobby governments;

(2) international legal measures and sanctions, which can impact trade, financial, and travel restrictions; (3) reputational pressures on stakeholders, which can relate to the influence that international organizations, RECs, or international business group have on trade in professional services; and (4) external skills and ideas, which relate to international practices and ideologies on doing business.

**Strategic Drivers** are referenced by the literature on the political economy of services in regional trade agreements (RTAs), which notes that “the political dynamics of RTAs and their service provisions can be seen at two levels, which we may identify as economic statecraft (international political economy) and the domestic politics of trade (national political economy)” (VanGrasstek 2011, 10). “Grand Strategic” considerations can be conceptualized as those that “speak to a country’s aspirations in the trading system as a whole, or even the broader system of international relations in which trade is just one component, and are especially significant when examining the agreements reached by the largest and most influential participants in that system” (Ibid, 12). While only the largest and most powerful countries in a trading system may have grand-strategic motivations, countries of all sizes can have “Strategic Political” interests, irrespective of size and levels of development, which “take into account when deciding whether to negotiate RTAs in the first place, with whom, and on what terms” (Ibid, 12). As noted by the literature, these considerations can be economic, political, or a combination of the two, and may have a binding effect on why a country may decide to negotiate services into a RTA as well as the terms that it pursues in the agreement.

In the case of trade in services in the EAC, it is difficult to say whether certain countries are factoring in grand strategic objectives. As noted earlier, Kenya (and Tanzania to a lesser extent) can be seen as the regional hegemon in the EAC, and may take a leading role in deciding which services sectors to liberalize. In addition, as highlighted by the OECD, by examining strategic interests, it can be easier to parse out the idea of openness between pro-trade institutions (executive branch, foreign ministries, etc.) and other more skeptical groups (legislatures and client-oriented ministries).

<sup>2</sup> The definition of services trade under the GATS is four-pronged, depending on the territorial presence of the supplier and the consumer at the time of the transaction. Pursuant to Article I:2, the GATS covered services can take four modes: (1) Cross border trade (i.e., from the territory of one Member into the territory of any other Member); (2) Consumption abroad (i.e., in the territory of one Member to the service consumer of any other Member); (3) Commercial presence (i.e., by a service supplier of one Member, through commercial presence, in the territory of any other Member); or (4) Presence of natural persons (i.e., by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member). See [http://www.wto.org/english/tratop\\_e/serv\\_e/gsintr\\_e.pdf](http://www.wto.org/english/tratop_e/serv_e/gsintr_e.pdf).

## 4. Applied Political Economy Analysis: A Sectoral Perspective

As mentioned in the theoretical political economy approach presented above, significant analysis can be done at the country, sectoral, and project levels. At the country level, the

**TABLE 7: Integrated Political Economy Framework for Regional Services Trade**

| Political Economy Driver  | Description/Example  | Applied to Trade in Services in EAC   |
|---|--|---|
| <b>Structural Drivers:</b><br>Factors beyond the control of the state which reflect deeper economic, political, social, and geo-spatial issues  | <ul style="list-style-type: none"> <li>Economic base/level of development</li> <li>Climate/geography</li> <li>Population/social dynamics</li> <li>Interaction with global economy (trade/migration)</li> <li>Poverty/inequality</li> <li>Natural resource endowments</li> <li>Regional security context</li> </ul>   | <ul style="list-style-type: none"> <li>Kenya produces 43% of EAC GDP</li> <li>Kenya and Tanzania are the most populous EAC countries</li> <li>Uganda, Burundi, and Rwanda are landlocked</li> <li>New natural gas reserves discovered in Tanzania</li> <li>Differing colonial history</li> </ul>  |
| <b>Institutional Drivers:</b><br>“Rules of the game,” based on formal laws and regulations, as well as less formalized customs, institutions, and relationships governing the behavior of actors, and their interaction | <ul style="list-style-type: none"> <li>Formal: Constitutional set-up, electoral rules, and codified laws</li> <li>Informal: Social norms, expectations, patronage networks, informal arrangements, kinship structures, and traditions</li> </ul>   | <ul style="list-style-type: none"> <li>Highly institutionalized regional organizations in the EAC</li> <li>Business climate differs greatly across countries</li> <li>Informal cross-border trade is prevalent in the region</li> <li>Differing systems of government across countries</li> </ul> |
| <b>Stakeholder/Actor/Political Process Drivers:</b><br>“Games within the rules” based on bargaining between social groups, political elites, state bureaucrats, and sector actors                                       | <ul style="list-style-type: none"> <li>Political elites (president, prime minister, ministers)</li> <li>State bureaucrats (mid-level technocrats employed by relevant ministries)</li> <li>Sector actors, producers, and consumers</li> <li>Civil society (political parties, interest groups, business associations, trade unions, etc.)</li> <li>External stakeholders (other governments, international organizations, development partners, international NGOs)</li> </ul> | <ul style="list-style-type: none"> <li>Institutional level: Core Public Agencies relating to trade, Compliance institutions, Immigration laws/authorities, etc.</li> <li>Actor level: Professional Service providers, professional associations, business promotion associations, etc.</li> </ul> |
| <b>Sectoral Drivers:</b><br>Technical features of a particular sector that influence governance and accountability, and result in differences in the way that actors approach reforms.                                  | <ul style="list-style-type: none"> <li>Some sectors have greater visibility than others and political elites are more accountable for reforms.</li> <li>Some sectors are prioritized more than others in terms of the government’s political agenda.</li> <li>Some sectors are easier to reform than others.</li> </ul>  | <ul style="list-style-type: none"> <li>Legal series are more heavily regulated and have restrictive explicit trade barriers</li> <li>Accounting and Engineering are more liberalized via Mutual Recognition Agreements</li> </ul>   |
| <b>International Drivers:</b><br>Global or regional factors that influence the domestic political economy of a particular country.  | <ul style="list-style-type: none"> <li>Sources of rents and unearned incomes</li> <li>Potential to move illicit assets</li> <li>Foreign investment</li> <li>Security threats</li> <li>International legal remedies and sanctions</li> <li>Reputational pressures</li> <li>External ideas and skills</li> </ul>   | <ul style="list-style-type: none"> <li>EAC countries compete for foreign investment</li> <li>International organizations and donors have a strong voice in aid-dependent countries</li> <li>Significant decision making power at the EAC level</li> </ul>   |
| <b>Strategic Drivers:</b><br>Strategic considerations designed not only to achieve commercial objectives but also to promote other objects of political and economic statecraft.  | <ul style="list-style-type: none"> <li>Grand Strategic: countries’ aspirations in the trading system as a whole</li> <li>Strategic Political: domestic bargaining which impacts the choice of policies</li> </ul>  | <ul style="list-style-type: none"> <li>Kenya has positioned itself as regional hegemon in the EAC</li> <li>Tanzania is significantly less EAC-motivated and oriented</li> <li>Other EAC countries have divergent strategic interests</li> </ul>   |

Note: This political economy framework for conceptualizing trade in services is based on governance, regional integration, trade, and political economy literature, which have referenced structural, institutional, stakeholder, sectorial, international, and strategic drivers, including:

- Problem-Driven Governance and Political Economy Analysis (Fritz, Kaiser, and Levy 2009)
- Arguing a Political Economy Approach to Regional Integration (Byiers, Vanheukelom, and de Roquefeuil 2013)
- International Drivers of Corruption: A Tool for Analysis (OECD 2012)
- The Political Economy of Services in Regional Trade Agreements (VanGrasstek 2011)

main purpose of understanding political economy issues is to comprehend “politics in action,” in terms of cross-cutting drivers, such as key functional dynamics, historical factors, key institutional structures, main actors and stakeholders, as well as other issues such as patronage networks and rents. However, as noted by the problem-driven approach, self-standing country-level analysis has limits, and in the case of the forthcoming analysis, a thematic—and sector-level approach is adopted as it provides the best level of analysis to examine challenges and vulnerabilities, governance and institutional arrangements, and the most relevant political economy drivers of trade in services.

#### 4.1 Institutional and Stakeholder Mapping at the Sectoral Level

Sectoral mappings can be a helpful tool in disaggregating a sector and defining what aspects are most important to analyze (Fritz, Kaiser, and Levy 2009, 64). Understanding the political economy of trade in services will require such a thematic level of analysis as there are a number of shared issues in the regulation of various professional services sectors (see Annex 1 for the key conceptual issues affecting regulation of professional services). However, not all sectors—within the “theme” of trade in professional services—operate in the same manner, which makes it essential to develop individual sectoral mappings to better understand key issues and levers of change. Once key

institutions and stakeholders are mapped out it is easier to understand the political economy dynamics of a particular system. As noted by Fritz, Kaiser, and Levy (2009), “the two are linked as actors shape institutions (especially where formal institutions are weak/volatile) and, vice versa, institutions influence the incentives and constraints that stakeholders face” (45).

In line with the framework developed in the previous section, this sub-section hopes to address two of the larger political economy drivers facing the service sector in the EAC. First, this analysis will attempt to unpack the policy elements that matter across the three professional sectors—accounting/auditing, engineering, and legal services. In doing so, analysis will map out each sector—illuminating the processes necessary for a professional or firm to render their service to market in a domestic or foreign context. Second, this analysis will examine the key institutional and stakeholder level incentives in each sector, based on a similar problem-driven methodology. These two levels of analysis will rely on templates provided by the business processes in each sector, and an institutional and actor-level framework. Drawing on past literature, especially World Bank (2010), the analysis drills down further to better understand the key institutions and individual stakeholders involved in the process, as well as the relationships, interests, and incentives of these parties with respect to expanding or constraining the trade in professional services in the EAC.

#### 4.2 Accounting and Auditing—Institutional and Stakeholder Mapping

##### Steps to Obtain Academic and Professional Qualifications



As noted by previous studies and regulator surveys, there are a number of steps to acquire the academic and professional qualifications necessary to work as an accountant/auditor in the EAC. First it is necessary to obtain the appropriate level of education, which is either a university degree (Rwanda and Tanzania) or a secondary school certificate (Kenya and Uganda). After the necessary degree is obtained, some countries require a period of practical training (Kenya and Tanzania). All countries in the EAC require that accountants then pass a national qualification exam in order to obtain a public accountant certificate

(CPA). In order to practice as a CPA, it is required that individuals become members of their national professional associations, who in turn issue the licenses necessary to practice domestically. In some countries (Kenya, Tanzania, and Uganda), professional associations require continuing education to maintain licenses to practice. Underlying this entire process are standards relating to the education, qualification, and licensing of professionals as well as technical standards (finance and reporting standards). The scope of accounting activities is similar across all EAC countries.

### Steps to Provide Services in the Domestic Market



Once the necessary academic and professional qualifications are obtained, domestic providers (professionals and firms) are subject to conduct regulations in delivering accounting and auditing services. In Kenya, Rwanda, and Tanzania providers must abide by competition laws. While none of the EAC countries regulate the pricing of accounting

services, advertising of such services is prohibited in Kenya, Tanzania, and Uganda. In addition, some countries (Kenya, Tanzania, and Uganda) restrict the type of legal entities through which accounting professionals can exercise their profession, and others (Tanzania and Uganda) limit the type of cooperation allowed with other professionals.

### Steps to Provide Services in Foreign Markets



Should accounting/auditing professionals and firms want to render their services in foreign markets, there are number of additional restrictions and regulations which must be met. While EAC countries do not impose residency or nationality requirements on professionals, a number of countries (Kenya, Tanzania, and Uganda) impose quantitative restrictions based on labor market or economic needs tests. Academic and professional qualifications are recognized qualifications obtained in EAC and IFAC member countries; however, Kenya and Uganda do not automatically recognize licenses obtained in other jurisdictions and require host country experience before domestic licenses are granted. (MRAs may change this situation.) In some countries (Kenya,

Rwanda, and Uganda), establishment of branches of foreign accounting firms are prohibited, and Kenya and Tanzania restrict foreign ownership by non-locally licensed professionals and firms. In other countries (Tanzania and Uganda), there are restrictions on the scope of cross border and procurement activities that foreign accounting firms can engage in. Finally, in order to render their services in a foreign country, accounting firms must meet the conduct regulations of the foreign market, as described above.

Table 8 summarizes the key institutions and stakeholders involved in reforms related to education, domestic regulation, trade, and labor mobility in accounting and auditing services.

## 4.3 Legal Services—Institutional and Stakeholder Mapping

### Steps to Obtain Academic and Professional Qualifications



To become a lawyer in the EAC, it necessary to obtain a university degree in law and undertake one additional year of practical training in a firm. Some countries (Kenya, Tanzania, and Uganda) even require post-graduate legal training. Once these educational requirements are met, legal professionals must pass a national bar exam and become members of their national bar associations, which regulate access to the profession by compulsory licenses to practice. In Kenya and Uganda, it is necessary to obtain continuing education to practice. Academic and professional

qualifications for paralegals are more relaxed than those for lawyers, as they do not require a university degree, licenses, or membership in national bar associations. Similar to accounting/auditing, legal professionals are bound by mandatory standards for education, qualification, licensing, and maintaining technical standards and professional conduct in Kenya and Tanzania, but not in Uganda and Rwanda. Likewise, there is a specific range of activities that legal professionals can exclusively engage in, and no quantitative restrictions exist.

**TABLE 8: Accounting/Auditing Services**

|                                |   | Burundi  | Kenya  | Rwanda   | Tanzania   | Uganda   |
|--------------------------------|---|--|--|--|--|--|
| <b>Institutions</b>            | <b>Trade and Commerce Institutions</b>            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.   | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.   | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.   | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.   | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.   |
|                                | <b>Immigration Institutions and Legislation</b>   |  | • Kenyan Constitution<br>• Government Bureaucracies  | • Rwanda Ministerial Orders<br>• Government Bureaucracies  | • Tanzania Immigration Acts of 1995 and 1997<br>• Government Bureaucracies   | • Uganda Immigration Board and Department  |
|                                | <b>Higher Education and Certification Boards</b>  | • University of Burundi Faculty of Economics   | • Kenya Accountants and Secretaries National Examinations  | • University Faculty and Ministry of Education   | • National Board of Accountants and Auditors   | • Public Accountants Examination Board   |
|                                | <b>Political and Regional Institutions</b>        | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements  | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements  | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements  | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements  | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements  |
| <b>Actors and Stakeholders</b> | <b>License Granting Professional Associations</b> | • Society of Professional Accountants (OCP)  | • Institute of Certified Public Accountants of Kenya (ICPAK)   | • Institute of Certified Public Accountants of Rwanda (ICPAR)  | • National Board of Accountants and Auditors (NBAA)  | • Institute of Certified Public Accountants (ICPAU)  |
|                                | <b>Private Sector Operators</b>                   | • Big Four Auditing & Accounting Firms   | • Big Four Auditing & Accounting Firms—BDO<br>• Grant Thornton   | • Big Four Auditing & Accounting Firms   | • Big Four Auditing & Accounting Firms   | • Big Four Auditing & Accounting Firms   |
|                                | <b>International Professional Associations</b>    | • Eastern Central and Southern African Federation of Accountants (ECSAFA)<br>• International Federation of accountants (IFAC)<br>• Association of Chartered Certified Accountants (ACCA) | • Eastern Central and Southern African Federation of Accountants (ECSAFA)<br>• International Federation of accountants (IFAC)<br>• Association of Chartered Certified Accountants (ACCA) | • Eastern Central and Southern African Federation of Accountants (ECSAFA)<br>• International Federation of accountants (IFAC)<br>• Association of Chartered Certified Accountants (ACCA) | • Eastern Central and Southern African Federation of Accountants (ECSAFA)<br>• International Federation of accountants (IFAC)<br>• Association of Chartered Certified Accountants (ACCA) | • Eastern Central and Southern African Federation of Accountants (ECSAFA)<br>• International Federation of accountants (IFAC)<br>• Association of Chartered Certified Accountants (ACCA) |
|                                | <b>Business/Trade Associations</b>                | • East African Business Council<br>• Trade Mark East Africa  | • East African Business Council<br>• Trade Mark East Africa<br>• Kenya Export Promotion Council  | • East African Business Council<br>• Trade Mark East Africa  | • East African Business Council<br>• Trade Mark East Africa<br>• Tanzania Investment Center  | • East African Business Council<br>• Trade Mark East Africa  |
|                                | <b>Civil Society</b>                              |  |  |  |  |  |
|                                | <b>International Organizations/Donors</b>         | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors   | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors   | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors   | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors   | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors   |

### Steps to Provide Services in the Domestic Market



Similar to the accounting/auditing profession, domestic providers of legal services are bound by a number of conduct regulations. Although competition laws do not apply to legal professionals in Tanzania and Uganda, they are in place in Kenya and Rwanda. Conversely to the accounting/auditing profession, however, Kenya, Tanzania, and Uganda have price regulations in place either through binding minimum or maximum pricing restrictions. In all countries, the advertising of legal services is prohibited for firms and

individual professionals. Likewise, countries in the EAC have a number of business structure restrictions that govern the types of legal entities through which legal professionals can practice, as well as restrictions on cooperation between legal professionals and other professions. While similar conduct restrictions are applied in a non-discriminatory manner to foreign providers as well, exceptions exist with respect to price regulations (Uganda), structure (Kenya and Uganda), and scope (Kenya and Uganda).

### Steps to Provide Services in Foreign Markets



Should legal professionals and firms want to render their services in foreign markets, there are number of further restrictions and regulations which must be met. Unlike accounting/auditing, Kenya and Tanzania place nationality requirements on legal professionals, while Uganda places discretionary limits on the presence of foreign professionals. At the moment, all countries recognize professional qualifications from EAC member states; however, foreign licenses are not immediately recognized. MRAs may change this situation. Establishment and entry of foreign firms is restricted in Kenya and Tanzania, and branches of

foreign firms are prohibited in Rwanda and Uganda. Finally, cross-border service provision is limited as individuals can obtain advice from firms located abroad, but firms without a domestic presence cannot advise on matters regulated by domestic law. Likewise, procurement and selling of legal services to government bodies is limited, and strict conduct regulations apply.

Table 9 summarizes the key institutions and stakeholders involved in reforms related to education, domestic regulation, trade, and labor mobility in legal services.

## 4.4 Engineering/Architecture—Institutional and Stakeholder Mapping

### Steps to Obtain Academic and Professional Qualifications



In all countries in the EAC, a university degree is necessary to work as an engineering professional as well as between three (Kenya and Tanzania) to four (Uganda) years of practical training under the supervision of a senior engineer.

Kenya and Tanzania require passing a national qualification exam, and professional competence requirements are necessary in Uganda. With the exception of Uganda, while membership in professional associations is not required,



**TABLE 9: Legal Services**

|                                |   | Burundi   | Kenya   | Rwanda  | Tanzania  | Uganda  |
|--------------------------------|---|---|---|---|---|---|
| <b>Institutions</b>            | <b>Trade and Commerce Institutions</b>            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            |
|                                | <b>Immigration Institutions and Legislation</b>   | • Burundi—Department of Immigration and Citizenship   | • Kenyan Constitution<br>• Government Bureaucracies   | • Rwanda Ministerial Orders<br>• Government Bureaucracies   | • Tanzania Immigration Acts of 1995 and 1997<br>• Government Bureaucracies                                  | • Uganda Immigration Board and Department   |
|                                | <b>Higher Education and Certification Boards</b>  | • University Departments of Law   | • University Departments of Law   | • University Departments of Law   | • University Departments of Law   | • University Departments of Law   |
|                                | <b>Political and Regional Institutions</b>        | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements |
| <b>Actors and Stakeholders</b> | <b>License Granting Professional Associations</b> | • Ordre des Advocats  | • Law Society of Kenya  | • Kigali Bar Association<br>• High Court  | • Tanganyika Law Society<br>• Zanzibar Law Society  | • Uganda Law Society (ULS)<br>• Law Council   |
|                                | <b>Private Sector Operators</b>                   | • No Market leading Firms   | • Kaplan & Stratton Dally & Figs<br>• Hamilton Harris & Mathews<br>• Anjarwalla & Khann                     | • No Market leading Firms   | • No Market leading Firms   | • No Market leading Firms   |
|                                | <b>International Professional Associations</b>    | • Ordre des Advocats  | • Law Society of Kenya  | • Kigali Bar Association<br>• High Court  | • Tanganyika Law Society<br>• Zanzibar Law Society  | • Uganda Law Society (ULS)<br>• Law Council   |
|                                | <b>Business/Trade Associations</b>                | • East African Business Council<br>• Trade Mark East Africa   | • East African Business Council<br>• Trade Mark East Africa<br>• Kenya Export Promotion Council             | • East African Business Council<br>• Trade Mark East Africa   | • East African Business Council<br>• Trade Mark East Africa<br>• Tanzania Investment Center                 | • East African Business Council<br>• Trade Mark East Africa   |
|                                | <b>International Organizations/Donors</b>         | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  |

as in accounting and legal services, in some cases engineering professionals must be registered to sign engineering contract documents. Despite this more relaxed requirement to join professional associations, Kenya, Tanzania, and Uganda regulate access to the engineering profession through mandatory licenses by professional associations. Continuing education is not required for the engineering

profession in most countries, the sector is largely unregulated in Rwanda. Mandatory standards related to education, qualifications, and licensing, and technical standards exist in Kenya and Rwanda, and the scope of exclusive rights varies considerably among countries, although there are no quantitative restrictions in place.

Steps to Provide Services in the Domestic Market



Similar to other professional services, domestic providers of engineering services are bound by a number of entry and conduct regulations. Although competition laws do not apply to engineering professionals in Tanzania and Uganda, they are in place in Kenya and Rwanda. Price regulations are only applied in Tanzania with respect to binding minimum prices, but do not exist in any other

EAC country. As with other professional services sectors, advertising restrictions are applied to foreign firms in a non-discriminatory manner, with advertising only being prohibited in Kenya. In terms of regulations of governance business structures, non-discrimination also applies; however, restrictions on business structure and permitted activities are generally more relaxed than in other sectors.

Steps to Provide Services in Foreign Markets



Should engineering professionals and firms want to render their services in foreign markets, there are a number of further restrictions and regulations which must be met. All EAC countries recognize professional and educational qualifications obtained abroad and licenses are generally recognized across countries with the exception of Kenya. Establishment and ownership and scope of activities is limited in Tanzania, but is generally unrestricted in other

EAC countries. Likewise, engineering is not bound by similar restrictions of procurement by government entities; however, Tanzania and Uganda do limit the scope of these activities based on firms having a national presence.

Table 10 summarizes the key institutions and stakeholders involved in reforms related to education, domestic regulation, trade, and labor mobility in engineering and architecture services.

**TABLE 10: Engineering/Architecture Services**

|                         |   | Burundi   | Kenya   | Rwanda  | Tanzania  | Uganda  |
|-------------------------|---|---|---|---|---|---|
| Institutions            | <b>Trade and Commerce Institutions</b>            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.                            | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.  | • Ministries of Trade, Labor, Commerce, Interior, Foreign Affairs, Finance, etc.  |
|                         | <b>Immigration Institutions and Legislation</b>   | • Burundi—Department of Immigration and Citizenship   | • Kenyan Constitution<br>• Government Bureaucracies   | • Rwanda Ministerial Orders<br>• Government Bureaucracies   | • Tanzania Immigration Acts of 1995 and 1997<br>• Government Bureaucracies  | • Uganda Immigration Board and Department   |
|                         | <b>Higher Education and Certification Boards</b>  | • University of Burundi Faculty of Applied Science  | • University Senate   | • University faculty and Ministry of Education  |   |   |
|                         | <b>Political and Regional Institutions</b>        | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements                                   | • EAC Institutions<br>• Common Market Protocol<br>• Multi Sector Council<br>• Mutual Recognition Agreements               |
| Actors and Stakeholders | <b>License Granting Professional Associations</b> | • No Data   | • Engineering Registration Board of Kenya (ERB)   | • Unregulated   | • Engineers Registration Board (ERB)  | • Uganda Institute of Professional Engineers (UIPE)   |
|                         | <b>Private Sector Operators</b>                   | • No Market leading Firms   | • Howard Humphreys<br>• Otieno Odongo<br>• CAS Consultants<br>• Uniconsult Kenya<br>• Sapamo Consultants    | • No Market leading Firms   | • No Market leading Firms   | • No Market leading Firms   |
|                         | <b>International Professional Associations</b>    | • No Data   | • Association of Consulting Engineers of Kenya<br>• Council of the Institution of Engineers of Kenya        | • Institution of Engineers Rwanda   | • Association of Consulting Engineers Tanzania<br>• Institution of Engineers Tanzania<br>• Tanzania Civil Engineering Contractors Association | • Uganda Association of Consulting Engineers (UACE)<br>• Uganda Institution of Professional Engineers (UIPE)<br>• UNABCEC |
|                         | <b>Business/Trade Associations</b>                | • East African Business Council<br>• Trade Mark East Africa   | • East African Business Council<br>• Trade Mark East Africa<br>• Kenya Export Promotion Council             | • East African Business Council<br>• Trade Mark East Africa   | • East African Business Council<br>• Trade Mark East Africa<br>• Tanzania Investment Center   | • East African Business Council<br>• Trade Mark East Africa   |
|                         | <b>International Organizations/Donors</b>         | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  | • World Bank<br>• EU<br>• AU<br>• AfDB<br>• Bilateral Donors  |

## 5. Applied Political Economy Analysis: A Problem-Driven Perspective

This section will investigate discrete, problem-driven questions facing the professional services sector from a political economy perspective. Given the regulatory challenges highlighted in the preceding discussion, and in line with the problem-driven approach to political economy analysis, this analysis will conceptualize four main “problems”: (1) Educational Issues and Constraints; (2) Domestic Regulatory Issues and Constraints; (3) Trade Barriers and Labor Mobility Restrictions; and (4) Liberalization and Regulatory Cooperation. Drawing on previous Bank studies (World Bank 2010a, 2010b, 2011a, and 2011b), the analysis in this section intends to highlight key constraints, interests, motivations, and incentives—across the structural, institutional, stakeholder, sectoral, global, and strategic dimensions—that can help explain the current state of the reforms and the respective bargaining dynamics that accompany them.

### 5.1 Educational Issues and Constraints

Given the increasing demand for professional services, why do the EAC training institutions fail to equip students with market-relevant skills? In terms of supply of professional training, why are financial frictions not reduced through student loan schemes? How can the quality and capacity of schools and other training institutions be enhanced? What potential exists to create new educational programs to fill existing gaps?

#### **Key Issues**

Based on previous reports as well as surveys of providers and consumers of professional services, there are a number of related issues, the first of which relates to difficulties of potential professionals covering the costs of the relevant education and training programs. The cost of professional education is relatively high in all countries across the EAC, with the median cost for becoming a professional ranging from US\$ 14,000 to US\$ 26,000.

Given these costs, obtaining a professional qualification is unaffordable for most of the population in these countries, particularly since the market for educational loans is not well developed. A key recommendation proposed in section 2 is to prioritize the development of tools for financing higher education to alleviate the financial constraints that prevent individuals from acquiring the relevant professional training. Options previously highlighted

include developing and properly managing student loan schemes (as Kenya has implemented and as Uganda and Burundi are currently considering), as well as devising cost sharing options which diversify funding sources for both students and universities—particularly with respect to the shared responsibilities of students, government, on-campus services, matching grants, donations, gifts, and R&D endeavors.

While these recommendations may provide a solution to existing financial challenges, there remain a number of problems. A key challenge is that the number of students attending university in Africa is outpacing the available support, and financial constraints prevent governments and other potential funders from providing the necessary levels of resources to accommodate potential students. At the same time, low levels of cost recovery in Africa (below 10 percent in some cases) have been exacerbated by interest rate subsidization, long grace periods, poor execution, and poor governance—leading many students to treat loans as they would grants that require no repayment. Lastly, most low-income countries in sub-Saharan Africa and in the EAC, in particular, lack capable and efficient legal systems to collect student loan payments.

A second, and related issue faced by EAC countries is systemic weakness in upstream secondary school education, which limits the ability of students to gain professional skills. Recent reports on services trade in Africa cite the general erosion of mathematical skills in all countries as a key explanatory factor in the declining number of applicants in science, engineering, and technology courses; hence, the shortages in the engineering sector.

In order to address these upstream problems, efforts should be mobilized to reinforce the quality and capacity of schools, especially in mathematics and sciences, including developing standards and guidelines for quality assurance. International and national experiences related to quality assurance of secondary and higher education could serve as a model for East African countries. One such tool comes in the form of “educational tuning structures” which rely on a certain methodology to (re-)design, develop, implement, and evaluate study programs. Importantly, such a methodology can serve as a platform for developing reference points at the subject level, such as different educational tracks or profiles within a given field (e.g., engineers, engineering technologists, and engineering technicians).

A final issue related to the supply of professional training in the EAC is related to the capacity and quality of downstream professional educational institutions. Absence of these institutions is common in many East African countries. In particular, some countries lack the institutions that

offer specialized (post-graduate) courses, for instance in legal and engineering studies. Moreover, some countries lack professional training institutions that offer academic and professional training courses for middle-level professionals, such as training programs for paralegals.

Given the undersupply of upstream professional educational institutions, as well as the varying quality and capacity of existing institutions, existing institutions may have to be improved while new ones may have to be created. This can be done through the emergence of new educational providers in the same category—so-called *horizontal* differentiation—operated by for-profit, non-profit, international, or local government entities to respond to the increased demand for access to higher education. Likewise, the range of quantity and quality of educational institutions can be increased by the emergence of new types of institutions such as polytechnics, professional institutes, junior colleges for middle-level professionals—so-called *vertical* differentiation—to respond to labor market needs for a greater diversity of graduate skills and levels of training. While both horizontal and vertical strategies can be investigated, expanding the scope for mid-level professionals, such as paralegals but also accountants and engineering technicians, may encounter resistance.

### Political Economy Drivers

■ **Structural Drivers:** Given the level of development of the countries concerned, most educational institutions operate in a resource and capacity constrained environment. The scope for funding and expanding professional educational programs will necessarily remain dependent on fiscal space for such public expenditures. Challenges in higher education financing affect both institutions and students. The small size of programs and their limited scope might thus remain a serious constraint in the medium- to long-run.

■ **Institutional Drivers:** Departments of Education and Universities may be unable or unwilling to work with national or regional student loan boards. On a formal institutional level, low levels of cost recovery may remain insurmountable unless the proper governance, credit, contractual, and legal remedy issues are addressed. The development of an EAC-wide loan scheme as part of EAC's Regional Higher Education Policy and Strategy could help address these issues and also foster regional student mobility. On an informal institution level, there are a variety of incentives for students to treat loans as grants because of interest rate subsidization, long grace periods, as well as poor execution and governance.

■ **Stakeholder Drivers:** In terms of the variety of programs offered—particularly with respect to mid-level professionals such as accounting and engineering technicians and paralegals—professional associations may have incentives to keep such mid-levels professionals out of the workforce in order to safeguard the compensation premia driven by the general scarcity of professionals; therefore, educational institutions do not have incentives to offer such programs.

What can be done to enhance the level of collaboration between universities, professional associations, and the private sector to help students acquire the necessary professional training and facilitate their regional mobility and the recognition of their academic qualifications?

### Key Issues

Even if a potential professional is likely to acquire the skills and requisite training necessary to become an accounting, engineering, or legal profession in the EAC, a lack of coordination between key parties may result in such an individual encountering a great deal of difficulty in finding appropriate employment. According to recent regional reports, the absence of links between educational systems, employers, and users of services leads to unmet needs and unemployed professionals, and explains the attrition of skills in several professions.

To counter this challenge, it is necessary that policy actions encourage collaboration between universities, professional associations, and the private sectors through internships and other related programs that can help students acquire skills and practical training. A regional success story is the Structured Engineers Apprenticeship program (SEAP) for Graduate Engineers developed by the Engineers Registration Board (ERB) in Tanzania.

Unfortunately this program stands in isolation in the region. Underlying this challenge are coordination problems faced by employers, professional associations, and education institutions in educational programs for engineers and accountants. Such problems are exacerbated by sectoral constraints, for instance, in the engineering sector where high training costs (four years)—in comparison with other sectors—make it difficult for potential employers to properly train and mentor future employees. If these graduates do not receive help immediately after graduation, evidence suggests that they will not be placed in their appropriate sectors and will shift to other jobs instead.

### *Political Economy Drivers*

- **Stakeholder Drivers:** Coordination between key institutions and stakeholders remains limited, with respect to universities, employers, and professional associations. In some sectors such as engineering, apprenticeship opportunities exist in certain countries. In others, such as accounting and legal services, practical training remains a double-edged sword, where young graduates must gain experience through training programs, yet limited availability and lack of interest of experienced professions to supervise trainees makes it difficult to train young professionals. At the same time, professional associations remain the dominant actors in training young professionals by designing curricula or providing training and continuous education. The dominance of professional associations thus undermines the role played by the private sector as well as institutional mechanisms to ensure the participation of employers in the formation of young professionals
- **Sectoral Drivers:** Some sectors, such as engineering, which requires a long period of apprenticeship (three to four years), are more inclined to devise institutional training programs, as evidenced by the Structured Engineers Apprenticeship Program (SEAP) in Tanzania. However, for legal and accounting professions, where similar practical training is necessary, no similar arrangements exist. In these contexts, there is a much larger scope for graduates to remain unmatched to work opportunities.
- **International Drivers:** While some sectors are dominated by large international corporations (e.g., the “Big Four” accounting firms in accounting), other sectors do not have market leading firms and the private sectors are highly fragmented among small firms (Kenya is the only country with market leading firms in legal and engineering services). As a result, there may be fewer opportunities for recent graduates to be recruited into young professionals programs, where private sector firms take a leading role in training young graduates.

## **5.2 Domestic Regulatory Issues and Constraints**

Given the increasing demand for professional services, why do domestic entry and conduct regulations continue to restrict the operations of services providers in the EAC market?

### *Key Issues*

Domestic regulation on the entry and on the operations of firms, presumably designed to meet social goals, can often undermine competition. This is especially true in professional services, where public interest theories argue that qualitative regulatory measures—such as qualification requirements or exclusive tasks that can be performed by certain professionals—are necessary to guarantee high-quality services and avoid adverse selection. While qualitative entry restrictions may be necessary in some circumstances, private interest theories caution that such qualitative regulations may be disproportionate as a result of excessive entry requirements set by rent-seeking professionals and professional associations. In addition, if the profession gains a monopoly over the organization of the required training, the education of necessary professionals may be limited. Given these risks, qualitative regulation measures are especially salient in the context of services trade in the EAC as they may impede the ability of firms and professionals to provide services. The most frequent measures relate to monopolies of professional associations over the higher education institutions that provide professional degrees, as well as the delineation of with exclusive rights (particularly in legal services) and multiple licensing requirements (which disproportionately affect auditing services).

In order to reduce the negative effects of such requirements, the recommendations put forth in section 2 suggest that it is necessary to relax disproportionate cumulative entry qualitative requirements—for example, by narrowing the scope of exclusive tasks in certain professions. While such exclusive rights may lead to increased specialization of professionals and guarantee a higher quality of service, they can also create monopolies that can have adverse price and allocation effects, especially if they are granted for services that can be obtained at a lower cost by less-regulated middle-level professionals. Likewise, multiple licensing requirements may hinder entry into the sector. Last, the control of professional associations may lead to higher barriers to entry for professionals and rent seeking behavior.

### *Political Economy Drivers*

- **Stakeholder Drivers:** Professional associations have a monopoly on determining many qualitative (educational and professional) entry requirements into professional services. As mentioned, professional associations govern the curricula of higher education



institutions as well as the delineation of exclusive rights. Accordingly, this may result in difficulties for mid-level professionals to perform certain activities, thereby creating rents for those able to gain the necessary licensing from professional associations.

- **Sectoral Drivers:** Differences emerge across sectors as exclusive rights are particularly binding for legal services and multiple licensing requirements which disproportionately affect accounting and auditing services. Since professional associations determine the scope of exclusive tasks in certain professions, the level of collaboration between these associations and market leading firms needs to be further investigated.

Similar to qualitative entry restrictions, conduct regulations continue to be applied. What can be done to relax such regulations to increase the availability of service providers in the EAC?

### **Key Issues**

Conduct Regulations—fixed prices, advertising restrictions, and restrictions on business organization—are employed to regulate trade in services in several EAC countries. With respect to price fixing, fees for professional services are negotiated freely between practitioners and clients in accounting and engineering services in almost all surveyed countries. However, while few developed countries regulate fees for lawyers, fees, and prices of legal services are regulated in Kenya, Tanzania, and Uganda. Likewise, although few non-African countries regulate prices in engineering service, Tanzania recently introduced fee regulations for engineering services. With respect to advertising prohibitions, several professions in Africa are subject to sector-specific advertising restrictions: accounting in Kenya, Tanzania, and Uganda, legal services in all examined countries, and engineering services in Tanzania. In general, East African countries have more severe regulations on advertising and marketing than most developed and developing economies. Last, with respect to restrictions on business organization, there are restrictions on business structure in all professional services sectors in most examined countries. These regulations can restrict the ownership structure of professional services companies, the room for collaboration within the profession and with other professions, and in some cases the opening of branches, franchises, or chains.

The recommendations put forward in section 2 call for the elimination of disproportionate conduct regulations

which restrict competition. With respect to price fixing, most of the economic literature argues that these regulatory instruments can seriously harm competition by eliminating or reducing the benefits that competitive markets deliver for consumers. Most agree that less restrictive mechanisms, such as better information on the services provided, could be established. Likewise, private interest theories maintain that there is no justification for prohibiting advertising that is relevant, truthful, and not misleading. Instead, advertising fosters competition by informing consumers about different products and allowing them to make better-informed buying decisions and can be a crucial competitive tool for new firms entering a market. Lastly, with respect to restrictions on business organization, private interest theories point to the fact that these regulations are clearly anti-competitive and may harm consumers by preventing providers from developing new services or cost-efficient business models.

Despite their clear anti-competitive effect, a number of national professional associations support the continued use of restrictive conduct regulations. For example, previous literature notes that price regulations are introduced and supported by national professional associations, who claim they help prevent the adverse selection problem. Likewise, some associations justify advertising restrictions by the need to protect consumers and such restrictions may continue to exist within the EAC. Last, in an attempt to justify restrictions on business organization, professional associations argue that professionals are more likely to give independent advice if certain forms of intra-professional partnerships are prohibited, while restrictions on multidisciplinary activities prevent potential conflicts of interests that are detrimental to consumers.

### **Political Economy Drivers**

- **Institutional Drivers:** Countries across the EAC may have different institutions that govern competition, consumer protection, and business environment. Accordingly, it is necessary to better understand the institutional set-up as well as the domestic “norms” that support such regulations.
- **Stakeholder Drivers:** Across sectors, professional associations seem to be the main influence on maintaining price regulation, advertising prohibitions, and business organization requirements. Such measures tend to favor the largest and most well-known firms. Keeping conduct regulation in place can thus be viewed as a rent capturing mechanism for bigger firms that have a stronger voice



and can influence professional associations. On a more positive note, the Law Society of Kenya (LSK) has finally allowed lawyers to advertise their services as of February 2014. The High Court decided that the advertising prohibition is unconstitutional and denied consumers of legal services access to information which could help them choose their favorite advocates and also impeded access to justice. This High Court decision triggered the debate on regulated advertising. The LSK Council has now approved certain forms of advertising of legal services but many limitations still remain in place (for example, information regarding fees or television ads are still prohibited). Despite relatively high usage of professional services (for example, 77 percent of the interviewed firms in seventeen COMESA countries as part of the World Bank Business Surveys conducted in 2012 indicated that they use accounting services, while 50 percent indicated that they used legal and engineering services), the influence of the private sector seems rather limited across all examined professional services subsectors.

### 5.3 Trade Barriers and Labor Mobility Restrictions

Why do international trade barriers—particularly those related to nationality/residency requirements and restrictions on the form of establishment—continue to impede the flow of services in the EAC? With respect to immigration issues within the EAC, what are the underlying interests surrounding nationality and residency requirements?

#### *Key Issues*

The fragmentation of regional markets for professional services and professional education in East Africa by restrictive policies and regulatory heterogeneity prevents countries from exploiting gains from trade based on comparative advantage, as well as gains from enhanced competition and exploiting economies of scale. Differences in national endowments of professionals and the capacity for professional training—reflected in differences in earnings of professionals and the costs of training across countries—suggest a substantial potential for trade and for large gains from eliminating impediments to trade. Deeper regional integration would enhance competition between service providers, allow providers to exploit economies of scale, especially in professional education, and produce a wider variety of services. Also playing a key role are the prospects for attracting investment, both domestic and

foreign, which are greater in an integrated regional market. Last, regionalization may also make it possible to reap economies of scale in regulation and supervision, particularly where national regulatory agencies face skill constraints; it could also reduce the possibility that private sector interests capture regulation.

To benefit from regional integration, explicit trade barriers need to be removed. A gradual liberalization approach could start by articulating the economic and social motivation for nationality and residency requirements. The objectives of nationality and residency requirements may be achieved by less discriminatory measures such as (a) require foreign service providers to undergo professional assessment when nationality requirement is used to ensure professional competence; and (b) appoint a representative agent, or liability insurance, in lieu of physical presence or residency requirement. How far and how quickly each country proceeds will depend on the political power of users and incumbent providers of specific professional services (an issue that merits deeper investigation than has so far been possible). Likewise, the EAC should develop a transparent and consistent framework for accepting professionals with foreign qualifications. Last, where foreign professionals are completely barred from practicing, it would be beneficial to recognize professional qualifications from other member countries that have similar standards to those applied in the East African countries.

#### *Political Economy Drivers*

- **Institutional Drivers:** In terms of immigration requirements, a number of institutional actors have a voice in the regulatory process. Among them are the relevant immigration agencies as well as supporting ministries such as the Ministry of Foreign Affairs, Labor, and Commerce. Accordingly, it is necessary for these institutions to develop a coherent policy governing the movement of foreign workers and firms with the domestic context, as well as the business arrangements they made with domestic professional service providers.
- **Stakeholder Drivers:** Individual actors play a key role in advocating for immigration and residency requirements of firms and professionals. Especially important are the interested incumbent providers of professional services which have the capacity to lobby key institutions for easier or more restrictive requirements. A key motivation for entrenched domestic providers would be to reduce access, and hence competition, from foreign professionals and firms.

- **Sectoral Drivers:** Despite the signing of the Common Market Protocol (CMP), a number of recurrent challenges exist. In terms of explicit barriers, the most restrictive measures for all modes of services supply are applied in legal services. The legal sector remains largely closed to foreign participation, and nationality requirements, which typically ban foreign entry, are imposed in several countries on providers of legal services. Likewise, economic needs tests or labor market tests are applied by several countries in accounting and legal services. Restrictions on the entry of foreign accounting and law firms exist in all countries in various forms (foreign ownership limits or restrictions on the form of entry).
- **International Drivers:** Issues related to foreign incorporation are closely tied to a country's immigration policy. While governed by various institutions and differing legislation across EAC states, such policies will be informed by security concerns, particularly given the presence of fragile and conflict affected states. In addition to well-documented histories of insecurity, recent events, particularly those related to the security situation in Kenya, can have an effect on the stance that institutions take with respect to immigration. Aside from immigration, foreign investment constitutes another key area that can influence immigration policy. Within an integrated regional market, both domestic and regional investment opportunities can affect policy related to immigration and incorporation.
- **Strategic Drivers:** Immigration has a close relationship to a country's strategic interest in engaging with regional and international trade agreements. Quantitative restrictions are informed by labor market tests and economic needs assessments in many countries. Should a domestic industry lobby for protection, this will have a great effect on the short- to medium-term immigration policies.

In addition to issues related to the temporary entry of foreign suppliers, why do forms of commercial establishment continue to impede the flow of professional service in the EAC?

### **Key Issues**

The recommendations put forth in section 2 suggest that it is necessary to minimize restrictions on forms of establishment. Likewise it is necessary to develop transparent criteria and procedures for applying economic needs testing and other policies; set a timeline for easing and

ultimately abolishing the policy. Where investments by nonprofessionals are not allowed, relax the prohibition and substitute it with less restrictive policies. Relax absolute prohibition on foreigners from forming partnership with local professionals. Instead, foreign and local partners should be jointly liable, and their liability for the partnership's debts should be unlimited. Last, governments should consider adjustments in policies where the social and economic motivations are ambiguous. This applies to mandatory membership in local professional associations, as well as mandatory partnerships with or hiring of locals of the same profession within the same area of competence.

### **Political Economy Drivers**

- **Stakeholder Drivers:** Foreign establishment is greatly influenced by stakeholders, particularly entrenched domestic private interests keen on avoiding foreign competition. Incumbent firms would be expected to avoid undue foreign competition which can subsequently affect their domestic market share and expected profits. Likewise, professional associations have a disincentive to support regulations which would make it easier for foreign firms to render their services.
- **International Drivers:** A country's willingness to increase foreign investment might run counter to the desire of domestic firms to protect their market positions. Nevertheless, the foreign investment prospects may encourage regulators to increase the opportunities for foreign entities to incorporate or otherwise cooperate with existing firms and professionals.

## **5.4 Liberalization and Regulatory Cooperation**

Despite the signing of the CMP and the MRAs, why do the applied policies—particularly those related to the movement of providers—continue to impede professional services in the EAC? What are the challenges regarding the implementation of the CMP and the MRAs in professional services? And how can we accelerate implementation?

### **Key Issues**

The five East African countries have made progress toward removal of explicit trade barriers and the mutual recognition in professional services through the East African Community CMP negotiations. The CMP, adopted by the Multi Sector Council in 2009, includes commitments related to professional services. Also the CMP includes an annex on a framework agreement on mutual recognition agreements

(MRAs) of academic and professional qualifications. However, there are numerous challenges related to the implementation of CMP commitments and the MRAs. For example, the key stumbling block related to the implementation of the CMP commitments is the linkage that has been made with regard to commitments on the temporary movement of service suppliers who are nationals of Partner States (“natural persons”) with the provisions on the free movement of workers. The full-fledged MRA would have to cover education, examinations, experience, conduct and ethics, professional development and re-certification, range of practice, and local knowledge and an effective implementation would require a preceding sectoral benchmarking of current regulatory frameworks.

In addition, as shown in World Bank (2015), the agreements were not initiated formally at the regional level. This has left the instruments resulting from these agreements in legal limbo. Although the parties involved have competence in relation to professional qualifications and licensing at a domestic level, they were not granted the power to conclude these international agreements. The lack of true “treaty” status for the MRAs means that they cannot require competent authorities to ignore existing domestic provisions (such as nationality requirements) that clash with the MRA requirements. Issues arising from this lack of legal recognition have subsequently become apparent leading to key implementation challenges.

The EAC Council of Ministers has recognized some broader issues that have prevented existing MRAs from being truly effective. Reflections are underway, as a result, on how commitments on free movement of skilled professional workers, which are essential to the success of the MRAs, can be delinked from the wider issue of free movement of workers.

### **Political Economy Drivers**

■ **Stakeholder Drivers:** The benchmarking of qualifications and licensing across countries poses significant problems in the EAC. Some countries may need to raise their standards beyond their current level to reach a jointly agreed minimum standard. All relevant governmental and professional organizations would need to take part in defining such requirements. It seems that the MRAs were negotiated without undertaking such benchmarking exercises complicating their effective implementation. Stakeholders involved in the implementation of these MRAs could learn from the experience of the education sector. The Inter-University Council for East Africa (IUCEA) is currently developing a Regional Quality Assurance System and a

Regional Qualifications Framework. This framework will be a generic instrument for harmonization of higher education and training systems in East Africa, and for facilitating mutual recognition of qualifications among the EAC Partner States. The process to develop the regional qualifications framework started in December 2011 and is expected to be completed in December 2014. The IUCEA is also developing appropriate legal provisions to guide and safeguard the principles for operationalization of the qualifications framework. The regional quality assurance system and the qualifications framework once fully developed can transform East Africa into a common higher education area.

■ **Institutional Drivers:** Professional associations have been mandated to draft the MRAs. However, it seems that the services negotiators and the EAC Secretariat have not been involved in the MRAs discussions. Although the signed agreements have all been presented to the EAC Council of Ministers, they have not yet been given any formal recognition as legal instruments of the EAC. Negotiations on the agreements were not formally endorsed by ministers and the authority to negotiate was not officially delegated to the relevant parties. The lack of stakeholder consultations and the absence of a clear mechanism at the EAC regarding procedures for reviewing and adopting MRAs generate delays with their implementation.

■ **Sectoral Drivers:** There seems to be disconnect between CMP commitments and MRA provisions in several sectors. For example, in accounting services, at least country one signed the MRA still imposes nationality requirements for the provision of certain accounting services. Similarly, work permit requirement and restrictive immigration rules challenge the implementation of the MRAs in all sectors (given the importance of temporary movements of professionals to provide these services).

■ **International Drivers:** International actors such as the TMEA, the World Bank, and other development partners have programs to foster regulatory cooperation and education in the region. Local stakeholders may request concrete assistance to accelerate implementation of reforms in professional services.

## **6. Conclusion**

This chapter attempts to identify the structural, institutional, stakeholder, sectoral, strategic, and international drivers that explain the status of reform and regional integration in professional services in East Africa.

The preceding analysis has demonstrated that **structural drivers** such as the level of development of the five EAC countries poses constraints for higher education financing and the capacity of various actors to implement regulatory reforms.

**Stakeholder drivers** are particularly important in all examined sectors. A recurrent theme is the important role of professional associations in both maintaining restrictive regulations and accelerating the implementation of reforms. For example, professional associations may have incentives to keep mid-level professionals out of the workforce in order to safeguard the compensation premia driven by the general scarcity of professionals; creating disincentives for educational institutions to offer training programs for engineering technicians or paralegals. Furthermore, professional services seem to be the main proponents of price regulations, advertising prohibitions and other trade restrictions that generate rents to incumbents or large firms that have a stronger voice and can influence professional associations. Another important finding is that coordination between key institutions and stakeholders such as universities, employers, professional associations, and trade ministries remains limited, hampering national reforms as well as the implementation of regional commitments. For example, professional associations have been mandated to draft the MRAs. However, it seems that the services negotiators and the EAC Secretariat have not been involved in the MRAs discussions. The lack of stakeholder consultations and the absence of a clear mechanism at the EAC regarding procedures for reviewing and adopting MRAs generate delays with their implementation.

Evidence from the region suggests that **institutional drivers** matter. For example, Departments of Education and Universities may be unable or unwilling to work with national or regional student loan boards. On a formal institutional level, low levels of cost recovery may remain insurmountable unless the proper governance, credit, contractual, and legal remedy issues are addressed. The development of an EAC-wide loan scheme as part of EAC's Regional Higher Education Policy and Strategy could help address these issues and also foster regional student mobility. Also, EAC countries may have different institutions that govern competition, consumer protection, and the business environment. Accordingly, it is necessary to better understand the institutional set-up as well as the domestic "norms" that support such regulations. In terms of immigration requirements, a number of institutional actors have a voice in the regulatory process. Among them are the relevant immigration agencies as well as supporting ministries such as the Ministries of Foreign Affairs, Labor,

and Commerce. Accordingly, it is necessary for these institutions to develop a coherent policy governing the movement of foreign workers and firms within the domestic context, as well as the business arrangements they made with domestic professional service providers.

**Sectoral drivers** can explain why certain professions (i.e., accounting and auditing), have registered more rapid progress with reforms than others. For example, some sectors, such as engineering, which requires a long period of apprenticeship (three to four years), are more inclined to devise institutional training programs, as evidenced by the Structured Engineers Apprenticeship Program (SEAP) in Tanzania. However, for legal and accounting professions, where similar practical training is less stringent, no similar arrangements exist. In these contexts, there is a much larger scope for graduates to remain unmatched to work opportunities. Differences also emerge across sectors when it comes to regulatory issues. Trade barriers and regulations for instance are particularly restrictive for legal services—the nature of the profession that limits its exposure to foreign competition as well as the strength of bar associations might explain such outcomes.

The chapter also highlights the positive role of these drivers in implementing national and regional reforms. For example, the Inter-University Council for East Africa (IUCEA) could serve as an example for the stakeholders and institutions involved in the implementation of regional reforms. In 2009 the East African Legislative Assembly (EALA) enacted the IUCEA Act 2009 and integrated IUCEA into the EAC operational framework. The Act spells out the objectives, functions, institutional set-up, and systems of governance and management of IUCEA. Similar arrangements between professional association, regulators, and ministries involved in the reform of professional services could clarify responsibilities, lead to institutionalized cooperation, and accelerate the implementation of MRAs. International actors such as the TMEA, the World Bank, and other development partners have programs to foster regulatory cooperation and education in the region. Local stakeholders may request concrete assistance to accelerate implementation of reforms in professional services.

## Appendix 1 Conceptual Issues: Regulatory Measures Affecting Professional Services

Skills shortages and skills mismatches as well as failures and poor export outcomes in professional services markets can be explained by inadequate policy measures

related to education, trade, domestic regulation, and migration. Limiting the analysis to the typical trade policy areas—namely trade policies and domestic regulation—would only partially address the diagnosed problems.

It is also important to analyze the education challenges in order to remedy the origin of the skills shortages and skills mismatches. Similarly, the general immigration restrictions (in addition to the barriers affecting mode 4) have to be analyzed to address the free movement of professionals that is necessary for the provision of professional services.

### Education Policies

Because professional services require a skilled workforce, the *quality* of education matters. Possible education-related barriers can be the financial constraints that may prevent individuals from acquiring professional education, or limitations in the capacity and quality of professional institutions that may prevent students from acquiring market-relevant skills.

### Domestic Regulation

Professional services have traditionally been subject to a high degree of regulation. These regulatory measures are a result of direct governmental regulation and rules adopted by self-regulatory bodies, and range from qualitative and quantitative entry regulation to conduct regulation. Entry regulation includes educational and professional qualification requirements, exclusive or shared exclusive rights to provide services, ownership restrictions, and restrictions on the numbers of providers. Conduct regulation considers regulations governing business structure and multidisciplinary practices, pricing, and advertising. These can be applied to both domestic and foreign providers.

While public interest theories claim that many of these regulatory measures are justified to address market failures—such as (1) information asymmetries; (2) externalities; (3) lack of economies of scale; and (4) equity concerns—private interest theories have been critical of many aspects of professional regulation and, especially, of self-regulation.<sup>3</sup>

#### ***I. The Typical Market Failure in Professional Markets Is That of Information Asymmetry.***

Professional services require that practitioners have a high level of technical knowledge, and many knowledge-intensive professional services can be considered credence goods—that is, the clients may not have the knowledge to judge the quality of the services they purchase.

A possible market-based correction mechanism for this problem is the reputation premium. However, in many professional services reputation is not enough to provide information about quality to consumers. This can result in overall quality deterioration because providers of the highest quality, who charge higher prices, are driven out of the market.<sup>4</sup> Therefore, public interest theories assert that education and qualification requirements, other qualitative entry requirements such as exclusive tasks reserved to professionals, or advertising regulations are needed to protect consumers. Similarly, public interest theories claim that regulatory intervention is needed to address the principal-agent problem that can generate supplier-induced demand: the agent (services provider) has an incentive to over-supply quality in order to charge higher prices even if the principal (consumer of services) would be better off with a lower quality service at a more reasonable price. Such adverse selection issues are often addressed by (minimum) standards or price regulation

#### ***II. The Second Justification for Regulatory Intervention in Professional Markets Is the Concept of Externalities.***

The use of professional services may bring benefits to users but also to third parties. For example, an accurate audit can help companies obtain credit while also helping creditors and investors make informed lending and investment decisions.

However, several providers and potential users, particularly small enterprises, may be unaware of the private and social benefits that the use of professional services offers; therefore, intervention in many professional service markets tries to ensure that positive social externalities occur and negative externalities are avoided. Negative externalities can be addressed through liability regulations—but this

<sup>3</sup> The classic references are Stigler (1971) and Posner (1974).

<sup>4</sup> This process of “adverse selection” results in overall quality deterioration, which is described as a “market for lemons” in Akerlof (1970).



approach operates ex-post and has limited success. Ex-ante quality requirements, such as standards related to education and training, seem preferable to address externality issues.

Positive externalities include public goods. Many professional services exhibit good public characteristics and create positive externalities for parties not involved in the transaction. For example, legal professionals may generate important positive externalities that benefit society in general by defining and enforcing property rights. In a free market public goods tend to be under-produced, since the producer cannot exclude non-paying beneficiaries. To guarantee that public goods are provided, states may decide to enact regulations on the provision of public goods.

Market power can be an additional reason for regulatory intervention. In certain professional services, such as accounting, leading firms (often foreign-owned) have a significant share of the market and a large gap exists between the average leading firm and the average other firm. These market structures may be a result of regulatory failure, such as uniform standards or licensing controls at multiple levels. In such cases, interventions may be needed to address inadequate direct or indirect regulation.

### ***III. Regulating Markets for Professional Services May Also Help Public Interest Goals Toward Equity.***

Markets sometimes exclude certain actors from access to education or services. Therefore, governments or professional associations justify regulatory measures, such as price regulation, to ensure access to services for low-income consumers.

### ***IV. Finally, the Lack of Economies of Scale for Practitioners and Professional Services Markets May Be Used to Justify Regulatory Interventions in Professional Services.***

The small size of the domestic market may prevent the development of large professional service sectors, including the skills base. For example, local business service providers often don't have the expertise to support manufacturing exporters. Also, professional service sectors may lack investment from foreign firms. In such cases, it is essential to (a) identify unnecessary measures and trade barriers that prevent local companies from exploiting economies of scale, and (b) examine how regional

and/or multilateral liberalization (along with mutual recognition agreements) can help compensate for underdeveloped local services markets.

While public interest theories claim that many of these regulatory measures are justified to address the above market failures private interest theories have been critical of many aspects of professional regulation and self-regulation, in particular the protectionist outcomes they often produce.

For example, public interest theories argue that qualitative regulatory measures are necessary to guarantee high-quality services and avoid adverse selection. Qualitative entry restrictions may thus be necessary. But private interest theories warn that qualitative regulations may be disproportionate as a result of excessive entry requirements set by rent-seeking professionals and professional associations. In addition, if the profession gains a monopoly over the organization of the required training, the education of necessary professionals may be limited.

It is difficult to determine whether the qualitative requirements are disproportionate. Several examples of typical restrictive qualitative requirements are: restrictions on access to the profession, mainly due to the monopoly of professional associations over training institutions, or multiple certification requirements (for instance, a country's banking and insurance laws may require that all companies use auditors approved by the banks or insurance institutions—generally auditors affiliated with one of the “Big Four” or other large companies—to prepare the financial statements for outside investors or other external parties to obtain a credit; these requirements may limit the access of smaller suppliers to the market).

Also, highly skilled professionals in all sectors have exclusive rights to perform certain activities (e.g., auditing, representation of clients before courts, advice on legal matters, feasibility studies, design, and planning). The argument in favor of exclusive rights is that they can lead to increased specialization of professionals and guarantee a higher quality of service. But the negative price and allocation effects of exclusive rights, which act as monopolies, can be substantial, especially if they are granted for standardized services that can be provided at a lower cost by less-regulated or non-regulated providers.

Furthermore, price regulations are introduced and supported by national professional associations, who claim they help prevent the adverse selection problem. But most of the economic literature states that these

regulatory instruments can seriously harm competition by eliminating or reducing the benefits that competitive markets deliver for consumers. Most agree that less restrictive mechanisms, such as better information on the services provided, could be established.

Public interest theories justify advertising restrictions by the need to protect consumers. But private interest theories maintain that there is no justification for prohibiting advertising that is relevant, truthful, and not misleading.<sup>5</sup> Instead, advertising fosters competition by informing consumers about different products and allowing them to make better-informed buying decisions. It is also stressed that advertising, especially comparative advertising, can be a crucial competitive tool for new firms entering a market.

Finally, restrictions on the business structure in all professional services—for instance, regulations that restrict the ownership structure of professional services companies, the room for collaboration within the profession and with other professions, and in some cases the opening of branches, franchises, or chains—are justified by professional associations with the argument that professionals are more likely to give independent advice if certain forms of intra-professional partnerships are prohibited, and that restrictions on multidisciplinary activities prevent potential conflicts of interests that are detrimental to consumers. But private interest theories stress that these regulations are clearly anti-competitive and may harm consumers by preventing providers from developing new services or cost-efficient business models. For example, these regulations might prevent lawyers and accountants from providing integrated legal and accountancy advice for tax issues. In general, restrictions on collaboration between members of the same profession seem to be less justifiable than restrictions on collaboration between members of different professions where there is a strong need to protect the independence and liability of professionals.

Guidance on whether the regulatory measures are disproportionate can be obtained from regulatory impact assessments, stakeholders' consultations, and business surveys.

<sup>5</sup> Stigler (1961) has argued that advertising by the providers of services can substitute for a large amount of searching efforts by a large group of consumers.

## Explicit Trade Barriers

The major share of the international trade in professional services takes place through commercial presence and through the temporary presence of natural persons. Thus, most restrictions faced by professional services exporters will relate to mode 3 and mode 4 in GATS terminology. Typical restrictions affecting commercial presence in professional services include the following:

- An economic needs test for the approval of foreign investment
- Numerical quotas on the number of operating licenses available to providers of professional services
- A joint venture requirement for the supply of professional services
- Regulation of contracts by value and number through an annual licensing system
- Nationality or residency requirements for foreign establishment for companies providing professional services
- A requirement that foreign businesses hire specific ratios of domestic staff to foreign staff
- A reservation of some service sectors or activities for nationals or residents.

The supply of professional services through mode 3 will often be accompanied by mode 4 supply to provide skilled and professional services directly to projects and to maintain local offices. Professional service firms use a variety of professionals, such as high-skilled auditors, lawyers, engineers, and specialized technicians. Restrictions on mode 4 may also arise from a country's overall immigration policy or specific labor market conditions. The following are common examples of conditions for approving the entry of service suppliers:

- Labor market testing
- Residency requirements for intra-corporate transferees and a requirement that the foreign company employ specific numbers of local staff
- Authorization subject to the non-availability of locals
- Authorization subject to performance requirements (employment creation, the transfer of technology, the level of investment).

The deployment of professionals for temporary assignments in export markets separately or as a complement



to foreign direct investment is common in these sectors. The movement of natural persons is a sensitive issue in many countries because of illegal immigration and security concerns.

Finally, trade in selected professional services, such as engineering consultancy services, can be provided via mode 1 by using mass communications systems (post, fax, telephone, Internet). The principal restrictions on the cross-border supply of professional services are that (a) the services be certified by locally registered service providers and (b) cross-border service providers already have a commercial presence in the importing country.

## Immigration Policies

The trade-migration linkage is an important part of the debate on migration reform. Trade policy officials should not neglect the immigration and labor market perspectives when considering temporary entry or mode 4 issues. Policies related to visas, work permits, and treatment of foreign workers must be considered.

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# Chapter 5: The Political Economy of Trade Facilitation in Eastern and Southern Africa

## 1. Introduction

Sub-Saharan Africa has a long record of supporting regional integration and while there has been some success in lowering and removing tariffs a plethora of non-tariff measures remain in place, and trade costs are high relative to other regions of the world. A strong political commitment to deepen regional integration and development over the past four decades has not been matched by implementation on the ground. Removing barriers to trade despite high level political commitments remains elusive and continues to be the exception rather than the norm.

Why has trade facilitation reform proved so difficult in many countries in sub-Saharan Africa? Specific initiatives aimed at modernizing customs, enhancing cross border cooperation, launching national single windows, and introducing risk assessment are all recognized as technically sound initiatives yet implementation has been very challenging. Ministerial meetings contain frequent references to removing and eliminating non-tariff barriers, year after year, with little apparent improvement. Why have many commitments to reform trade facilitation been circumvented, repeatedly deferred, or simply stonewalled? Common explanations include a lack of political will, a shortage of technical capacity, and the binding constraint of limited financial resources. These are not mutually exclusive and indeed it is possible that, in varying degrees, all may be applicable.

Justifying the lack of progress on trade facilitation as a consequence of exogenous constraints, should be subjected to scrutiny. Since placing the “blame” on factors outside the scope of the agencies and actors responsible for implementation enables these agencies to continue to publicly commit to change while continuing with the status quo. Attributing the constraints to external and exogenous factors has also resulted in the International Cooperating Partners (ICP) responding with additional funding to assist with implementing trade facilitation through enhancing

physical infrastructure including ICT equipment and software and providing technical assistance.

The focus on physical infrastructure (for example, building new border crossings) and technical assistance risks deflecting attention from asking a number of the more fundamental questions as to why trade is regulated in a specific way in the country under review. This may include asking which Ministries and Agencies determine and implement the regulations, identifying the opportunities and incentives as well as the constraints and disincentives facing the different actors involved in the trade process, and accounting for the factors determining the implementation of trade facilitation measures. Further why have some low-income countries been able to significantly reduce trade costs despite continuing to experience human resource and capital constraints?

This chapter seeks to show how adopting a political economy analysis (PEA) approach to trade facilitation may begin to answer these questions. Over the past decade donors have increasingly adopted PEA as a tool to better understand specific institutional problems or constraints with the objective of identifying how to support the momentum for change. Examples include the World Bank’s “Problem Driven Governance and Political Economy Analysis,” the DFID “drivers of change,” the OECD “Governance Assessments,” and the recent EU approach to assessing and addressing sector level governance issues. The burgeoning literature on the political economy of reform has gradually increased in sophistication from models focusing on aggregate welfare gains and losses, to ones addressing distributional issues and identifying relative degrees of power. More recent sector specific models include time inconsistency, power and information asymmetry, principal-agent issues, and credible commitment issues.

PEA has provided valuable insights into approaches to decentralization, the water sector, energy policy, the design of effective public health campaigns, and the determination of tariff reforms to mention a few. Trade facilitation which encompasses political, economic, business, administrative, technical and technology issues continues to be viewed rather one-dimensionally as essentially a

technocratic reform that will unfold axiomatically once the funding and capacity building are in place. This assumption should not be left unchallenged. Technical characteristics invariably have political implications and understanding who benefits and who loses, or who perceives they will benefit or lose can assist in improving implementation and service delivery. In brief, the technical is political and that applies to the implementation of trade facilitation reforms.

This chapter seeks to provide insights into the resistance to trade facilitation reforms at the national level. It aims to identify the interests of the different stakeholders involved in trade facilitation and show how their interests are represented. How do government policy makers weigh the divergent views of these stakeholders? Which factors have contributed to the persistence of trade barriers and held back reform? How are specific stakeholders able to influence and block reform?

This chapter surveys a number of trade facilitation initiatives in Southern and Eastern Africa in the context of multilateral and regional commitments and aims to address four key questions. Firstly, can a PEA assist in explaining slow or the non-implementation of trade facilitation initiatives? Secondly, does adopting a PEA have potential programmatic implications for the different stakeholders including governments and ICPs? Thirdly, can a PEA assist in identifying practical initiatives that will support implementation? Fourthly, what does adopting a PEA approach mean for the existing trade facilitation initiatives including A4T, the DTIS, and National Trade Facilitation Assessments?

The chapter is organized in four sections. Following the introduction the second section outlines the characteristic elements of trade facilitation, and draws attention to the importance of adopting a more comprehensive definition based on the trade costs involved in the physical movement of goods. Section 3 looks at trade facilitation through the political economy lens and places the recent WTO Trade Facilitation Agreement in the context of longer term negotiations at the multilateral and regional levels and the broader goal of increasing competitiveness. This is followed in Section 4 with a preliminary outline of a PEA to a series of specific examples, including the regional customs bond guarantee, border management cooperation, and national quality infrastructure and technical barriers to trade. These examples represent exploratory sketches based on secondary (and publicly available) publications and reports and serve to illustrate the merits of adopting a more comprehensive PEA which would involve interviews with all the stakeholders. The final section of the report outlines the preliminary lessons, presents indicative

pointers for programs targeting trade facilitation reform, and makes recommendations for further detailed case study assessments of specific trade facilitation instruments using a PEA.

## 2. Characteristics of Trade Facilitation

Trade facilitation has been defined as “the plumbing of international trade”—it is necessary for trade to flow smoothly and is an essential building block for efficient regional integration. The reference to plumbing is appropriate since it encapsulates two of the traditional characteristics of trade facilitation—it is a necessary part of any trade agreement and while always present it is not always at the forefront. When we seek to define the term “trade facilitation” in terms of specific tasks or activities it becomes apparent that the definition depends on the context. In the context of the WTO trade facilitation is defined rather narrowly with a focus on border management procedures. Others, including the Asia Pacific Economic Cooperation (APEC), adopt a much broader definition that includes all policies, regulations, and procedures that impact on trade costs. The broader definition encompasses the WTO definition while also allowing for the inclusion of measures impact on transport and logistics efficiency, the treatment of regulations governing standards, and conformity with international regulations. The broader definition is operationally more useful as it more comprehensively captures the factors determining supply chain efficiency.

The rise to prominence of trade facilitation within the World Trade Organization (WTO) over the past twenty years culminated in the breakthrough agreement on trade facilitation in Bali in December 2013. Trade facilitation is not new, the preamble to the General Agreement on Trade and Tariffs (GATT) made explicit reference to “other,” non-tariff barriers to trade and there is a long history of agreements seeking to simplify trade procedures. Nevertheless trade facilitation (narrowly defined) with its focus on the procedural, administrative, and operational details differs from “traditional” trade negotiations which historically have focused on tariffs.

For the WTO trade facilitation is concerned with the simplification and harmonization of international trade procedures. The WTO training note defines trade procedures as “activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade.” The essential features of trade facilitation

include simplifying, standardizing, and harmonizing all the procedures and related information requirements involved in moving goods across borders. Trade facilitation in regional and multilateral trade agreements refers to the procedures and controls governing the movement of goods across borders with the aim of minimizing costs (reducing “red tape”) while ensuring public policy objectives are satisfied.

In summary the key principles of trade facilitation in the WTO include:

- Transparency and predictability;
- Simplification and international harmonization of customs procedures; and
- Increased (and effective) cooperation between customs and other government offices.

Effective trade facilitation seeks to reduce transit times and costs, increase the reliability of transit and border clearance times, and lower clearance costs while ensuring compliance with existing regulations.

Individual customs territories (sovereign nations) have developed their unique regulations, procedures, and administrative structures to satisfy their regulatory requirements. It should not be a surprise to find the large diversities manifest between nations in their respective cultural, social, economic, and political spaces extends to and has implications for the design, development, and operation of trade facilitation. Indeed what is perhaps more surprising is a belief that “one size fits all.”

Despite the recognized diversity there is a global consensus on the benefits of the key principles of trade facilitation as evidenced by the WTO Agreement on Trade Facilitation and its inclusion in all the regional economic agreements. A recent report by UNECA considers there is a “consensus in the empirical literature, regardless of the methodology utilized, on the positive and significant impact trade facilitation could have for Africa’s trade performance.” The potential for Africa to benefit disproportionately from reducing trade costs follows from the region experiencing higher costs relative to other regions.

Given the global consensus over the importance of trade facilitation there is widespread recognition that effective implementation remains the key challenge. In this vein the UNECA report also encapsulates the consensus within developing countries and among large sections of the broader international community in placing the emphasis on the investment and cost requirements and the necessity of providing technical and financial assistance.

### 3. Approaching the Political Economy of Trade Facilitation

The problem driven approach to political economy has three stages: identifying the challenge, mapping the relevant institutional and governance structures, and identifying the political economy drivers and potential roadblocks holding back reforms (change). Essentially this approach seeks to understand why the existing institutional arrangements do not support the reform process. With a focus on structures, institutions, and actors this approach results in a focus on effective communication strategies for building support for change (how to build a constituency for change).

Using PEA as a key development management tool in trade facilitation is still relatively novel. A Google search for trade facilitation and political economy returned two studies. The World Bank approach to PEA adopts the following sequence. The analysis begins by clearly defining the challenge and mapping all the institutions and actors in order to locate a focal point for change. The focal point for change will then begin to actively communicate the benefits of collective action with other stakeholders. Once the actors have been identified it is important to assess their influence (power relationships), credibility and legitimacy (or lack thereof), and interests—specifically, how they stand to gain or lose from any proposed changes. In parallel with the launch of an active marketing campaign for specific reforms by the “champion(s) of change” it is necessary to continue research and analysis to accumulate evidence that will develop and deepen the rationale for broadening the coalition for reform. The timing and sequencing of activities will be critical to the success or setbacks to the reform process.

The World Bank PEA approach is premised on arriving at long-term positive sum games and should not be confused with a short-term zero-sum struggle that reflects entrenched interests. Successful reform will be a “win-win” outcome and the approach needs to ensure that is communicated at all stages of the process. Attempts to shortcut and telescope the reform process to fit into ICP targets or self-serving domestic targets, or ambitious REC objectives will not be successful. Specific targets and deadlines are best developed through stakeholder consensus with the champion of change taking the lead. Analysis and action cannot be rigidly separated and differences in perception are key influences on policy outcomes.

Identifying the institutional arrangements underpinning trade facilitation and assessing their efficiency against

international best practices requires a mapping exercise. It is necessary to understand the motives and rational for each of the participants involved. Why are the existing policies and institutions not being reformed? What are the incentives of the different stakeholders? Who would win and who would potentially lose (in the short-term) from reducing trade costs? Are there lessons from countries that have implemented substantive trade facilitation reforms and established a modern national quality infrastructure?

The trade facilitation environment is characterized by competition, complexity, and conflict. The interests of the principal clusters of stakeholders may conflict should they have competing goals. There may be competing policy priorities within government and between different segments of the private sector, such as large international companies, import competing firms, small- and medium-scale distributors. Most stakeholders or actors involved in the supply chain understand the elements in which they are directly involved (immediate backward and forward linkages) but have limited appreciation of the whole supply chain. Operating businesses understand existing trade facilitation procedures and regulations and know how to work with them. Similarly government officials understand the negative and positive aspects of existing trade facilitation procedures. There may be strong support from vested interests to maintain the status quo in order to retain ongoing rents.

The wide range of actors/stakeholders involved in trade facilitation is shown in Table 11 below. Five major clusters of actors are involved in various elements of trade

facilitation. For each of the specific groups involved it is important to try and understand their motivations and priorities or, put differently, identifying the incentives for supporting the proposed reforms relative to the existing situation. Understanding the inter-relationships within and between broad groups of stakeholders and their scope to influence events is required. Assessing the influence of different stakeholders and their ability to mobilize human and financial resources in support of their commitment to either promote or stymie reforms is critical for determining specific intervention strategies.

Domestically trade facilitation concerns government politicians, public sector officials, and a diverse range of firms and individuals from the private sector. Within the specific groups of Actors the lead government agency and major private sector firms or private sector organizations may be expected to be the “drivers of change.” In both these cases trade facilitation represents their core business or activity from which they earn their income. While all of the other clusters or groups have an interest in advancing trade facilitation it is only one among an array of interests. Support and commitment for reform from these broad clusters is important but must be considered a complement to the lead agency or drivers of change. Such broad support from ICP or the Political Institutions while necessary, it is not sufficient and cannot serve as a substitute for a lack of commitment by the “natural” lead agency.

Once the “driver of change” and the “roadblocks” have been identified it is important to map out a convincing argument for change taking into account specific conflicts and competing interests. The leadership of the lead agency responsible for implementing trade facilitation is required to build a convincing argument for the change as they will need to win over both their own staff and many users within the private and public sectors.

The recent World Bank handbook on Border Management Modernization, McLinden, Fanta, Widdowson, and Doyle (2011) discusses the importance of building a convincing business case for border management reform. This approach was further extended by Hoekman and Jackson (2013) who highlighted the importance of the different players along a supply chain as key enablers in stimulating further trade reform. Both these interventions recognize that implementing effective trade facilitation reforms requires much more than a straightforward technical commitment to apply “best practice” procedures. It recognizes that any existing institution/regulatory framework will operate in a way which creates incentives and disincentives for each of existing stakeholders.

**TABLE 11: Actors Involved in Trade Facilitation**

| Cluster of Actors          | Specific Groups of Actors   |
|----------------------------|---|
| International Institutions | WTO, WCO, World Bank, COMESA/ EAC, International Cooperating Partners   |
| Political Institutions     | Heads of State/Minister of Finance, Parliament  |
| Core Public Agencies       | Minister of Trade/Agriculture, Senior and Junior officials involved with administration of trade regulations, National Standards Bodies |
| Private Sector Operators   | Importers & Exporters, customs clearing agents, transport companies, freight forwarders, testing and certification companies            |
| Compliance and Enforcement | Judiciary, anti-corruption groups, Parliamentary oversight  |



## 4. Case Studies of Trade Facilitation

The EAC countries have committed to an active regional agenda for trade facilitation through both the EAC and COMESA. Under the auspices of the WTO and the WCO several countries have undertaken comprehensive Trade Facilitation Assessments. As part of the Aid for Trade agenda the EIF has also financed several Diagnostic Trade Integration Studies in the region to identify the key technical constraints to implementing WTO commitments and increasing regional and international trade. Notwithstanding these and other initiatives progress on trade facilitation has proven to be slow.

What can be learned from the experience of trade facilitation in Eastern and Southern Africa over the past decade? How should one approach a PEA given the dearth of published reports? A preliminary answer to this question may involve focusing in more depth on specific trade facilitation commitments and asking the following fundamental question. If the recommendation is so important and has high level political commitment why has progress been so challenging?

At the outset it is important to obtain an accurate estimate of the changing trade facilitation environment in the region by documenting progress and setbacks. In the absence of detailed case studies much of the evidence focuses on investments in infrastructure and the introduction of computerization. Information on more objective indicators such as number of physical inspections, time-release, customs valuations are rarely made publicly available and tend to be one of assessments rather than information collected on a routine basis over time.

The negotiations leading up to the recently approved WTO Agreement on Trade Facilitation raised the profile of trade facilitation and encouraged the completion of comprehensive national level Trade Facilitation Needs Assessments. The commitment to negotiate an Agreement on Trade Facilitation at the WTO began formally in 2004 with a focus on “clarifying and improving relevant aspects of Article V, VIII and X of GATT 1994.” The Trade Facilitation Needs Assessment represented an integral part of the process and sought to empower developing and least developed countries to identify their trade facilitation needs and priorities and to identify the cost implications of the proposed measures.

All of the assessments were undertaken using a standardized guide (which was an official WTO document based on the evolving Consolidated Negotiating Text). The

assessments of needs and priorities were conducted by the recipient country which was also responsible for drafting the final report. The final report remains the property of the recipient country and is only made public with their permission. The WTO estimated that the needs assessment workshop will take five working days and stated that it should be conducted by national trade facilitation task force comprising all the relevant border agencies, private sector, and other government agencies that would be affected by the new WTO trade facilitation agreement. The national workshops are considered to be primarily technical with the potential for input in an advisory or consulting capacity from international institutions (WCO, WTO, World Bank etc.). Political institutions, identified in Table 11 as one of the major cluster of actors determining the nature and pace of trade facilitation are not mentioned as participants in the national workshop.

The Trade Facilitation National Needs Assessment is designed to address technical shortcomings. Indeed the implicit assumption is that there is an inadequate understanding of the proposed measures (such as expedited clearance, risk assessment, simplification of formalities, and documentation requirements) and what is required is to “explain the proposed measures and help participants understand what they would need to do to implement each measure.” While technical shortcomings and the lack of resources may represent a partial explanation for the current state of play it leaves many unanswered questions. For example, it cannot account for the current state of play in many countries.

The Revised Kyoto Convention (RKC) adopted by the WCO Council in 1999, entered into force in February 2006. The RKC represents a blueprint for modernized customs procedures and may be considered a precursor to the principles embodied in the WTO Agreement. This complementarity is illustrated in Table 12 and serves to highlight the length of time that many of the trade facilitation tools have been under consideration. Within the EAC Kenya, Uganda, and Rwanda are signatories to the RKC. Furthermore, the agreements at the multilateral level are complementary with regional agreements within the EAC and COMESA. Given the extensive trade facilitation discussions by customs and trade officials in multiple fora over the past decade, and ongoing technical assistance projects at the national and regional levels in Eastern and Southern Africa accounting for the implementation delays and in some case the non-implementation by recourse to a lack of detailed understanding of the technical issues leaves much unexplained.



**TABLE 12: Examples of Complementarity between WCO Revised Kyoto Convention and WTO Trade Facilitation Agreement**

| Principles  | WCO Revised Kyoto Convention and          | WTO Trade Facilitation Agreement |
|---|---|----------------------------------|
| Transparency and Predictability                             | Yes, General Annex, Chapter 1, 7, and 9   | Articles 1 and 2                 |
| Procedural Simplification and Streamlining of documentation | Yes, General Annex, Chapter 3, 7, and 9   | Articles 3 and 10                |
| Coordinated Intervention with other Border Agencies         | Yes, General Annex, Chapter 3 (also SAFE) | Article 8                        |

Source: Adapted from the WTO Trade Facilitation Toolkit, List of Articles in Section 1 of the WTO Agreement on Trade Facilitation—Referenced to WCO Instruments and Tools, February 2014.

The trade facilitation agenda is inherently political with many interested parties including senior politicians, existing businesses, and a wide range of actors who undoubtedly understand the specific technical issues. The actors currently engaged in cross border trade are familiar with the existing procedures and know how to operate and trade profitably. Engaging in major procedural change is aimed at reducing trade costs; however, it will also shift the costs and benefits to both existing and potential traders. Focusing solely on the technical aspects of trade facilitation takes attention away from those actors who may feel threatened by the proposed changes, such as small custom brokers and clearing agents, customs officials at the border, and politicians who can confer patronage through approving exemptions.

Initially the slow progress was ascribed to “capacity constraints” which resulted in donors funding trade capacity building activities to support trade facilitation. A narrow focus on capacity constraints has resulted in the national reform process, and the role of vested interests being largely excluded from detailed analysis. Slow progress on implementing Ministerial commitments at regional fora is invariably ascribed to a “lack of technical capacity.” However, there is growing evidence that a specific constituency, such as financial institutions, clearing and forwarding agents, import competing private companies, and parastatal entities may be benefiting from the existing policy and regulatory framework and may actively oppose any change.

Untangling the web of influence within the political decision making process is rarely obvious or straightforward. Furthermore, the balance of incentives often favor non-implementation as few regional agreements have penalties for delayed implementation and effective monitoring and compliance mechanisms are still in their infancy.

#### 4.1 Trade Facilitation in the East African Community

Trade facilitation in East and Southern Africa is heavily influenced by recent global developments as all the members of SADC and the EAC are members of both the WTO and the WCO as are a large majority of the members of COMESA. Further commitments under the regional economic groupings include trade facilitation. A review of regional trade and transport facilitation instruments in the EAC (Kitenga and Nyangweso 2010) and the 2012 Report by the USITC reported on the progress and challenges. The World Bank Logistics Performance Index (LPI) and the Trading across Borders Doing Business Indicators provide an indication of the performance of the five EAC members relative to all other countries. During the period 2009–2011 the Doing Business reports noted no reforms relating to the Trading across Borders indicator. Relative to sub-Saharan Africa the EAC members are performing close to the continent wide average, indicators in 2014.

The LPI index which has a more detailed breakdown of developments in trade facilitation shows Kenya and Rwanda improving relative to all other countries over the period 2007–2014. Unfortunately the LPI only includes data from Uganda for one year (2010). The ranking on the LPI and the Trading across Borders performance for the EAC are shown in Table 13. The recently released EAC Scorecard provides a useful tracking of de jure compliance by EAC Partner States with their commitments to implement the Common Market Protocol. The scorecard examines compliance with eliminating tariffs and equivalent measures on intraregional trade, elimination of non-tariff barriers, implementing the common external tariffs, and harmonization and mutual recognition of sanitary and phytosanitary standards and technical standards.

**TABLE 13: Rankings on Logistics Performance Index, 2007–2014 and Doing Business Indicators for 2014**

| Country                     | 2007 | 2010 | 2012 | 2014 | Documents to Import                        | Documents to Export | Days to Import | Days to Export |
|-----------------------------|------|------|------|------|--|---------------------|----------------|----------------|
| Logistics Performance Index |      |      |      |      | Doing Business Trading Across Borders 2014 |                     |                |                |
| Burundi                     | 113  | n.a. | 155  | 107  | 10   | 9                   | 32             | 46             |
| Kenya                       | 122  | 76   | 99   | 74   | 9  | 8                   | 26             | 26             |
| Rwanda                      | 148  | 151  | 139  | 80   | 9  | 7                   | 30             | 26             |
| Tanzania                    | 137  | 95   | 88   | 138  | 11   | 7                   | 31             | 18             |
| Uganda                      | n.a. | 66   | n.a. | n.a. | 10   | 7                   | 33             | 30             |

Note: n.a. not available Ranking out of 143 countries in 2014

Source: LPI, 2007–2014 and Doing Business, 2014

Despite considerable improvements in individual countries in SSA the majority of African economies, including Eastern and Southern Africa continues to lag on all the international measures of trade facilitation.

## 4.2 Mapping the Actors: Interests, Motivations, Incentives, and Pressures

Trade facilitation encompasses a wide range of professional activity areas and stakeholders (see text box). The wide range of institutional actors with an interest in various elements of trade facilitation ensures that introducing fundamental changes will be challenging and complex to manage. Over the past two decades the global economy has been transformed with the rise of global value chains, increased concern over cross-border trade in illegal products as suppliers seek out “weak links” and increased security concerns following the 9/11 attacks. These developments have created new challenges for all the agencies involved in the management and control of cross-border movements.

On the one hand the increase in trade transactions and value, along with the reduction in transit time and the importance of increased reliability has placed a premium on enhancing trade facilitation as a key factor in competitiveness. Concern over illegal cross-border movements and the spread of violent conflict into neighboring countries (for example Sudan-South Sudan, Nigeria, Kenya-Somalia, DRC) has exerted pressure for increased controls and checks. All of these developments have served to raise the profile of the border control agencies. Ensuring more efficient border controls to facilitate the legitimate

movement of goods and people while also more effectively identify the illegal trade is essential for economic growth and stability.

This challenge has served to raise the profile of trade facilitation to the highest level. Although challenges remain as the linkages between trade facilitation and the general competitiveness of the economy are not always sufficiently attributable or direct enough for a positive pay-off. Recent work raising awareness of these linkages and highlighting the direct costs of foregone investment has encouraged higher level political involvement in trade facilitation initiatives. For example, in May 2014 the Presidents from Kenya, Rwanda, and Uganda, the second Vice President of Burundi, and the Prime Minister of Tanzania all attended the official launch of the Kenya National Electronic Single Window System. At the launch President Kagame stated:

“I just want to reiterate how this is one of many important projects that the EAC Partner States have undertaken to deepen integration that we have been seeking, make business more efficient, and lower the cost of doing business as we move forward.”

This high level commitment at the level of Regional Heads of State, while positive for advancing trade facilitation needs to be weighed against competing objectives which may be more prominent at the national level. These may include fighting smuggling, tackling general corruption, retaining the support of the domestic import substituting firms who complain about unfair competition and undervalued imports, and the need to raise domestic revenue

### **BOX 3: Key Activity Areas in Trade Facilitation**

Transport Infrastructure  
 Transport Equipment  
 Hub Development (Free Zones, Logistics and Distribution, Inland Clearance, Container Repositioning)  
 Integrated Transport Planning  
 Trade and transport regulation  
 Customs transparency  
 Modern customs practices  
 Customs clearance facilities  
 Inefficient public logistics services  
 Complex Tariffs and NTBs  
 Inter-ministerial/Interagency coop  
 Cross border movements  
 Transit regimes  
 Foreign Exchange restrictions  
 Trade Finance  
 Trade promotion and market information  
 Information systems  
 Quality and regulation of Logistics  
 Sector Consolidation (transport and logistics companies)  
 Supply Chain integration  
 Foreign participation in logistics services  
 Trade Facilitation and Security  
 Technical Regulations and Quality Assurance

#### **Key Actors**

Importer/Exporter  
 Forwarder  
 Integrator  
 Customs Broker  
 Transport Operator  
 Container Terminal  
 Zone Operator  
 Warehouse  
 Bonded Facility  
 Financial Institution  
 Value added logistics  
 Testing and Certification

### **MULTIPLE MANDATES AND INTERESTS**

Revenue Collection  
 Safety and Security (dangerous goods, illegal goods)  
 Environment and Health (quarantine)  
 Consumer Protection (product testing)  
 Trade Policy (anti-dumping)

from border taxation. Notwithstanding these challenges there is growing evidence that in some selected high profile activities the EAC has made significant progress, for example border clearance times at Malaba crossing (between Kenya and Uganda) are now measured in hours rather than days. The cumulative impact of high level political commitment, long-term donor funding for technical assistance and infrastructure improvements, and increasing commercial pressure from both sides of the border all played a role in reducing transit times.

The political leadership within the EAC Partner States (as in most countries) retains the power to appoint key staff within government and the public sector. Understanding the motivation and interests of key appointees in the revenue agencies and other agencies and departments responsible for trade facilitation is important for determining implementation of the reform agenda.

Many National Revenue Administrations are driven by the need to maximize revenue generation. The commitment to facilitate trade is frequently a secondary objective even if publicly stated in their mandate. In many countries career development and bonus payments are linked to the revenue agency meeting a specific revenue target. Import duty collected by national revenue administrations continues to be an important element of total domestic revenue accounting for 9 to 15 percent of the total. Further these revenue agencies also collect value added or sales taxes on imports and manage all the export declarations that provide the evidence for duty and VAT rebates on inputs which serves to magnify the importance of revenue collection. The box below illustrates the multiple mandates and interests that exist within the agencies with responsibility for customs clearance.

Understanding the probability of trade facilitation reform requires the proponents to understand the set of interests, motivations, and priorities, incentives, and pressures that operate on staff throughout the revenue agency. While identifying the publicly stated goals represents the starting point it is essential to go beyond that

and identify the interests, concerns, and motivations of different groups within a specific institution. The interests of the senior management team all appointed on fixed term contracts may not be identical to the career customs officers at specific border posts. Different sets of actors within an institution, for example, senior management and front-line staff may face quite different incentives. There may be group pressure to reform from top management yet at the frontline there may be resistance because the reforms would reduce informal payments. A bonus system based on revenue collected may encourage both a higher level of physical inspection and undervaluation by firms as they anticipate their valuations will always be subject to uplift. At the border (frontline) there may be pressure on a new customs officer to participate in higher inspection levels and other practices which increase the costs of trade as this will increase the revenue collected. A new recruit may face repercussions from colleagues from refusing to engage in illegal clearance practices. Understanding the specific circumstances of the officials responsible for implementing customs and border clearances is a necessary element of mapping a reform program.

Among private sector operators it is necessary to distinguish between those that benefit from the status quo and those that have the most to gain from improved trade facilitation. It may be that the organized private sector has negotiated an informal fast track for their products while medium- and small-scale firms face longer delays and increased uncertainty. Table 14 seeks to map out the dominant incentives facing major stakeholders for a range of trade facilitation initiatives.

There is a dearth of detailed political economy analyses of specific trade facilitation incentives. Surveys of major reforms generally focus on the technical issues encountered and highlight how approaches have evolved over time. A good example of this approach is the recent paper by Jonathan Tsen (2011), “Ten Years of Single Window Implementation: Lessons Learned for the Future.” This examines how the concept of the Single Window has evolved along with a summary of implementation and a review of how information technology developments will accelerate the move away from paper-based exchanges.

The paper implicitly refers to political economy constraints by highlighting how the concept of the NSW challenges the traditional compartmentalized approach to regulatory control of the movement of goods. Indeed the author notes that “the challenge of coordinating all the different agencies (and their procedural and data requirements) into coherent and simplified procedures that could be automated is often more political than technical” and

presents an example from Madagascar showing how many of the stakeholders were opposed to change. The focus then shifts to outlining the staged approach to developing a NSW which focuses on the process. Virtually all the reports on implementing the NSW focus on the technical process with a reference to ensuring dialogue, however, there is a dearth of reports outlining the specific activities that contributed to developing the coalition to support implementation, and there are even fewer case studies documenting why NSW have failed or taken much longer than were originally scheduled.

The remainder of this section begins to sketch a more detailed outline of the experience in Eastern and Southern Africa of implementing the Regional Customs Bond Guarantee, Border Management Cooperation, and more tentatively the development of regional cooperation in quality infrastructure and addressing technical barriers to trade.

### 4.3 Regional Customs Bond Guarantee

For the past three decades the commitment to implement a Regional Customs Bond Guarantee (RCBG) scheme has been on the trade agenda in Southern Africa. Indeed the regional bond guarantee scheme was on the Preferential Trade Area (PTA) agenda at the Ministerial Meeting in Lusaka in December 1985—this predates the establishment of COMESA. The COMESA Heads of State and Government signed the Regional Customs Bond Guarantee Agreement in 1990, however, implementation was deferred until all the modalities and the legal and technical instruments were agreed. Further the Agreement had to be formally ratified by nine states for it to enter into effect. After protracted negotiations COMESA finalized their provisions for the RCBG in 2005 and seven countries had ratified. Zambia had delayed ratification stating the need to assess and quantify the impact on business taking into account concerns raised by some private sector groups on possible job losses.

In Zambia freight forwarders and clearing agents must be licensed by the revenue authority to carry out transit related services. In 2005 Zambia had licensed 196 Customs clearing agents and approximately 30 percent dealt with Removal in Bond or Removal in Transit. Transit traffic between South Africa and the DRC through Zambia remains a profitable business for the clearing agents. This tends to be the larger agents who are comfortable absorbing the risk of default. Since the trade is unbalanced with few goods being exported in transit from the DRC to South Africa the Zambian clearing agents stand to lose the transit business when the RCBG is implemented. Unlike their

**TABLE 14: Mapping of Incentives of Key Public Agency Actors in Trade Facilitation**

| Core Public Agencies                                   | Main Priority   | Single Window  | Integrated Border Management   | Use of Risk Assessment  | Increased Transparency  | Authorized Economic Operator Scheme  |
|--|---|--|--|---|---|--|
| <b>Ministry of Trade, Registration &amp; Licensing</b> | Increase exports, promote SMEs  | Positive, limited role   | Positive, limited role   | Support, limited role   | Supports as increases compliance with WTO   | Positive, limited role   |
| <b>Ministry of Agriculture</b>                         | Ensure food security  | Positive likely to insist on retaining power to issue import permits for sensitive products                                | Reluctant to delegate authority for issuing import permits                           | Support, limited role   | Supports as in compliance with WTO  | Limited role   |
| <b>Revenue Authority/ Customs Senior Management</b>    | Meet Revenue targets  | Very Positive—SW usually led by Revenue/ Customs   | Positive as Revenue/ Customs usually the lead agency                                 | Yes, in principle but in practice slow as believe it will reduce revenue    | Yes, in principle but has not been a priority   | Yes, in principle but concerns over setting up and staffing Post Clearance Audit Units                                     |
| <b>Revenue Authority/ Customs Line Officials</b>       | Deliver revenue targets   | Reduces discretion, linked to introducing electronic data, concern over changing practices and potential reduction in jobs | Generally positive as perceived to increase authority of the Revenue/ Customs Agency | Reluctant to implement—removes discretion, threat of less control and power | Yes, in principle but still need to change the culture to one of Open Access to information for all | Need convincing by Senior Management as a major change of culture for officials used to a high rate of physical inspection |
| <b>SPS Officials</b>                                   | Minimize outbreaks of food poisoning/ generate funding                      | Will insist on retaining their authority to test regulated products  | Will insist on retaining their authority to test regulated products                  | May resist using risk assessment and recognition if revenue is a concern    | Yes, in principle in conformity with the WTO Agreement  | Need to ensure this is linked with recognition of foreign/ regional test results   |
| <b>Standards and Technical Regulations (TBT)</b>       | Promote Quality policy, ensure adequate funding for National Standards Body | Will insist on retaining their authority to test regulated products  | Will insist on retaining their authority to test regulated products                  | May resist accepting foreign tests if revenue a concern                     | Yes, in principle in conformity with the WTO Agreement  | Need to ensure this is linked with recognition of foreign/ regional test results   |
| <b>Road Transport Officials</b>                        | Maintain and expand physical road network, promote road safety              | Likely to insist on maintaining their mandate to weigh/check vehicles  | Expected to insist on maintaining their mandate to weigh/check vehicles              | Will require training   | Senior Officials support, but not a priority in allocating resources                                | Considers this a customs issue   |
| <b>Security/Police</b>                                 | Minimize trade in prohibited goods  | Will retain authority to search  | Will retain authority to search  | Sees this as a customs issue  | Requires a change of culture  | Considers this a customs issue   |

counterparts in South Africa the Zambia clearing agents have structured their prices so that a disproportionate amount of the change relates to the transit bond. An earlier report (2005) estimated that up to 500 jobs could be at risk, on the assumption that growth in exports was not matched by the reduction in the costs of transit trade. The number of import declarations is three times the number of export declarations.

COMESA carried out pilot operations of their Transit Management System (TMS) over the period 2007–2010 on the Northern Corridor covering Kenya, Uganda, and Rwanda. The trial was very small with approximately 251 transit runs (out of this 240 were related to imports). Approximately 900 declarations per day (in February 2010) were transmitted from Mombasa port through the Malaba border post. COMESA launched their scheme in March 2010 although this was suspended because a number of revenue authorities had not put in place the necessary regulatory reforms to transform the pilot test activities into routine operations. The scheme was re-launched along the Northern Corridor countries of Kenya, Uganda, and Rwanda in 2012 and by February 2014 almost 200 guarantees totaling \$89 million had been executed by Clearing and Forwarding Agents. The Uganda and Rwanda Revenue Authorities—both landlocked countries were the main drivers for change. They took the initiative and pushed to replace the National Bond with a Regional Bond.

The earlier pilot (or trial runs) organized by COMESA in 2007–2010 were characterized by a lack of awareness by field staff at the border posts. This is despite the long build up to the pilot with numerous regional meetings organized by the Secretariat and the item remaining on the agenda of both the Officials and the Ministers of Trade meetings. During the discussions between the officials numerous technical details were raised which required the matter to be deferred while Member States carried out their own analysis. Once the officials returned back to their capitals there was no sense of urgency to undertake the consultations and carry out the research. On several occasions donors were requested to fund technical work to advance the Regional Bond Guarantee system. The failure of member states to prioritize the RCGB, along with in at least one country (Zambia) active resistance to change by customs clearing agents, assists in accounting for the delay of seventeen years between the approval by the Heads of State and the launching of a pilot in 2007.

#### 4.4 Border Management Cooperation

The border agencies are responsible for the smooth processing of people and goods at the points of entry and exit in accordance with domestic regulations. Efficient border management requires a number of agencies to work together in a coordinated manner. Coordination is required between the two countries (cross-border), between the different agencies with mandates at the border, and within the agency between the border post and the Head Office. Efficient communication is essential for ensuring the smooth flow of goods and people while also ensuring public safety and security.

A review of the Mwanza, Malawi border post in 2011 by the Southern Africa Trade Hub found serious challenges relating to inter-agency cooperation. When interviewed the challenges listed by the different government agencies, including the Malawi Revenue Authority, Ministry of Health, Immigration, Malawi Bureau of Standards, Forestry, Plant Health, and Road Traffic Directorate focused largely on infrastructure shortfalls. These included a shortage of computers, lack of examination tools such as forklifts and scanners, frequent power outages. Government officials also complained about routine under-invoicing by traders and incomplete knowledge of trade regulations by the Customs Clearing and Forwarding Agents. Private sector complaints included duplicate tests which wasted time, too many agencies at the border, long delays between taking a sample and the publication of test results.

The 2011 assessment found limited coordination among the agencies at the border resulting in duplication of inspections, or goods being released without being attended to by all the required agencies. In spite of most of the agencies at the border requiring access to the same information no data sharing took place. In 2013 the DTIS Update team visited the Mwanza border post and found little change from the situation two years earlier in terms of duplicate testing, the absence of data sharing, and a lack of coordination on operating hours.

Each agency at the border operates in accordance with its own policy and procedures (this was also confirmed to be the case in recent review of Zimbabwe) which means that each of the staff members have their own incentives that would not appear to be coordinated to deliver efficient trade facilitation. Establishing Joint Border Committees and/or ensuring regular meetings at the border of all



the stakeholders have been proposed. The dialogue of the stakeholders at the border is useful in highlighting challenges and in many cases agreeing on practical compromises, however, the major constraints require regulatory changes that must be recommended and approved by the Head Offices/Minister and then notified through the legislative process.

#### **4.5 Quality Infrastructure and Technical Barriers to Trade**

Increased living standards and a growing demand for safe, reliable, and environmentally friendly products have resulted in a large increase in the number of technical regulations and standards adopted by both developed and developing countries. Balancing the pursuit of legitimate public policy objectives with a commitment to more open trade lies at the heart of the both the multilateral level WTO TBT Agreement (1994) and at the regional level the EAC Standards, Quality Assurance, Metrology and Testing Act (SQMT)(2006). Both agreements seek to ensure that public safety, health, and security are implemented in a non-discriminatory manner that minimizes the impact on trade. Notwithstanding these commitments all five EAC Partner States continue to experience challenges in implementation and in ensuring that mandatory standards (technical regulations) do not function as technical barriers to trade.

The evidence in the EAC is consistent with many other developing countries Regional Economic Communities. Namely as traditional tariffs have been removed or reduced technical and regulatory barriers to trade have risen in prominence. Technical barriers to trade figure prominently in the surveys of formal Non-Tariff Barrier complaints by Partner States. The recently published EAC Scorecard (2014), the Annual Report on Status of Elimination of Non-Tariff Barriers in the EAC (2013) highlight the continuing importance of technical barriers to trade. Despite a long history within the EAC of committing to eliminate NTBs through harmonizing standards, progress has been slow and labored. Recommendations to agree to mutual recognition of quality marks within the EAC predate the existing SQMT Act.

In 2012 the Secretary General of the EAC blogged on the Ministerial Meeting dedicated to “getting rid of NTBs.” One year later, in July 2013, the East African Business Council organized a dialogue between trade facilitation practitioners in Dar es Salaam which served to highlight the absence of coordination within Tanzania between the Tanzania Food and Drug Agency and the Tanzania Bureau of Standards which resulted in multiple testing, certification,

and licensing within the same country. A recent Breakfast Meeting convened by the East African Business Council in Arusha (May 13, 2014) highlighted the obstacles to trade resulting from Non-Tariff Barriers.

Following the approval of the EAC SQMT Act in 2006 Partner States and the EAC Secretariat were required to establish three new administrative structures to address QI issues at the regional level: the East African Standards Committee (EASC), the Liaison Office (to provide administrative support to the EASC), and the East African Accreditation Board (EEAB). Prior to the SQMT Act the EAC Partner States had established (in 2004) a number of technical sub-committees. These included standards, quality assurance, metrology (further divided into legal and scientific and industrial), and testing. After 2006 these sub-committees continued and reported to the EASC. Subsequently a further sub-committee focusing on Technical Regulations and Cross Cutting Matters (CCM) has been established. Draft regulations to “operationalize the EAC SQMT Act” were submitted to the 15th Meeting of the EASC in June 2011. At the same round of meeting Officials considered “Procedures for the Development of East African Standards.”

The EAC Regional Quality Infrastructure and the Partner States Quality Infrastructure has received financial and technical assistance from a wide range of donors over the past decade. In a partnership between the EAC Secretariat and German development cooperation the Physikalisch-Technische Bundesanstalt PTB (from Germany) supported the establishment of a Regional Quality Infrastructure over the period 2004–2013. The first phase through to 2007 focused on establishing the legal framework and on capacity development for the EAC Secretariat and its Technical Committees. The second phase focused on implementation with a special emphasis on mutual recognition of conformity assessment procedures (ensuring EAC countries used the same testing procedures), strengthening of metrological and testing services, and increased participation of the private sector in standard setting. The final phase from 2011–2012, provided support to the EAC Secretariat and national QI institutions to support implementation of the SQMT Act.

The PTB project listed a number of key problems encountered during project implementation in a Case Story report for a major A4T conference in 2011. The problems included a lack of coherence between national development priorities and EAC integration principles. Partner Countries delayed implementing the SQMT Act and in some cases “rejected” implementation. The EAC Secretariat has no mechanism for applying sanctions. Further the EAC Secretariat lacks the technical capacity to coordinate



and support effective implementation of the SQMT Act. At the highest political level the Presidents and Ministers have reaffirmed their commitment however within each country lobbying by specific industries has served to delay implementation. The project also supported the establishment of a comprehensive website on EAC SQMT ([www.eac-quality.net](http://www.eac-quality.net)).

Other donor projects have supported the establishment of harmonized standards for agricultural and horticultural commodities (USAID-COMPETE), strengthening the role of the private sector through establishing the Regional Private Sector Standards Platform within the EABC (Trade-mark East Africa), Trade Capacity Building in Agro-industry products for establishment and proof of compliance with international market requirements (NORAD, implemented by UNIDO), Trade Promotion through environmental standards for the EAC region (Swedish Standards Institute).

The projects with a regional dimension all supported regional meetings and dialogue. A number of the donors provided testing and technical equipment for public sector laboratories. The proliferation of committees and sub-committees has resulted in a large increase in the number of regional meetings. Many of these meetings are externally financed. Table 15 below shows the participation in the 2011 East African Standard Committee Meeting in Arusha. Participation is dominated by the respective National Standards Bodies with virtually no involvement from the parent Ministries of Trade. Indeed only one participant was attached to a Ministry of Trade the other government delegates were from the Ministry of East African Affairs. Rwanda and Burundi had no representatives from the private sector. The private sector representatives from Kenya

came from very large companies with significant cross border trade—Procter and Gamble, Nestle and East African Breweries and the Kenya Association of Manufacturers. Only one person from the EAC Secretariat worked specifically on RQI the others were responsible for trade and industry and administrative support.

The national quality infrastructure systems in the founder members of the EAC are relatively well established institutions. Reforming the national regulations toward a harmonized WTO compatible system is proving challenging. Several EAC countries have established a large number of compulsory standards (technical regulations) and receive considerable revenue from mandatory testing. The 2008–2009 Annual Report for the Uganda National Bureau of Standards noted how the standard bureaus in both Kenya and Tanzania were able to raise more than 80 percent of their total budget from testing and other fees and made a recommendation that UNBS be permitted to introduce similar schemes “from which revenue generation grows with the economy so as to be able to provide effective support services to the country.” The report went on to recommend introducing schemes such as an industrial levy, a pre-export Verification of Conformity (PVoC), and an import inspection levy.

Establishing a universal industrial levy effectively imposes a tax on all domestic producers to cover the costs of the national quality infrastructure. Similarly requiring all imports to be subject to an inspection levy will increase trade costs. The various levies and inspection fees have been driven by the National Standards Bodies as they seek to reduce their dependence on government funding and provide increased services. At the national and regional

**TABLE 15: Participation on the East African Standards Committee Meeting June 2011**

| Country/Agency  | National Standards Body | Weights and Measures | Food & Drug Agency | Government Ministry | Private Sector | Other/ Technical | Total     |
|-----------------|-------------------------|----------------------|--------------------|---------------------|----------------|------------------|-----------|
| Burundi         | 6                       |                      |                    |                     |                | 1                | 7         |
| Kenya           | 8                       | 2                    |                    |                     | 5              | 1                | 16        |
| Rwanda          | 2                       |                      |                    |                     |                |                  | 2         |
| Tanzania        | 6                       | 2                    | 3                  | 1                   | 3              |                  | 15        |
| Uganda          | 10                      |                      |                    | 2                   | 1              | 1                | 14        |
| EAC Secretariat |                         |                      |                    |                     |                | 4                | 4         |
| EABC            |                         |                      |                    |                     |                | 2                | 2         |
| COMESA          |                         |                      |                    |                     |                | 1                | 1         |
| Donors/Projects |                         |                      |                    |                     |                | 5                | 5         |
| <b>Total</b>    | <b>32</b>               | <b>4</b>             | <b>3</b>           | <b>3</b>            | <b>10</b>      | <b>14</b>        | <b>66</b> |

Source: Derived from Report EAC/TF/46/2011 (available on line)



level attention has identified inadequate laboratory testing equipment/facilities, lack of quality awareness, staffing shortages, and funding shortfalls as government budgets are strained as the major constraints to developing an efficient national/regional quality infrastructure. Considerably less attention has been accorded to the regulatory framework. Frequently the regulatory framework is treated as a given, although recent work by the OECD, the World Bank, and others on regulatory best practices and the WTO Accession process have served to highlight how NQI can be trade restrictive.

Examples include duplicate testing, the failure to accept testing/accredited results from trade partners, excessive reliance on mandatory standards, and specific national standards. These continue to be recorded as major Non-Tariff Barriers and have been targeted for removal at the regional level. Progress on implementing a Regional Quality Infrastructure in the EAC is proceeding slowly as each Partner State seeks to retain its own technical regulations and negotiate to a harmonized standard. Effectively the RQI has been superimposed onto all five existing NQI with

each Partner State seeking to try and preserve as much of its own NQI as possible.

Although the SQMT Act allows for mutual recognition of technical requirements across all Partner States, there has been limited take up with each partner preferring to negotiate harmonized standards. Why have the Government Officials who were the primary architects of the EAC SQMT strategy shown a strong preference for the time-consuming harmonization approach when experience from the European Union might urge caution. Who is driving the RQI agenda? Is it trade officials, technical standards officials, private laboratories, international firms, ICPs? All these stakeholders have an interest in the NQI and the RQI. Table 16 on the following page presents a preliminary illustrative mapping of the incentives facing the major stakeholders in the NQI. What are their interests and main priorities? Do they have the power to influence specific outcomes? Is it possible to identify the incentives facing particular stakeholders, do the incentives vary within institutions? Which stakeholders determine the outcome?

**TABLE 16: Illustrative Mapping of Incentives of Key Actors in the National Quality Infrastructure**

| Actors/<br>Stakeholders                   | Status and<br>Functions  | Main Priority  | Power to Influence  | Incentives   | Harmonization   |
|---|--|--|---|--|---|
| <b>National Standards Body</b>            | Responsible for setting technical regulations, testing, metrology, and accreditation | Mandate states public safety and promoting quality but frequently prioritize activities that raise revenue   | Powerful as parent Ministry is often technically weak.  | Promote testing to raise fees, increase the number of technical regulations to increase influence    | Extremely time consuming—requires numerous meetings by mid—level officials.   |
| <b>Ministry of Trade</b>                  | Promote trade, preserve existing import competing industries                         | Prevent sub-standard imports counterfeits, and support domestic industry                                     | Often technically weak on Standards Issues  | Reduce dependence of NQI on government revenue   | MTI officials may attend frequent meetings. Creates opportunities for non-wage income enhancement   |
| <b>Ministry of Agriculture</b>            | Ensure food security and food safety   | Protect small holders from imports   | High—as agriculture is source of livelihood for majority  | Controls over licensing agricultural inputs determines investment in agriculture                     | Extremely time-consuming requiring numerous meetings  |
| <b>Ministry of Health</b>                 | Food safety, poison control  | Promote Public Health—improve laboratories   | High  | Controls over drug licensing provides opportunities for investment                                   | Extremely time-consuming  |
| <b>Accreditation Body</b>                 | May not exist as an independent entity   | Ensure quality of testing and other regulated services/products conform with public policy                   | If part of NSB influence will be weak. New Accreditation Body with International recognition will have more power | If part of NSB may be under pressure to recognize domestic testing services to promote own influence |   |
| <b>Domestic Laboratories</b>              | Most state owned laboratories are not internationally accredited                     | Achieve international accreditation  | Limited   | Promote mandatory testing to generate revenue for laboratories                                       | Slow progress results in additional demand for testing services   |
| <b>International Laboratories</b>         | Provide internationally accredited testing and verification                          | Deliver quality service for profit   | Medium/High as provide link to international markets  | Stand to benefit from mandatory testing schemes  |   |
| <b>Consumer Groups</b>                    | Likely to be weak  | Promote value, fair trade and consumer safety  | Very low—limited visibility   | Raising profile  | Usually do not have the technical expertise to engage on regulatory issues  |
| <b>International Cooperating Partners</b> | Provide technical and financial support to NQI                                       | Support A4T agenda, bilateral donors encourage NQI consistent with their own NQI and market access interests | High as have both technical and financial expertise   | Ensuring compatible NQI facilitates market access  | Technical focus may result in emphasis on provision of testing equipment (laboratories), and training with less emphasis on moving toward a best practice and sustainable NQI |



The rise to prominence of standards and technical regulations on the trade agenda is relatively recent with many trade officials being unfamiliar with the technical issues. Further, the technicians in the National Standards Organizations unused to taking part in trade negotiations now had the opportunity to access ICP resources (through A4T) to strengthen their laboratories and empower their institutions. ICP partners recognize the importance of NQI in ensuring public safety for both developing and their own consumers and also for effective market access.

## 5. Key Findings and Recommendation for Further Work

The approach to trade facilitation has been dominated by projects and is driven from the top down through high level political commitments, developments in multilateral and regional trade fora, and initiatives from ICPs. This top down approach follows from the WTO/WCO agreements including the recent Trade Facilitation Agreement in Bali, the Revised Kyoto Convention, and the Regional agreements—COMESA, EAC, SADC, and more recently the negotiations for the Tripartite. One of the lessons from PEA is the importance of combining a top (or high) level commitment to a strategy of building ownership for trade

facilitation from the “bottom up.” Locking in reforms at the multilateral and regional level requires a legally binding agreement by the Government which is then subject to effective enforcement. Formal mechanisms for transparency and dialogue at the regional level can assist implementation through “peer pressure.” Ongoing performance assessments and dialogue also increase awareness of genuine constraints to implementation and enable the regional Secretariat, partner states, and ICP to offer technical and financial support. At the Multilateral level the A4T initiative aims to perform this role.

### 5.1 Ensure Ownership for Trade Facilitation

At the outset identify and map all the stakeholders (actors) involved and identify their interests and concerns—what matters to the different users—small traders, large traders, clearing agents, facilitators, etc. Ensure from the outset that there are mechanisms for effective communication and dialogue. The implementation schedule should be developed with the active involvement of the key stakeholders ensuring their concerns are addressed. The timing and sequencing of trade facilitation is critical. Beginning with activities that build confidence and deepen understanding of stakeholders interests will be more sustainable than an approach imposed from a high level political objective. Externally driven initiatives that do not have a



local champion or driver for change are unlikely to succeed. It is necessary to obtain buy-in from the actors on the ground—this is best undertaken by local champions for change. The development of a National Trade Portal which promotes transparency by making all the rules, regulations, and tariffs publicly available brings together all the agencies involved in cross border management in a non-threatening manner.

## 5.2 Learn from Experience

The commitment to trade facilitation and the A4T agenda has now been in place for more than a decade. Additional insights may be gleaned from more in-depth monitoring and evaluation which identifies the roles played by specific actors (institutions) in implementing regional and multilateral trade commitments. Lessons can be learned from both the success stories and the areas where countries have experienced serious difficulties in advancing reforms. Detailed evaluations on specific initiatives could provide useful lessons and deepen the trade facilitation toolbox. Examples include customs valuation, risk assessment, Authorized Economic Operator schemes, the use of information technology, and reforming the national quality infrastructure.

Policies, regulations, organizational structures, and administrative procedures all assist in determining the incentives facing the actors with a stake in trade facilitation. In designing interventions to advance trade facilitation it is necessary to identify these incentives as they will assist in determining the pace of reform. The standard recommendation of requiring high level political buy-in is certainly necessary but is certainly not sufficient. Opposition to reform can originate at a low level and may delay or even derail the process. The champions of reform must try to comprehend the institutional power play between the different stakeholders.

Finally, it is recommended to deepen the analysis through detailed case study assessments of specific trade facilitation instruments. Such studies should adopt a political economy approach that identifies and maps the interests, motivations, incentives and pressures and power relationships of all the actors in trade facilitation. Areas for further study may include the introduction of Single Customs Border Posts, adoption of the Authorized Economic Operator scheme, adoption of WTO Customs Valuation, strengthening of national quality infrastructure, and regulatory harmonization and mutual recognition. We would suggest comparing the progress, performance, and

challenges at two border posts—one in the EAC (Malaba) and one in SADC (Beit Bridge)—using political economy analysis. Adopting the border post as the focal point would include all the trade facilitation tasks in the physical movement of goods as well as the wide range of stakeholders involved at the border.

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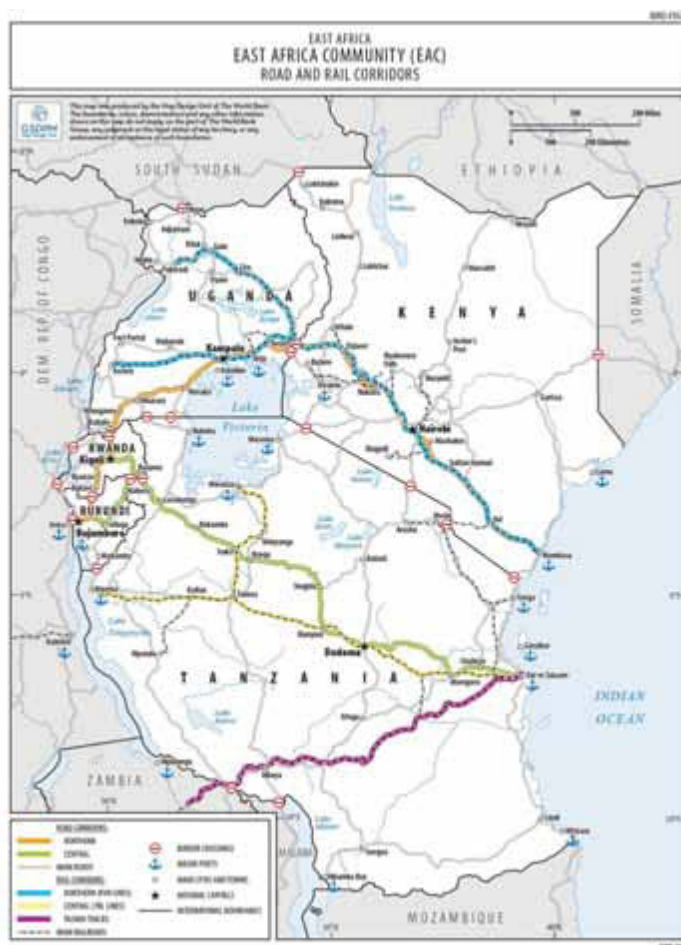
# Chapter 6: Political Economy of Transport Sector Integration in the East African Community

## 1. Introduction

The transport infrastructure in East Africa Community (EAC<sup>1</sup>) member states has improved dramatically over the past two decades. Among the more notable achievements are (1) vast improvements in the quality of the region's trunk roads; (2) substantial reductions in road travel times; (3) growing compliance with vehicle weight restrictions; and (4) falling transport prices due to the aforementioned changes, mainly along the Northern Corridor.

This chapter elucidates the political economy factors that supported these improvements. The findings are largely consistent with recent literature on the political economy of regional integration and transport economics. From the former, the results resonate with existing studies that argue regional integration efforts are most likely to be successful when one country emerges as a leader in favor of integration and the private sector strongly advocates for it. They also support the thesis that transport prices are likely to fall when (1) transport becomes more efficient, (2) road quality improves, and (3) competition becomes more intense. For many years, the second and third condition existed in East Africa, but not the first. Efficiency is now improving along the Northern Corridor, but less so along the Central one, for reasons the paper will explicate. The result is that transport prices are falling along the former, but not the latter.

The next section examines the transport infrastructure in the region as well as how economic development is affecting it. The subsequent section explicates the institutions of the EAC that promote integration and impediments to it. Following that it discusses the processes of overcoming these challenges in areas where it has occurred. Next, we describe the structure of the transport sector in the region, with a particular focus on the trucking industry as



it currently accounts for more than 95% of the EAC's land transport, and describe why increases in efficiency are leading to falling transport prices. The final section discusses challenges to greater integration in the transport sector.

## 2. EAC Transport Sector Infrastructure

Before examining performance in the transport sector, we provide basic data about its size and quality. We examine conditions of the roads, rail, and ports.

Barak D. Hoffman and George B. O. Kidenda

<sup>1</sup> Five states comprise the EAC, Burundi, Kenya, Rwanda, Tanzania, and Uganda. The original EAC, which was comprised of Kenya, Tanzania, and Uganda, collapsed in 1977 due to irreconcilable differences between the member countries.

## 2.1 Road Transport

Over the past two decades, the quality of the EAC's trunk roads has improved dramatically. As late as 2000, for example, there was no fully paved road network linking the major cities in the region. By contrast, paved trunk roads now connect all of them. Today, less than one-fifth of the region's paved roads are in poor condition and nearly half are in good condition.

Nevertheless, the length of the paved road network is very short. Only 10 percent of the region's roads are paved. Outside of the main trunk roads and urban areas, almost all roads in the region are unpaved. As a result, maintaining the existing network and adding to it are both high priorities.

The trucking sector is growing very rapidly. Kenya has the largest fleet of trucks in the region followed by Tanzania. This is not surprising given as they are the largest economies in the EAC and are the only countries with ocean ports. The available Kenyan fleet in 2011 was 67,668 compared to 64,790 in Tanzania. Uganda had 33,425 trucks in 2009, the latest year for which data are available for the country. These figures come from partner member states reporting to the EAC, so they may not be directly comparable. In particular, the large rise in the number of

**TABLE 17: Number of Trucks in the EAC: 2000–2011**

|      | Burundi | Kenya  | Rwanda | Tanzania | Uganda |
|------|---------|--------|--------|----------|--------|
| 2000 | 1,935   | 57,796 | 1,025  | 6,314    | 13,240 |
| 2001 | 2,017   | 58,501 | 1,116  | 5,153    | 14,441 |
| 2002 |         | 59,835 | 1,162  | 10,134   | 15,719 |
| 2003 |         | 61,538 | 1,137  | 10,917   | 16,122 |
| 2004 |         | 63,999 | 1,412  | 12,819   | 17,530 |
| 2005 |         | 66,472 | 2,100  | 7,178    | 18,684 |
| 2006 |         | 35,838 | 2,351  |          | 20,496 |
| 2007 |         | 42,654 | 2,784  | 43,811   | 23,323 |
| 2008 |         | 51,445 | 3,054  | 51,477   | 28,501 |
| 2009 |         | 60,365 | 3,319  | 59,066   | 33,425 |
| 2010 |         | 67,668 | 3,595  |          | 64,790 |
| 2011 |         |        | 3,134  |          |        |

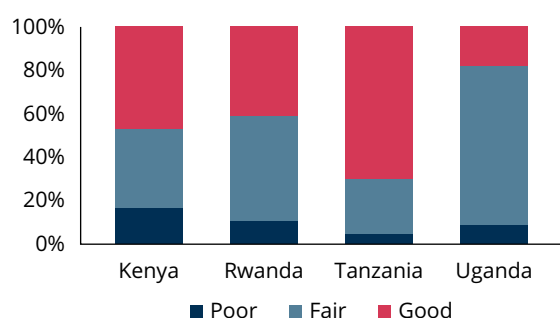
recorded trucks in Tanzania between 2005 and 2007 suggests a change in the method of gathering and reporting this information, rather than a six-fold increase in the number of trucks in a two-year period.<sup>2</sup>

## 2.2 Rail Transport

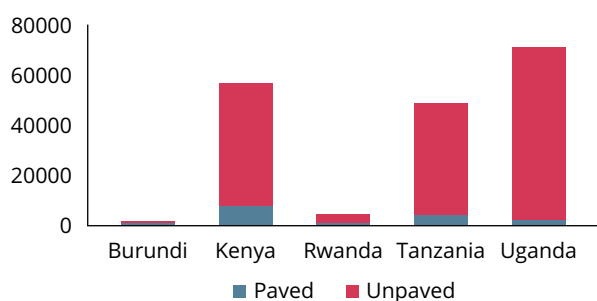
While rail had been the main form of land transport for decades in East Africa, by the 1990s the railways had nearly collapsed due to years of neglect. Starting in about 2000, the Governments of Kenya, Tanzania, and Uganda began to privatize their rail networks. These efforts were generally unsuccessful, although there have been some recent improvements along the northern rail corridor operated by Rift Valley Railways.

Tanzania's Central Line has suffered an extreme decline. The railway is barely functional today and in dire need of repair. The previous concession of Tanzania Railways to a strategic partner, RITES,<sup>3</sup> encountered substantial challenges and the Government of Tanzania cancelled it in 2010 as a result. The World Bank has recently given the Government of Tanzania, US \$300 million loan to start rehabilitating the state-owned railway. Whether it will remain so or concession operations to a private provider following the Bank's current rehabilitation project is unclear. Rail along the Northern Corridor has also suffered, although the drop in traffic is only 85 percent from its peak

**FIGURE 38: Quality of Paved Road Network**

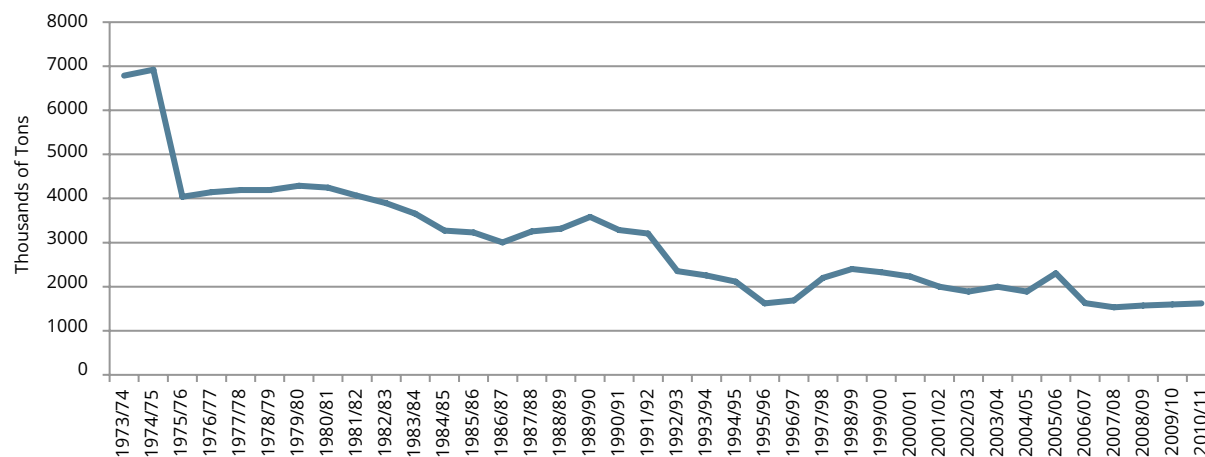
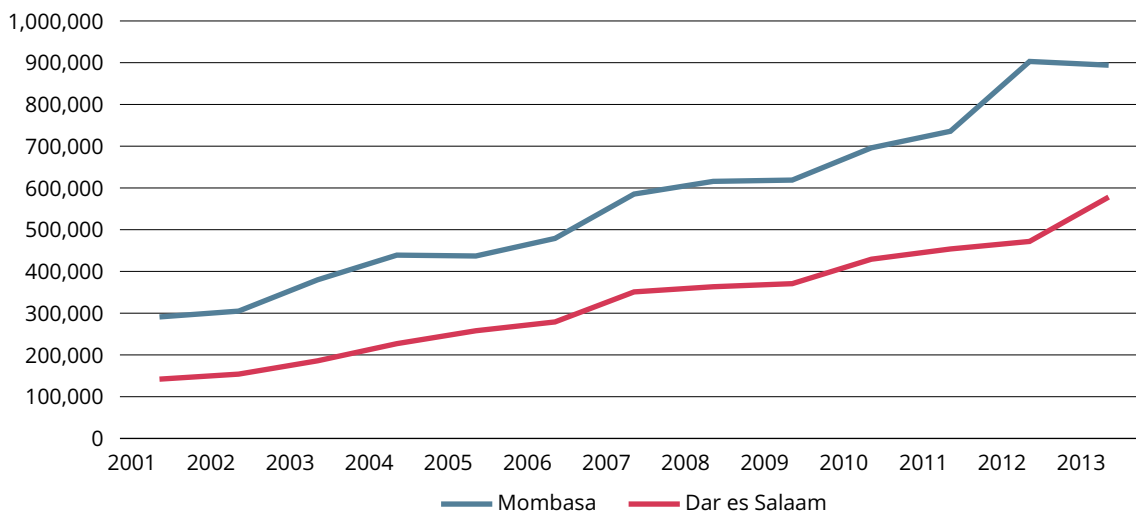


**FIGURE 39: Length of Road Network in East Africa (KM)**



<sup>2</sup> In particular, this timing coincides with the creation of Tanzania's Surface Marine Regulatory Authority (SUMATRA).

<sup>3</sup> Rail India Technical and Economic Service.

**FIGURE 40: Kenya Freight Volumes by Rail****FIGURE 41: Port Volumes in Dar es Salaam and Mombasa: 2001–2013**

in the 1970s compared to a more than 95 percent drop along the Central Corridor. In 2006 the Governments of Kenya and Uganda awarded the railway concession to Rift Valley Railways (RVR), a consortium led by Sheltam Ltd of South Africa. It encountered serious difficulties right away. By 2010, freight volumes were almost half of 2006 levels and RVR had invested very little in rehabilitation. IFC and KfW, the German Development Bank, helped restructure the RVR consortium in 2010 to replace Sheltam with Citadel Group from Egypt, a more experienced rail operator, as the lead investor. After Citadel took over, RVR's performance improved and it is starting to earn profits.

Governments along the Northern Corridor have very ambitious plans for railway expansion. Kenya has recently entered into a bilateral contract with China for the

construction of a new standard gauge railway line along the Northern Corridor between Mombasa and Nairobi. At \$4 billion, it is the largest project in the country's history. China Exim Bank will finance 90 percent of the railway while the Government of Kenya will fund the balance. The Governments of Kenya, Rwanda, and Uganda aspire to have the railway extend to Kigali, but are far from securing the necessary finance and it is unclear they will be able to do so given that less than 30 percent of the traffic on the Northern Corridor flows beyond Nairobi.

### 2.3 Ports

As with the rest of the transport sector, port volume has grown rapidly, at approximately 7 percent per year, since

**TABLE 18: Cargo Traffic at Dar es Salaam and Mombasa Port: 2009–2013**

(Thousands of Dead Weight Tons)

| <b>Dar es Salaam</b> |         |         |         |         |         |
|----------------------|---------|---------|---------|---------|---------|
|                      | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 |
| Imports              | 6,181   | 7,089   | 8,086   | 8,992   | 10,443  |
| Exports              | 1,237   | 1,316   | 1,715   | 1,749   | 2,000   |
| Total                | 7,794   | 8,552   | 9,919   | 10,866  | 12,530  |

| <b>Mombasa</b> |        |        |        |        |        |
|----------------|--------|--------|--------|--------|--------|
|                | 2009   | 2010   | 2011   | 2012   | 2013   |
| Imports        | 16,507 | 16,201 | 16,938 | 18,732 | 19,150 |
| Exports        | 2,450  | 2,575  | 2,788  | 3,045  | 2,983  |
| Total          | 18,957 | 18,776 | 19,726 | 21,777 | 22,133 |

2000. Berth occupancy at the ports of Dar es Salaam and Mombasa is close to 100 percent, well above the recommended maximum rate of 70 percent to allow for efficient operations. The graph below shows the increase in port volume over the past fifteen years. Both desperately need to expand capacity.

The annual average container traffic growth rate in Mombasa port in 2013 was down by 1.0 percent from 903,000 TEUs in 2012 to 894,000. This was mainly due to the drastic decline in container business in the months of February to April 2013, caused by anxiety prior to the general election in March 2013. However, the second half of 2013 recovered to register a growth of 7.3 percent when compared with a similar period in 2012. In Dar es Salaam, total cargo throughput increased from 7.7 million tons in 2009 to 10.4 million tons in 2013, reflecting an overall growth rate of 34 percent and an average annual growth of 8.0 percent over the five-year period from 2008–2013.

Table 19 examines the destination of cargo in the ports of Dar es Salaam and Mombasa. Not surprisingly, both ports overwhelmingly serve their domestic market. In addition, each has one primary transit market, Zambia for Dar es Salaam and Uganda for Mombasa. Combined, these account for approximately 90 percent of the volume for each port. The remaining three main destinations, Burundi, DRC, and Rwanda are contestable, albeit small, markets for each port. The table also makes clear that the volume of traffic along the Northern Corridor is much greater than the Central Corridor. Mombasa Port is twice as large as Dar es Salaam and almost all the cargo leaves Mombasa to inland destinations using the Mombasa-Nairobi highway. By contrast, a substantial portion of cargo in Dar es Salaam Port remains in the city, and the portion that leaves is spread

**TABLE 19: Dar es Salaam and Mombasa Cargo Destination 2011**

(Millions of Tons)

|                  | <b>Dar es Salaam</b> |         | <b>Mombasa</b> |         |
|------------------|----------------------|---------|----------------|---------|
|                  | Volume               | Percent | Volume         | Percent |
| <b>Total</b>     | 10.9                 | 100%    | 19.9           | 100%    |
| <b>of which:</b> |                      |         |                |         |
| Domestic         | 7.8                  | 72%     | 14.1           | 71%     |
| Burundi          | 0.4                  | 4%      | 0.2            | 1%      |
| DRC              | 0.7                  | 7%      | 0.5            | 3%      |
| Rwanda           | 0.4                  | 4%      | 0.3            | 2%      |
| South Sudan      |                      |         | 0.1            | 1%      |
| Uganda           | 0.1                  | 1%      | 4.3            | 22%     |
| Zambia           | 1.6                  | 15%     |                |         |

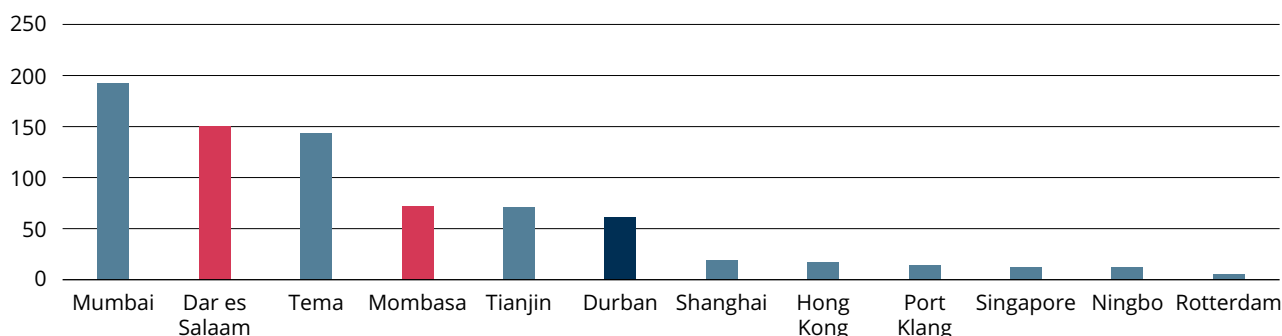
over three routes: the Southern Corridor to Zambia, the Central Corridor, and to northern Tanzania. According to the data below, traffic flows are at least three times higher along the Northern Corridor than the Central one.<sup>4</sup>

Inefficient port operations, especially in Dar es Salaam, compound lack of space. Figure 42 shows average ship turn-around time. This measures how quickly ships off-load and load cargo. This takes three days in Mombasa and just over six in Dar es Salaam. The former compares well to sub-Saharan Africa's most efficient port, Durban, while the latter is one of the least efficient in the world. Crane productivity in Dar es Salaam and Mombasa are fourteen and eighteen moves per hour, respectively, far below the global standard of twenty-five to thirty. In practical terms, these data suggest that Dar es Salaam and Mombasa ports could process up to 80 percent and 40 percent more cargo respectively per year than they currently do without increasing physical capacity through more efficient operations.

Container dwell time inside the ports of Dar es Salaam and Mombasa is about ten and five days, respectively. However this is a misleading measure of efficiency. In order to reduce port congestion, both governments demand that cargo move to inland container depots (ICDs) for clearing and forwarding operations and customs processing rather inside the port. Data on the amount of time cargo spend

<sup>4</sup> It is difficult to get exact figures for corridor traffic because we lack data on the domestic destination of cargo for Kenya and Tanzania. However, transit traffic along the Central Corridor was 1.6 million tons, while the Northern Corridor carried at least 5.4 million tons past Nairobi.

**FIGURE 42: Average Ship Turn-Around Time**  
(Selected Ports)



in ICDs are not easy to get since the government does not collect this information and it does not require companies to publish it. In addition, even if such data existed, time to clear cargo from ICDs is not only a function of the efficiency of port processing operations, but also depends on the behavior of the depot owners and customers. As a result, container dwell time isn't a very useful measure of port efficiency.

The Government of Kenya recently secured \$1 billion from the Government of Japan to build three new container berths and access roads from the port that bypass the Mombasa Central Business District.<sup>5</sup> The Government of Tanzania is very keen on expanding Dar es Salaam port as well. It recently signed a Memorandum of Understanding with the World Bank, the UK's Department for International Development, and TradeMark East Africa for a \$565 million project to double the port's capacity by 2020. However, to realize the benefits of this expansion, port efficiency will need to increase as well. Delays in either threaten to marginalize the Central Corridor as an attractive transport route, especially given the concurrent improvements in Mombasa Port. The chapter discusses this issue in detail in subsequent sections.

## 2.4 Inland Water Transport

Cargo traffic on Lakes Tanganyika and Victoria are practically non-existent. While they carried significant amounts

of cargo in the past, it was under a different institutional structure and transport environment than currently exists. We describe this in the next section. Beyond these institutional and structural issues, political economy factors also are not propitious for reviving lake traffic in the near future. In order to resume lake traffic, three conditions that do not exist must occur:

1. At least two EAC countries will need to agree on a route to develop.
2. Either Kenya or Tanzania will need to develop functional rail service to a port.
3. Countries in the region will need to prioritize ferry traffic over roads and rail.

Currently, political forces in EAC member states do not support these types of plans. The most logical organization to undertake a regional transport plan, the EAC, lacks the capacity for reasons we explain in detail below. In the absence of a regional organization that possesses the authority to make these choices, national governments must take the initiative. This has not happened around ports on Lakes Tanganyika and Victoria because they are not a priority mode of transport at the moment.

## 3. Overview of the EAC

The contemporary EAC came into force in 2000 with the same three countries as the first failed attempt toward regional integration following independence (Kenya, Tanzania, and Uganda), and expanded in 2006 to include Burundi and Rwanda. As with original EAC, there are strong fears among some member states that a common market

<sup>5</sup> The new container terminal has three phases. Phase I, funded by JICA, has two terminals (berth 20 and 21). Phase II will have one terminal (berth 22), and same with Phase III (berth 23). KPA is negotiating with JICA to fund Phase II also. Phase II is planned to be completed in July 2019, while Phase III (which has no funding) in January 2022.

will benefit Kenya over the other countries in the organization.<sup>6</sup> A crucial difference is that Rwanda and Uganda are willing, at the moment, to accept Kenyan economic dominance within the EAC because the two landlocked countries place a high degree of importance on driving down transport costs, enhancing access to the sea, and encouraging trade and foreign investment.

EAC efforts at integration are broad based covering political, economic, and social sectors of the participating countries. Four sequential initiatives guide these efforts:

- Customs Union;
- Common Market;
- Monetary Union; and
- Political Federation

The community envisions transitioning from one stage of integration to the next. Member states have developed a set of protocols for each initiative. This follows the standard textbook model of sequentially deepening integration perhaps best exemplified in the spirit of the European Union, if not the exact practice.<sup>7</sup>

As in many other regional economic communities (RECs), implementation of many EAC acts at the domestic level lags regional-level endorsement of them by heads of the member states. According to a recent IMF review of the EAC (McAuliffe, Saxena, and Yabara 2012, 39):

While EAC members have embraced market-supportive policies at the broader level and often put in place legal frameworks amicable to investors, business surveys show that enforcement is problematic. Investment incentives are uncoordinated and often enterprise-specific. Such obstacles not only constrain investment and export levels, but also hamper private investment in infrastructure, further increasing costs; and they deter innovation,

and thus output and export diversification. Although most EAC country authorities have plans to improve the investment climate, progress to date has been uneven across the region, with only Rwanda implementing ambitious and comprehensive reforms. In addition, reform efforts have not been closely coordinated at the regional level, reducing to some extent their impact.

There are numerous explanations for the gap between EAC integration plans and their execution. One important reason is that the private sector has not advocated strongly for it. This is changing as Kenyan firms in particular are investing more regionally and are thus placing pressure on their government to accommodate their needs. This is consistent with how integration often happens. Mattli (1999), for example, shows clearly that demand for integration generally tends to come from the private sector. Moreover, Cowles (1995) attributes much of the success of EU integration to private sector as well.

The private sector is not inherently pro- or anti-integration, however. Rather, it seeks to protect its interests. For some companies in the EAC, regional integration is an opportunity, while for others it presents a threat. For example, while trucking companies have been at the forefront of pressing governments in the region to improve transport efficiency, they generally support efforts to restrict foreign competition in the transport sector. Moreover, some members of the Kenya International Freight Forwarders and Warehousing Association (KIFWA) and Tanzania Freight Forwarders Association (TAFFA) see greater integration in the transport sector as a threat. They are therefore campaigning against the move to allow foreign Clearing and Forwarding (C&F) agents to handle domestic cargo as the single customs territory theoretically allows. Other freight forwarders, by contrast, see it as an opportunity for partnerships and mergers between the Tanzanian and/or Kenyan forwarders and their counterparts in the landlocked countries.

Another source of the EAC's weakness is differing views on integration between Tanzania on the one hand, and Kenya, Rwanda, and Uganda on the other. Due to geography, integration is far more important for Burundi, Rwanda, and Uganda, than Kenya and Tanzania. The latter two are the largest economies in the EAC<sup>8</sup> and the only ones with access to the sea. The former three are far smaller and more than one thousand kilometers from the

<sup>6</sup> There is strong academic evidence to support this argument. Venables (2003), for example, argues that the gains from regional integration among low income countries will accrue almost entirely to the country with the most sophisticated economy. The paper uses EAC integration in the 1960s and 1970s as an example. Mutual gains from comparative advantages, Venables argues, only begin to accrue as economies become more specialized. Collier and Venables (2008) argue that policy coordination, agglomeration, increasing market size, and joint production of public goods (e.g., infrastructure) partially offset these losses.

<sup>7</sup> Integration in Europe was far slower and more haphazard than the textbook model suggests. The chapter discusses this divergence in more detail below.

<sup>8</sup> Kenya and Tanzania's GDP.



nearest ocean port. As a result, regional integration is a necessity for Burundi, Rwanda, and Uganda, while it is far more optional for Kenya and Tanzania. At the moment, the private sector in Kenya has placed more pressure on its government to expedite regional integration, while these demands remain more latent in Tanzania. Due to the aforementioned factors, the Governments of Kenya, Rwanda, and Uganda have taken the lead in a number of areas of EAC integration, such as infrastructure development, single tourist visa, enhanced labor mobility, and implementation of the single customs territory. Government support and private sector demand both have played a role. Such flexibility need not be an impediment to integration, but can help facilitate it.

Due to the aforementioned domestic challenges, the EAC is not able to ensure implementation of integration. Rather, integration efforts are mainly occurring at the national level and thus subject to domestic political incentives and constraints. As Byiers, Vanheukelom, and de Roquefeuil (2013, 14–15) observe:

The EAC has succeeded in establishing a range of formal organs including the East African Court of Justice, the East African Legislative Assembly and various sectoral committees. . . . However, indicative of wider concerns, the EAC has achieved greater convergence in simplifying and lowering the cost of regulatory processes for businesses than in providing the implementation teeth to those legal institutions that are relevant to business regulation. . . .

Underlying the slippage in the implementation of these formal declarations and protocols are a range of concerns and political positions that appear likely to hinder progress . . . the practicalities of proceeding with regional integration appear to rely on a group of countries with greater interest in and political reliance on the regional project.

This is a very accurate description of how recent integration reforms in the transport sector have occurred as we will show. Nevertheless, it is important to place EAC integration in a comparative context. For example, it compares favorably to the EU's integration in the transport sector. According to Mattli (1999, 77) as late as the 1980s:

manufacturers who began in those years to produce and market on a European rather than nation-by-nation basis were confronted with burdensome obstacles: different national tax regimes that

necessitated detailed paperwork and checks on fuel and goods at each frontier, resulting in lengthy border delays for trucks moving parts from plant to plant, and different regulations on axle weights, truck safety, vehicle exhaust emissions, and hours permitted behind the wheel.

As Preston (2012) shows, this was not because of lack of a policy for transport sector integration, but due to very slow implementation of the 1957 Treaty of Rome's Common Transport Policy (CTP). The EU's level of development when it implemented the CTP was far higher than income levels in the EAC today as well.

As we will explain, the transport sector in the EAC is following a similar trajectory, and as a result, we have witnessed rapid progress in the integration of this sector over the past few years, especially along the Northern Corridor, due in large part to pressure from the private sector. Recent results include reducing border crossing times, eliminating many weighbridges and police checkpoints on the roads, and growing compliance with weight restrictions. In these cases, regional governments, especially the Government of Kenya, were responding to specific pressure from the private sector as well as other presidents in the region. We discuss how this has occurred in subsequent sections. Prior to that it is useful to discuss the planning process for regional transport infrastructure is occurring in the EAC at the moment.

## 4. Development of Transport Infrastructure

For many decades, rail was the dominant mode of transport in East Africa. However, over the past two decades, road transport has a near monopoly on land transport, although governments in the region are attempting to rectify this imbalance. This section reviews the development of transport infrastructure in East Africa and identifies contemporary challenges.

### 4.1 Historical Evolution

From the creation of East Africa Railways and Harbors (EARH) in 1948 until the collapse of the original EAC in 1977, EARH had a near-monopoly on long-distance transport in Kenya, Tanzania, and Uganda. EARH operated more or less as a private company, responsible for maintenance from its own revenue and relatively free from government interference.<sup>9</sup> It ran the ports of Dar

es Salaam and Mombasa, ports on Lake Victoria, the railways in all three countries, and was the sole transporter on the railways and Lake Victoria. Roads were very underdeveloped compared to rail at that time, by contrast.

The collapse of the EAC in 1977 led to the dismantling of EARH. The Governments of Kenya, Tanzania, and Uganda broke up the company into five constituent parts (Kenya Rail, Tanzania Rail, Uganda Rail,<sup>10</sup> Kenya Ports Authority, and Tanzania Ports Authority) and put them under government control. Reconstituting EARH as government agencies made them dependent on government budget allocations for maintenance and provision of new equipment, and more subject to government interference than hitherto existed. Subsequent economic stagnation in the region and political instability in Uganda caused governments to underinvest in the transport sector, especially the railways. In addition, they also forced the railways to provide uneconomic services, such as low passenger fares and rates for carrying government cargo, but failed to reimburse the railways for these subsidies. Eventually this led to a severe deterioration in the railway and port infrastructure. Ports on Lake Victoria and Lake Tanganyika suffered the most as they were dependent on smooth functioning ocean ports and railways for their cargo.

When growth returned to the EAC in the late 1990s and early 2000s, governments in the region chose to invest in road construction and rehabilitation, but not in the development and maintenance of the region's railways, as we discussed above. Today, the regional road network is quite good and, perhaps more importantly, a number of politically powerful trucking firms have come into existence in Kenya and Tanzania. For example, a former president of Kenya, Daniel Moi, and the current one of Tanzania have family members running large trucking companies.

<sup>9</sup> A 1955 World Bank appraisal of EARH was very positive. It stated (World Bank 1955, i-2) "The EARH is an efficient organization . . . it has regularly shown a fair surplus of revenue. . . Its financial position is sound. . . The management of the Railways and Harbours is excellent. . . There is no doubt of the ability of the management and staff to . . . operate the transport systems in an efficient and satisfactory manner." At the time, EARH employed 62,000 people of whom 2 percent were European, 8 percent were Asian, and 90 percent were Africans.

<sup>10</sup> Uganda never created a ports authority. Rather, ports fell under the control of Uganda Railways.

## 4.2 Contemporary Challenges

The EAC road network carries far more than its optimal share of traffic. This has exerted substantial pressure on the region's roads, leading to damage from overloading and high road maintenance costs. The Government of Kenya has a focused plan to address this imbalance along the Northern Corridor through ongoing service enhancement by RVR and the Standard Gauge Railway, although the former is operating far below expectations and the latter is far from operational. Reviving rail along the Central Corridor requires substantial effort from the Government of Tanzania, although it is far less exigent due to the far lower levels of traffic.

Another large barrier to the development of a competitive and effective transport sector in the EAC is the lack of funding. Despite the massive improvement in trunk road quality over the past two decades, only 10 percent of the region's roads are paved. In particular, the paved road network does not serve large parts of northern and eastern Kenya, and southern and western Tanzania. Moreover, nearly all of the highways are just one lane in each direction. In addition, EAC countries are also planning massive investments in ports, railways, and airports. Finding the sums of money necessary for this infrastructure development and maintenance will be a challenge for the foreseeable future.

In addition, road development has not kept pace with the region's rapid pace of urbanization. This has resulted in increasing congestion in the region's major cities:

- All trucks leaving Dar es Salaam and Mombasa Ports must pass through the central businesses districts in both cities. Plans for expanding Mombasa Port envision a by-pass road to address this issue.
- The Mombasa County Government permits Container Freight Stations (CFSs) to operate in the center of Mombasa. This not only reduces land available for commercial and/or residential development, it also causes massive traffic jams for the thousands of trucks shuttling back and forth from the port to the various CFSs. The expanded port may resolve this issue if more efficient port operations obviate the need to store cargo in CFSs or if the new Mombasa bypass road encourages CFS owners to relocate outside the city.
- There are no bypass roads in the major cities in the region. As a result, every truck in the region must go through the center of each city it passes, adding to the already massive urban congestion in East Africa. Kampala and Nairobi are constructing ones, however.

Congestion around the ports contributes appreciably to inefficiency in the transport sector. Transporters in Mombasa, for example, claim that it takes on average four to six days to offload an empty container, service the truck, pick a loaded container, and start a new journey. This unproductive time is nearly equivalent to one round trip to Kampala so amounts to at least \$3,000 in lost revenue per trip. Some firms have addressed this inefficiency by placing depots on the Mombasa-Nairobi highway. They use old trucks to shuttle cargo between the depot and the port, and new ones only for inter-city transport. This allows more modern trucks to minimize turn-around time because they can avoid the port completely. By-pass roads are the optimal solution and are currently planned in Mombasa.

Improving public safety on the roads is another substantial challenge to the development of an efficient transport sector. Despite the small size of the paved network, all EAC member states have very high levels of road fatalities. This is primarily a governance challenge because it is due, in part, to poor enforcement of vehicle quality and traffic regulations. The roads in the EAC as a result are clogged with crowded and poorly serviced vehicles that provide unreliable services, lead to frequent accidents, and often cause long and unpredictable transit times as a result. With the gradual improvements in the EAC road infrastructure there is a great need for transporters to improve the safety and reliability of their vehicles. The Government of Kenya is taking the lead on addressing these issues through plans to improve enforcement of road regulations and develop more stringent requirements for vehicle and driver quality.

The final challenge of infrastructure planning is slow progress in expanding Dar es Salaam port and its potential deleterious impact on the further development of the Central Corridor. Freight forwarders and transporters in Burundi and Rwanda, for example, are presently considering routing their containers through Mombasa and Terveta on the border between Kenya and Tanzania because of slow processing times at Dar es Salaam port compared to Mombasa. The Government of Kenya already has secured the funding that will allow it to rehabilitate the road to Terveta.

## 5. Successes in Overcoming Integration Barriers

For many years, the transport sector was stuck in a sub-optimal equilibrium where over-loading was common and governments in the region responded by building numerous roadblocks and weighbridges. Rapid economic growth since the turn of the millennium changed the preferences for

importers/exporters and transporters toward more efficient movement of goods, especially along the Northern Corridor. When volumes on the region's transport networks were low, trucking companies placed a substantial amount of effort into seeking the greatest cargo load per trip because it was scarce. Importers and exporters were largely indifferent to this. However, sustained high GDP growth rates have changed incentives for transporters and many private sector firms in favor of reforms to improve efficiency.

As the private sector develops in the region, for example, supply chain management has become increasingly important, especially for manufacturers, builders, and importers in the consumer retail sector, such as Nakumatt, Tuskys, and Uchumi, who seek to ensure full stocks of a range of imported foods in its disbursed network of stores,<sup>11</sup> and on-line retailer Jumia, which promises seven-day delivery anywhere in Kenya. Likewise, as transport volumes grow, most leading trucking companies increasingly focus more on fleet volume than truck volume, and now view the system of roadblocks and weighbridges as constraints on the amount of cargo they could carry. As a result, over the past few years, private sector demand for more efficient transport networks has become intense especially along the Northern Corridor. EAC leaders have taken ambitious steps to improve the business environment in the transport sector. Among the more impressive positive results are:

- The removal of roadblocks, weighbridges, more efficient administrative procedures, and eliminating multiple bonds has reduced the transit time to move a container from Mombasa to Kampala and Kigali from 18 to 4 days and 22 to 7 days, respectively.
- Axle load limits have also been standardized in the EAC at 56 tons for the Gross Vehicle Weight inclusive of the cargo.
- Partial implementation of the Single Customs Territory (SCT) is beginning to occur.
- Increasing power of trade associations to influence policy design and implementation.

This section discusses how this has occurred in the aforementioned areas.

### 5.1 Regulatory Harmonization

EAC member states are making some progress on regulatory harmonization in the transport sector. Axle load

<sup>11</sup> Combined, these retailers operate approximately 150 stores in East Africa.

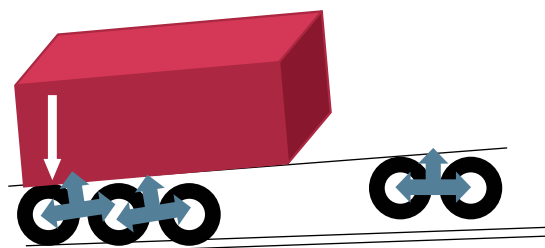
harmonization is one such area. This is perhaps one of the most important policy issues in the transport sector because it determines the maximum weight a truck can carry. Harmonization seeks to have all EAC member states use the same policy for axle load.

Difficulties in axle load harmonization are an excellent example of commercial disputes masking as technical discussions. The core issues of the debate are whether countries in the region should weigh trucks using Gross Vehicle Weight (GVW) or individual axle weight, the reasonable allowance for overweight vehicles, and the types of fines. However, underneath the surface it is clear that the difficulties in reaching a common policy are less about technical coordination than trucking domestic industries pressing their governments to provide them an advantageous policy environment. Below we describe challenges to axle load harmonization as well as recent progress in resolving it. Because Kenya and Tanzania have the largest trucking sectors in the region by far, the debate has largely been between these two countries

The EAC passed the Vehicle Load Control Bill in May 2013. The Bill sets the permissible maximum gross vehicle weight at a metric tonnage of 56 and permits the vehicles to have up to seven axles. Kenya and Tanzania do not interpret the bill the same way however. The Kenya Highway Authority (KenHA) gives a strict allowance of 400 kilograms per axle and a maximum GVW of 56 tons with no allowance to transporters for overweight trucks. By contrast, the Tanzania Roads Authority (TANROADS) allows up to 3,000 kilograms allowance on the GVW. The Kenyan government also subsequently imposed new axle rules that require transporters to load a maximum of 56 tons for a six-axle truck, less than the seven axles the EAC Vehicle Load Control Bill permits.

Problems with harmonized standards are a domestic as well as regional problem. For example, the implementation of vehicle load control continues to be a contentious matter between the national transporters associations and the National Highways Authorities managing transport corridors in Kenya. KenHA's introduction of the axle based weighing of cargo rather than gross vehicle weight to confirm compliance met stiff resistance from the Kenya Transporters Association (KTA) who took the matter to court. They preferred the use of the vehicle's gross weight, which was then pegged at 48 tones for a truck with six axles. KenHA, on the other hand, held firm, insisting that its preference for the axle weighing is because the axle (wheels) exerts pressure on the road, not the entire weight of the truck. KTA lost the court battle after one year.

The predicament facing the drivers and truck owners is that they often have only limited control over weight distribution of the cargo they carry. For example, asphalt cannot be redistributed as it solidifies and can only be removed after heating to very high temperatures. The transporters also maintain they cannot open transit goods in order to redistribute weight between border posts in the absence of customs agents. Transporters contend that such unwitnessed breaking of the customs seals exposes the transporters to the risks of pilferage and damage to cargo for which the clients hold the transporter liable. The transporters also face the dilemma of carrying containers on trailers with weak and sagging suspensions on their rear axles. This causes the weight load to tilt toward the back, exerting a heavier load on the axles while the truck and the containers are still within the GVW limit. There is, however, no current legal provision to handle the issue. One solution would be to not allow them on the roads, but this would be unpopular and difficult to enforce.



**Container loaded on a weak and tilting trailer suspension**

Finally, even compliant trucks are harassed at times by the police. During our interviews with truck owners on the Northern Corridor were told of some cases of enforcement officers following trucks cleared by weigh-in-motion bridges and bringing them back to be weighed motionless. Due to lack of proper calibration of the machines, such trucks are at times found to be overweight on one or two axles and penalized thus negating the purpose of weighing in motion. Petty harassment like this, often in order to solicit bribes, is common on the region's roads, although governments are taking steps to reduce its frequency. This matter needs further verification and rectification where necessary.

While EAC member states are making progress on axle load harmonization, there nevertheless exist a number of outstanding related issues such as:

- **Transport sector liberalization.** There is no existing EAC policy for a liberalized regional transport sector where trucks can deliver cargo between any two points

in EAC territory regardless of the intra-EAC borders. Rather, each member state has its own policy designed, in part, to protect domestic trucking industries through restricting cross-border operations. EAC is, however, not unique in this aspect. Cabotage has always been a contentious issue even in other regional trading blocs like the EU and the US.

- **Approach to overloading.** In Kenya it is a criminal offence to overload, while all other EAC states have decriminalized it.
- **Charging policies.** The extent of cost recovery (fines versus actual cost of damage) varies throughout the region.
- **Liability for overloading.** EAC member state laws hold the owner of the truck responsible for any overloading instead of the owner of the cargo. However for imported containers, the importer in consultation with the exporter determines the weight. Under the current law, even though the importer indirectly pays for the penalties, the truck owners/drivers bear the bigger burden through time loss, bribes, and reduced trips. However at a meeting in Kampala in August 2014, the trucking industry stressed that EAC Axle Load regulation should consider the shipper liable as well. They have yet to amend the law appropriately.
- **Vehicle standards.** The EAC does not have common standards for vehicle importation. In particular, in Kenya one cannot import vehicles which are more than eight years old while in other EAC states older vehicles are allowed. The Government of Kenya nevertheless allows these vehicles to operate in the country. This puts the Kenyan transporter at a disadvantage, as he/she is restricted on the price of vehicles that he/she can obtain on the international vehicle market.

## 5.2 Border Crossings

Border waiting times in the region have fallen substantially over the past few years. Much of it has been the result of efforts of the governments and private sector working with the assistance of development partners such as DfID, USAID, GTZ, and World Bank. Since 2009, for example, the USAID-funded Competitiveness and Trade Expansion (COMPETE) program has been working to improve the efficiency of operations at border posts in East Africa. A major component of their efforts has been assisting governments and the private sector to coordinate border management through the establishment and support of Joint Border

Committees (JBCs) at sixteen border posts in East Africa. JBCs are working groups made up of government agencies and private-sector stakeholders involved in cross-border trade. They facilitate coordination between government agencies and businesses to enhance efficiency at borders (USAID/COMPETE 2013).

The most notable achievement has been to substantially reduce border crossing times at Malaba, by far the EAC's busiest border crossing, between Kenya and Uganda. It's an excellent example of how regional integration often occurs. For many years, the border post had been in a sub-optimal equilibrium. Rising trade volumes led to a proliferation of agencies at the border performing a range of regulatory functions. There was little coordination and side-payments to facilitate quicker processing times were common. As a result, border crossing times became slower and slower. At the same time, rising trade volumes caused affected private sector firms to see the procedures at the border as an increasingly onerous burden.

In 2009, relevant government agencies and trade associations, with the assistance of development partners, began to develop a platform for reducing congestion at the region's borders. Importantly, development partners did not attempt to provide a solution to the problem. Rather they assisted in coordinating the relevant entities to help them design their own solutions. Government and private sector representatives held joint meetings to explain the various problems at the border, such as time to cross and number of procedures, from their perspectives. This strategy ensured that ownership would come from the participants, and would allow them to address the issues they see as most relevant and ignore less important ones. What emerged from the discussions was that from the private sector perspective, the key issue wasn't the number of procedures or the various fees and facilitation payments, but the time to cross the border. As a result, they were amenable to solutions that would permit faster crossing times. This was also acceptable to many (but not all) government participants. Strong private sector support for the program was critical because they were willing to place pressure on their governments to go along with the proposal and jointly develop a plan. In addition, the groups came to a voluntary agreement, rather than push for official recognition in order not to lose momentum. This reinforces the importance of taking a flexible view toward integration that we discussed earlier. The results have been extremely impressive. According to a 2012 study done by the sub-Saharan Africa Transport Policy Program (SSATP), crossing times at the border dropped from twenty-four hours in



2011 to less than four hours in 2012. The study estimates that, thanks to improved management and coordination in Malaba, the corridor now saves over \$69 million per year because of this reduction in time.<sup>12</sup>

### 5.3 Road Conditions and Transit Times

The quality of road infrastructure has improved greatly in the last two decades. This has resulted in shorter transport times and lower maintenance costs. The trunk roads in most of the region are in fair or good condition, including the entire length from Mombasa to Bujumbura via Kampala and Kigali. In addition, the Government of Tanzania has greatly expanded the trunk road network in Western Tanzania to the border with Burundi. The Government in Burundi has also begun to rehabilitate its network to the border with Tanzania. As a result, the roads of the Northern and Central corridors are very close to a complete paved circuit.

Road maintenance has also improved substantially, especially in Kenya, Rwanda, and Tanzania over the past decade. Much of this has been through strong pressure from donors and trucking companies. The latter have been an extremely strong pressure group mainly out of self-interest. This is because poor road conditions raise their maintenance fees and slow travel times.

Finally, there has been a sharp reduction in the number of roadblocks and weighbridges, especially along the Northern Corridor. As with the Joint Border Committees, these changes have substantially improved travel times. For example, transit times from Mombasa to Malaba have fallen from ten to fifteen days as late as 2010 to two to three days in 2014.

As we have mentioned, Kenya's private sector has pushed hard for many of these gains. Soon after President Kenyatta came into office, for example, a range of shippers' and importers' associations, such as the Shippers' Council of East Africa (SCEA), the Kenya Private Sector Alliance (KEPSA), and the East Africa Business Council (EABC), engaged in a sustained lobbying effort to improve the performance of the transport sector. Shortly after engaging the president, he announced a sweeping set of reforms

in the port and along the roads, including removing roadblocks and weighbridges.

Government initiative also deserves a large part of the credit for improved road conditions. The Tanzania National Roads Agency (TANROADS), for example, reduced the proportion of poor trunk roads from 50 percent in 2000 to 5 percent by 2010. It also has introduced performance-based road maintenance contracts. Under these contracts, firms charged with road upkeep only receive payment if they meet the specified quality conditions.

### 5.4 Implementation of the East African Single Customs Territory

The implementation of the Single Customs Territory (SCT) along the Central and Northern Corridors is the latest move to enhance intra-EAC trade and lower expenses for businesses. Not to be confused with a Customs Union, the SCT allows transporters to pay customs for their final destination at the port of entry. It thus reduces transit times at EAC borders. Member states are in the process of setting up one-stop Electronic Single Window System (eSWS) for cargo clearance in the region. Kenya, Uganda, and Rwanda have taken the lead in this process.

The Single Window System allows the use of Regional Customs Transit Guarantee (RCTG) to cover transit goods from or to the ports. Trucks that have RCTG are not required to have multiple national transit guarantees. Instead the single RCTG cover is accepted throughout the customs territory. In Mombasa, there are plans to integrate all port community members' systems into the Kenya National Electronic Single Window System by December 2014 and have 70 percent of cargo use the green channel.

The SCT integration program, not surprising, is experiencing implementation challenges. For example, there is concern by stakeholders that there has not been proper coordination under the customs departments. The country revenue authorities also have been slow to issue passwords to the freight forwarders thus impeding the rollout of the program. In addition, the export management team and the project coordination team are not working in tandem. Furthermore there has not been sufficient training of the freight forwarders in the use of the eSWS. These predictable difficulties are slowing down the integration process, but are very unlikely to stall or reverse it.

### 5.5 Business Associations

A number of National Business Associations have formed apex bodies that promote harmonized business processes

<sup>12</sup> According to Fitzmaurice and Hartmann (2013, 8), "estimates of the monetary costs of the delays were at \$247.40 per 24 hours for a truck, and \$137.00 for the goods, a total of \$384.40 for a loaded truck. On the basis of 600 trucks per day, over 360 days, and a savings averaging of 20 hours, the total annual savings can be estimated at \$69,192,000 (\$44,532,000 for the trucking enterprises, and \$24,660,000 for the traders)."



and better engagement with governments in trying to improve the business climate in the region. Their performance is uneven across sectors and countries. At one end of the spectrum are powerful organizations that have been very effective in improving transport sector integration. The East Africa Business Council (EABC), the Kenya Manufacturing Association (KMA), and the Kenya Private Sector Alliance (KePSA) are good examples, as we explained above. Moreover, competent transport sector associations like Kenya Shippers Council (KSC) and the Uganda Shippers Council (USC) have made the Shippers Council of East Africa (SCEA) a powerful advocate for regional integration.

Some effective business associations are supporters of some efforts for greater transport sector integration, but not others. For example, the Kenya Transport Association (KTA) and the Tanzania Transport Association (TATO), the strongest EAC transport associations, lobby hard for improved efficiency along the region's roads, but not efforts to liberalize it. Rather, these organizations advocate protecting their sector from greater regional competition.

Finally, many business associations in the sector are weak. For example, the Kenya International Freight and Warehousing Association (KIFWA), which for many years was the model freight forwarding association for EAC, has become embroiled in a number of court cases over its internal election processes and its effectiveness has suffered as a result. The decline also has discouraged professionally run freight forwarding companies from participating in it. Consequently, the leadership of KIFWA remains largely in the hands of owners of small companies with little experience in effectively engaging governments in policy dialogue. There also exist two rival freight forwarding associations in Uganda, the Uganda Clearing Industry and Forwarding Association (UCIFA) and Uganda Freight Forwarders Association (UFFA). Efforts to merge the two associations into one national association have failed in the past due to uncompromising leadership styles. Such lack of cooperation undermines their influence on policy in the sector.

Lack of financial sustainability is a challenge for many organizations. While the potential is great for the associations to mobilize internal funding, often lack of transparency and poor leadership has created disillusionment among members and therefore some of the associations survive only on donations from international development partners.

## 5.6 Data and Transparency

Data about conditions of transport networks has improved substantially over the past few years, especially along the

Northern Corridor. The Northern Corridor Transit Transport Coordination Authority in 2012 launched the Transport Observatory Project (TOP) as a tool for monitoring the performance of the Northern Corridor. The TOP uses a set of predetermined Corridor Performance indicators (CPIs) to measure transport sector performance. The program aims to enhance the use of evidence-based decision-making by providing easy access to reliable data. Having multiple stakeholders and data sources, including electronic data and surveys, the TOP collects data points such as duration of trips, traffic delays, truck volume and capacity, transit rates and costs, efficiency, and productivity. The observatory data are available on the Internet. The Central Corridor Transit Transport Facilitation Authority (CCTTFA), by contrast, is lagging in this area.<sup>13</sup> In addition, the SCEA also produces an annual logistics performance survey for the entire EAC that examines transport prices, travel times, and volumes. All of the aforementioned organizations make their data available for free and place it on the Internet.

The cumulative impact of the aforementioned changes has led to falling road transport costs and prices. We examine how and where this has occurred in the following section.

## 6. Structure of the Transport Sector

How the changes we discussed in the previous section affect transport prices depends heavily on the structure of the transport sector. Transport prices can fall due to improvements in road quality, reductions in transport times, and/ or increased competition. The previous section examined the processes that led to the first two outcomes. However, Raballand and Teravaninthorn (2009) contend that while achieving these outcomes will bring down transport costs, it won't necessarily reduce transport prices. Rather, lack of competition in the transport sector can permit firms to increase their profits if costs fall. This section examines the degree of competition in the transport sector to determine whether falling transport costs are reducing transport prices in the EAC. We do so by first examining the profile of sector and then by looking at costs and prices.

<sup>13</sup> At the time of completing this document, September 2014, the CCTTFA's website was not functioning.

## 6.1 Firm Profiles

According to (Harttman and Asebe 2013), road cargo transport operators face a range of challenges that vary according to the size of fleet, entrepreneurial exposure of the fleet owners, and their management styles. The most significant factors that account for cost of transport and ability to compete effectively in the sector are:

- Vehicle costs and bank interest rates
- Costs of fuel and spare parts
- Cargo availability
- Road quality and transport times
- Ability to supply credit

Due to the aforementioned factors, the EAC trucking sector is currently bifurcated. At one end of the spectrum are the large and professional operators. The largest 5% of firms operate 45% of the truck fleet in Kenya and 40% in Tanzania, for example. At the other end are a large number of very small and informal firms. Approximately 50% of the enterprises in Tanzania operate seven trucks or less and four or less in Kenya. In Rwanda, almost 80% of the enterprises operate only one truck.

An examination of the environment in which the trucking sector operates explains its bimodal distribution. The analysis makes clear that large trucking companies are unlikely to survive through transport alone and small companies face considerable barriers to expanding their operations. The place to begin is to recognize that trucking is not a stand-alone service, but embedded in a larger transport and logistics process. Truck owners don't simply go to the port, pick up cargo, and negotiate with a customer. Rather, they obtain cargo from clearing and forwarding (C&F) agents that have already negotiated a price with the customer. The transporter can then determine whether to use his or her own truck, or sub-contract it. Transport companies also need consistent access to cargo in order to have a large volume of business. Because such information is not available publicly at the moment in Dar es Salaam or Mombasa ports, to get a consistent supply of cargo requires forming close relationships with experienced C&F firms that are able to process cargo quickly through the port. Thus, access to information about freight is the first hurdle a transport company must overcome. As a result, at the moment, only transport companies that have close ties to shipping and/or C&F firms know when specific cargo will be coming into the port.

However, consistent access to cargo is only one challenge. A second one that C&F and transporters alike must overcome is the need for a large supply of cash or lines of credit that allow them to purchase as much cargo as possible. C&F agents and transporters must spend their own money shipping cargo before customers pay. Many importers are unable to pay for their shipments at the time of delivery and ask for credit as well. Thus, a medium size operator (e.g., fifty trucks) carrying purely third-party cargo could easily find itself owed \$100,000 in products it has already shipped. As a result, pure shipment companies are likely to always have large outstanding balance sheets. In addition, since profits in the transport sector are tightly linked to the volume of cargo a company can carry, firms that want a high volume of business must be able to access very large amounts of finance.

Scaling up for small trucking companies is risky. An eight-year-old truck and trailer costs about \$100,000 in East Africa. Businesses tend to finance it through a combination of their own cash and bank loans. The latter tend to be short-term (less than five years) at interest rates around 17%. This is roughly equivalent to approximately \$1,500 payment per month. As we will demonstrate in the cost section below, covering these loans is very difficult. In addition, increasing fleet size without having access to sufficient cargo volumes is likely to lead to idle capacity. Such an outcome is catastrophic for firms that have bought their trucks on credit. While financing a truck from one's own account solves the bank repayment problem, it reduces the amount of cargo a company can finance and hence could constrain its ability to increase the volume it can afford to carry.

Given these challenges, the bifurcated structure of the industry is easy to understand. Operating a large fleet requires (1) large cash reserves and/or a large line of credit and (2) excellent relations with C&F agents as well as port authorities. Only firms well established in other areas will have the former, while only those with extensive port operating experience will have the latter. Thus, it is not surprising that large trucking firms have one or more of the following characteristics:

- Regular contact with C&F agents
- Direct access to freight
- Are combined with C&F services
- Carry their own goods
- Have contracts with large importers
- Have the ability to provide credit

Given the above factors, small-scale operators face enormous risks and challenges in expanding their fleet. As a result, the sector is bifurcated between established, large-scale firms that combine third-party transport with some other form of business and small-scale operators dependent on sub-contracts from larger firms.

This also explains why there are a large number of very old trucks on the roads in East Africa. Large firms have many price advantages that smaller ones do not. Large firms can charge higher rates than smaller ones because they can provide credit, while many small firms cannot. In addition, reliable firms can charge higher prices for customers needing high-quality service because they can operate more efficiently than small ones. The latter tend to wait many days in the port before starting their next journey due to the aforementioned challenges of finding new cargo. By contrast, large firms that have consistent access to cargo can operate depots outside congested port areas and use dilapidated trucks to ferry cargo from the port to the depot. This permits their newer and more reliable trucks to have very short turn-around times and operate on a much more predictable schedule. Because sub-contractors can only compete on prices, they need their costs to be as low as possible. Using old trucks they can buy cheaply is an effective way of minimizing fixed costs and thus an effective strategy to compete on low prices.

## 6.2 Determinants of Road Transport Costs and Prices in East Africa

This section explains why transport prices are currently falling along the Northern Corridor, but not the Central Corridor. We do so first by explicating the process and cost of moving a container from the port to its final destination, the prices importers pay, and truck operating costs.

Box 4 shows the steps and current costs to move a hypothetical 40-ft. container from a ship in Mombasa Port to a customer in Uganda.

Table 20 presents a breakdown of the indicative prices. If container deposit is removed from the total, transport prices are two-thirds of the total, while customs, port, CFS, and inspection charges account for the balance.

We now examine the determinants of transport prices. Table 21 shows current transport prices along the Central and Northern Corridor to various East African destinations. According to the East African Business Council 2014 Logistics Performance Indicator, the prices of transport along the Northern Corridor fell about 20 percent from 2011 to 2014. Rates fell for all markets except Kampala, which rose

### BOX 4: Steps and Costs to Move a Container from Mombasa to Uganda

1. Vessel arrives in port.
2. Container loaded on to truck for delivery to Container Freight Station (CFS).
3. Container arrives at CFS and awaits customs processing by consignee or Clearing and Forwarding Agent (CFA).
4. CFA negotiates transport charge with transporter and price with customer.
5. CFA processes the cargo through Customs. Pays duties and taxes (domestic destination) or executes a Customs Bond (foreign destination).
6. CFA pays container deposit (\$4,500) to shipping line and obtains delivery order.
7. Goods are verified by Customs and other relevant authorities then released.
8. CFA pays CFS charges and instructs transporter to load the cargo on truck. Hands over copy of entry and supporting documents. CFA pays transporter 50 percent of agreed rate.
9. Transport loads cargo and proceeds to deliver.
10. Cargo is processed on both sides of Malaba/Busia border and weighed again.
11. Cargo is delivered and container released to be returned to shipping line.
12. Transporter returns container to shipping line and obtains Container Interchange to attach to the invoice for the CFA together with a copy of Delivery Order as proof of return of container. Transporter receives rest of payment.
13. CFA raises invoice to client for Customs (\$500), CFS (\$350), processing (\$500), and transport (\$3,000).

by 9 percent. However, this is a fall in real prices. By contrast, prices have risen along the Central Corridor, confirming the divergence between them we examined in previous sections.

Falling prices along the Northern Corridor are a positive development. What is driving these prices down? Can we attribute it to any of the specific policy changes we discuss in the chapter? To answer these questions, we must establish a direct link between the various interventions and the variation in prices paid by the owners of the cargo.

**TABLE 20: Indicative Costs for Importing 40-Foot Container into Kampala from Mombasa**

|                             | USD          |
|-----------------------------|--------------|
| Container Deposit*          | 4,500        |
| Local Shipping Line Charges | 377          |
| CFS Handling                | 350          |
| Electronic Tracking Charges | 10           |
| KPA Handling                | 165          |
| RE—Marshalling              | 150          |
| Wharfage                    | 105          |
| Verification                | 100          |
| C & F Charges               | 500          |
| Transport**                 | 3,000        |
| <b>Total</b>                | <b>9,257</b> |

\* Refundable on safe return of container

\*\* With profit

We begin by looking at the cost components in a transporter's operations. The analysis is based on an imported, eight-year-old used Mercedes Benz Actros truck costing \$65,000 and a brand new local trailer costing \$30,000. We assume the owner uses a bank loan to purchase the equipment at 16.5% interest per year on a reducing balance. We further assume that the truck covers 100,000 kilometers per year on twenty brand new tires.<sup>14</sup> We allow for a 25% profit margin. The costs we derive would approximate

<sup>14</sup> This mileage is equivalent to one round trip from Mombasa to Kampala per week or two round trips between Mombasa and Nairobi per week.

those for an average truck in the fleet of a large operator owning a range of trucks from financed new ones to fully-owned old ones.

Table 22 breaks down these costs by component. Our data show that the round trip per kilometer rate based on a container with a gross weight of 27 tons from Mombasa to Kampala is \$1.35 per kilometer or \$3,154 per container. Add to this rate a 25% profit margin and the price to the client should be \$1.68 per kilometer or \$3,942 per container. Assuming that this is a large fleet owner engaged in return cargo contract and assuming that it gets \$900 per container for return cargo from Kampala, the transporter would be able to charge as low as \$3,000 per container for the Mombasa to Kampala leg and still make a comfortable margin.

Our simulated rate compares favorably with the rates we obtained during our interviews and those we show above. We found that for the large fleet owners, current average transport only rates from Mombasa to Kampala range between \$2,500 and \$3,050 for imports. One company with a C & F Department is currently offering an all in flat rate (C&F plus transport) to Kampala for contract clients at \$3,050 for 20-foot containers and \$3,150 for 40-foot containers regardless of weight. For exports from Kampala the flat all in contract rate is \$1,250 per 20-foot container, inclusive of customs and clearance fees.

The data also allows us to examine costs by their percentage contribution. Direct costs account for a combined 81% of the total operating cost of transport. The three top individual cost components are fuel at 38% followed by cost of truck and trailer at 19%, with tires in third position at 10%. The crew cost, the indirect costs, and overhead costs each contribute 9% of the total per kilometer cost of operating the truck.

**TABLE 21: Transport Prices Along the Central and Northern Corridors: 2011–2014**

|                     | Bujumbura | Goma  | Juba  | Kampala | Kigali | Nairobi |
|---------------------|-----------|-------|-------|---------|--------|---------|
| <b>From Dar</b>     |           |       |       |         |        |         |
| <b>2011</b>         | 4,400     | 3,600 | N/A   | 2,500   | 3,300  | N/A     |
| <b>2014</b>         | 4,500     | 4,700 | N/A   | 4,600   | 4,300  | N/A     |
| <b>Change</b>       | 2%        | 31%   | N/A   | 84%     | 30%    | N/A     |
| <b>From Mombasa</b> |           |       |       |         |        |         |
| <b>2011</b>         | 8,000     | 9,500 | 9,800 | 3,400   | 6,500  | 1,300   |
| <b>2014</b>         | 6,500     | 7,000 | 7,500 | 3,700   | 4,800  | 1,045   |
| <b>Change</b>       | -19%      | -26%  | -23%  | 9%      | -26%   | -20%    |

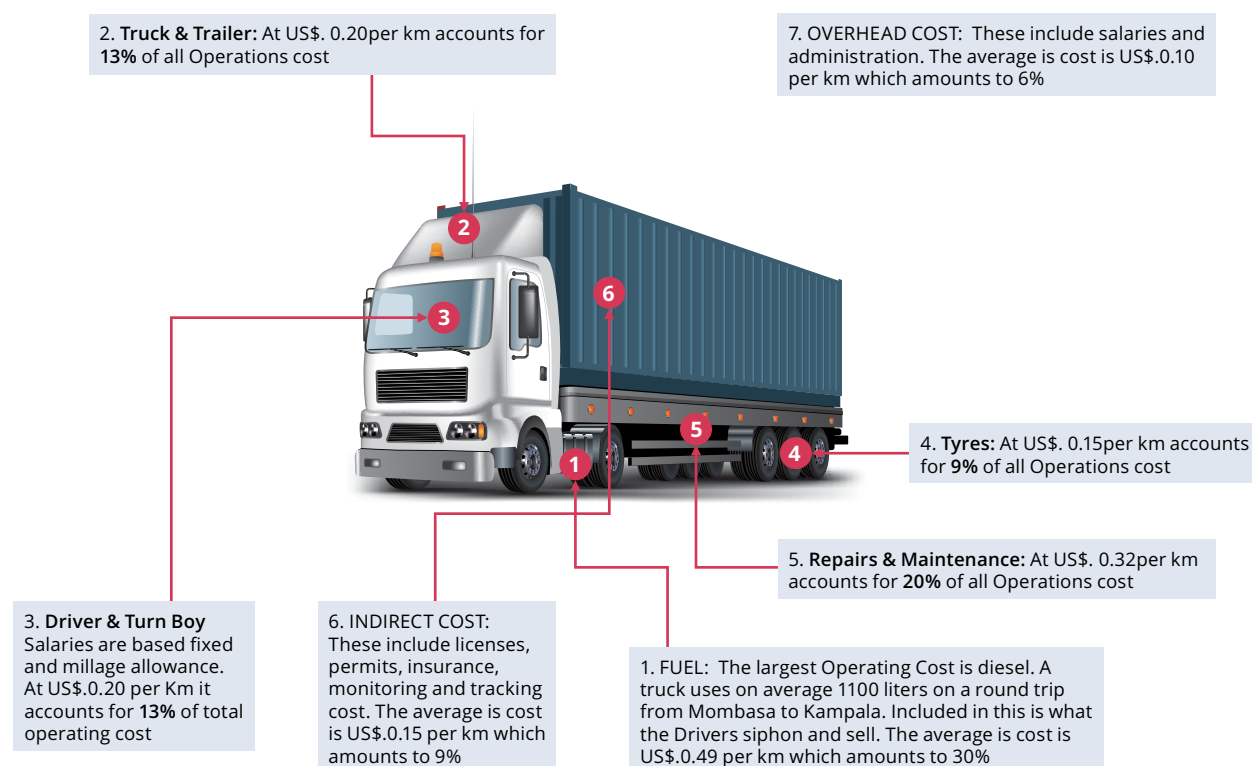
**TABLE 22: Composition of Current Total Operating Costs per Kilometer in East Africa (Bank-Financed 8-Year-Old Truck)**

|   | Dollar Cost | Percent Cost |
|---|-------------|--------------|
| <b>Truck and Trailer</b>                  | \$0.25      | 19%          |
| <b>Fuel</b>                               | \$0.51      | 38%          |
| <b>Repairs and Maintenance</b>            | \$0.08      | 6%           |
| <b>Tires</b>                              | \$0.13      | 10%          |
| <b>Driver and crew</b>                    | \$0.12      | 9%           |
| <b>Indirect Cost (e.g., insurance)</b>    | \$0.12      | 9%           |
| <b>Overhead Cost (e.g., office staff)</b> | \$0.12      | 9%           |
| <b>Total</b>                              | \$1.35      | 100%         |
| <b>Memo: Fixed Cost</b>                   | \$0.49      | 37%          |
| <b>Variable Cost</b>                      | \$0.84      | 63%          |

These cost components allow us to focus on why prices can fall as travel times decline. The fixed costs of the truck, mainly loan repayments, are approximately \$1,500 per month. As travel times have fallen in the region, an aggressive operator could double the number of trips to Kampala per month from two to four. This would allow an operator to spread his or her fixed costs over four trips per month (\$350 per trip) instead of two (\$750 per trip). They can also lower their profit margins, but nevertheless earn more money by carrying a larger volume of cargo. These are two reasons transport prices are currently falling in the region. Falling prices due to increases in efficiency suggest the sector is very competitive as Raballand and Teravaninthorn (2009) argue.

One negative impact of the fall in transport times is a large oversupply of trucks. Years of economic growth in the EAC led to rising demand for trucks along the Central and Northern Corridors. Slow port operations, poor road conditions, and inefficient management systems, led most large fleet companies to keep more trucks and trailers in

## Components of Transport Costs



Source: Interviews with Transport Operators





their fleets than would otherwise be necessary in an efficient environment. In addition, as transport rates shot up, many new firms ventured into the transport business. Between the year 2007 and 2010, for example, the number of Kenyan trucks grew from 42,654 trucks to 67,668, a 59 percent increase. The number of trucks in Tanzania and Uganda increased a similar amount.

Due to falling transport times, the number of trucks necessary to carry the region's cargo is declining rapidly. First, shorter travel times allow firms to operate more efficient fleets. In addition, because quicker travel times makes investing in reliable trucks worthwhile, a number of transport operators are opting to buy new trucks and reduce their reliance on sub-contractors. As a result, demand for sub-contracts is waning. Some sub-contractors have substantial scope for lowering their prices if they own their trucks, while others do not. It is unclear how the market will clear the excess supply of trucks at the moment, although attrition of the least efficient trucks is the most likely candidate.

Finally, we can also explain why prices are falling much faster along the Northern Corridor than the Central one. The main reasons are competition and infrastructure improvements. The efficiency improvements we have discussed above are far more evident in the former than the latter, and the Port of Dar es Salaam, in particular, is an increasing bottleneck. In addition, the traffic is far heavier along the Northern Corridor than the Central one. This is evident from the data on regional transport volumes we showed earlier. Unfortunately, the latest data we have for both countries is 2011, before many of the improvements along the Northern Corridor occurred. Even then, however, close to 80 percent of the transit cargo in East Africa (including DRC and South Sudan) was along the Northern



Corridor. As a result, it is not surprising competition is much stronger along this route.

## 7. Conclusion

For many years the transport sector in the EAC was stuck in a sub-optimal equilibrium of poor road quality, slow travel times, and high transport prices. Over the past few years, the situation has improved dramatically. This study has examined the political economy factors that account for this change. There is no question that transport sector integration in the EAC, led by governments and private sector pressure, has led to a range of positive changes:

- The Port of Mombasa has become much more efficient.
- The removal of NTBs over the last decade has had a significantly reduced transit time and increased competition among transporters. Key developments that have helped to facilitate regional trade include the implementation of joint border committees, the single customs territory, and reductions in the number of road blocks and weighbridges.
- Road quality and compliance with weight limits has improved substantially.
- Transport prices are falling, especially along the Northern Corridor.

Nevertheless, there are a number of challenges toward greater integration and perhaps sustaining the current level of infrastructure:

- The region has massive infrastructure needs and limited financing for it.



- Traffic congestion at the ports and major towns along the corridors makes travel much slower than it needs to be.
- Slow expansion of Dar es Salaam port threatens to marginalize the Central Corridor as an attractive transport route and hence reduce corridor competition.
- Railways are still problematic. RVR is operating far below estimates, the Standard Gauge railway is mired in controversy, and Tanzania Railways is undergoing a difficult restructuring.
- The EAC remains institutionally weak and is unable to coordinate regional infrastructure investment plans and enforce integration. It seems unlikely to gain these capacities in the near future.

The chapter's findings align with the broader literature on transport economics and the political economy of regional integration. The study supports results from the former that competition and efficient movement of goods are necessary for high road quality to bring down transport prices. In addition, consistent with the broader academic literature on regional integration, it also finds that strong private sector pressure and leadership from a powerful state account for these changes.

We also provide clear recommendations for the Bank's work in regional integration in Africa. In particular it provides three actionable suggestions:

- Engage the private sector to determine its preferences and willingness to pressure governments to implement policies necessary to achieve them.
- Jointly work with relevant private sector organizations and government agencies on developing consensus to address challenges.
- Accept solutions that can gain consensus even if they are far from optimal.

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## Appendix: Transport Sector Stakeholders

| Major Stake Holders                     | Sphere of Influence and Impact   |
|---|--|
| East African Community                  | Drive the integration process.   |
| Country Line Ministries                 | Articulate country interests in the integration  |
| Country Revenue authorities             | Monitor and enforce legislation on revenue collection and management in the region. Can streamline customs processes to reduce administrative costs for transporters while enhancing revenue collection.                     |
| Country Roads Authorities               | Create road infrastructure development strategies and monitor implementation. Protect and rehabilitate the existing infrastructure.  |
| Country Ports Authorities               | Promote development of regional ports with their country spheres to facilitate trade   |
| Country Maritime Authorities            | Ensure sustainable safe, secure, clean, and efficient water transport for the benefit of stakeholders through effective regulation, coordination, and oversight of maritime affairs.   |
| Country Railway Authorities             | Promote, facilitate, and participate in regional, national, and metropolitan railway network development.  |
| Country Airport Authorities             | Facilitate infrastructure development for aviation services within the region and internationally.   |
| Development Partners                    | Promote bilateral engagement on the development of transport infrastructure to enhance trade and integration in the region.  |
| Country Business Councils               | Provide a regional platform through which the business community can present their concerns at the EAC policy level, with the overall aim of creating a more conducive business environment through targeted policy reforms. |
| Country Shippers Councils               | Provide a platform for cargo owners to articulate their concerns and demands to service providers and policy makers. Advocate for enactment of appropriate legal and regulatory framework.                                   |
| Country Transporters Associations       | Represent advice and support road transporters in the East African Region. Advocate for a safe, reliable, efficient, professional, and environmentally friendly road freight industry.                                       |
| Country Freight Forwarders Associations | Professionalizing the freight forwarding industry, providing information, and advocacy for an effective freight logistics industry in the East African region.   |

### EAC Transport Sector Stakeholders

|  |  |  |
|--|--|--|
| Central Corridor Transit Transport Facilitation Agency         | Intergovernmental Standing Committee on Shipping (ISCOS)   | Tanzania Airports Authority                                    |
| Customs Authorities  | Kenya Airports Authority                                   | Tanzania Maritime Authority                                    |
| Development partners (World Bank, USAID, TMEA, JICA, EU, AfDB) | Kenya Maritime Authority                                   | Tanzania Ports Authority                                       |
| East Africa Drivers Association                                | Kenya National Highways Authority                          | Tanzania Railways Authority                                    |
| East African Business Council                                  | Kenya Ports Authority                                      | Tanzania Roads Authority (TANROADS)                            |
| East African Community   | Kenya Railways Corporation                                 | Tanzania Zambia Railway Authority                              |
| East African Shippers councils                                 | Kenya Rural Roads Authority                                | Uganda Airports Authority                                      |
| East African Transporters Association                          | Kenya Urban Roads Authority                                | Uganda National Roads Authority                                |
| Federation of East African Freight forwarders Association      | Kenyan Roads Board   | Uganda Ports Authority   |
|  | National Traffic Police Authorities                        | Uganda Railways Authority                                      |
|  | Northern Corridor Transit Transport Coordination Authority | Various line ministries (e.g., Trade, tourism, and industries) |

Regional integration in sub-Saharan Africa is crucial for its further economic development and, more importantly, its structural transformation away from agriculture towards higher value-added activities, such as manufacturing and services. Yet there are many paths towards greater integration, some of which are easier than others. In addition, integration need not follow a linear path or occur mainly through formal inter-governmental economic coordination. In order to gain insights into how regional integration is occurring in sub-Saharan Africa, determine impediments to it, and develop recommendations to further facilitate it, this volume examines the political economy of regional integration in sub-Saharan Africa.

In a comparative context, the findings suggest cautious optimism for regional integration efforts in sub-Saharan Africa. They also question perceptions that regional integration in sub-Saharan Africa is doomed to be less successful than in other parts of the world. Economic integration is typically difficult, especially among less developed economies. In addition, failed integration attempts and slow implementation of integration policies is a global pattern, not only an African one. Yet integration is occurring in sub-Saharan Africa, despite these obstacles. This volume demonstrates that regional integration is more likely to succeed when it has strong support among governments and/or the private sector as well as when key actors take a pragmatic and flexible path to integration rather than a rigid and all-encompassing one. Similarly, it shows that economic integration is more likely to succeed when it occurs alongside regional attempts at improving political stability and/or developing joint infrastructure. Arguably, regional integration in sub-Saharan Africa is perhaps somewhat more successful than one would predict given the challenging environment in which it is occurring.

