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## **Trade Effects of the East African Community\***

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This article evaluates the trade effects of the new East African Community, which fosters trade liberalisation among Kenya, Tanzania and Uganda. The analysis uses a disaggregated approach at the two-digit level of the Standard International Trade Classification. The commodities that will be particularly affected by the customs union are identified. The results show that considerable trade effects cannot be expected, except for a very narrow range of products. The transitional fund, which has been proposed to counter trade imbalances due to the new customs union in East Africa, becomes less urgent from this perspective.

Keywords: Customs Union, EAC, Kenya, Tanzania, Uganda

## **1. Introduction**

There has been a relatively long tradition of attempts to integrate the economies of East African countries. Starting in 1948 with the East African High Commission, several attempts have been made to foster deeper integration of Kenya, Tanzania and Uganda. With various factors playing confounding roles, most of these efforts finally failed. The most recent attempt, the new East African Community (EAC), however, reaches far beyond the failed efforts of the past. The new EAC treaty, agreed on in 1999, envisages the establishment of first a customs union, then a common market, a monetary union and ultimately a political federation. The first step, the establishment of the EAC customs union, came into force in September 2004, aiming to eliminate all remaining intra-regional tariffs, remove non-tariff barriers and introduce a common external tariff.

There have been fears that the application of provisions for the establishment of a customs union and a common market would lead to severe trade imbalances. These fears have been stated in all relevant documents of the EAC. For instance, Article 77 of the treaty is titled “Measures to Address Imbalances Arising from the Application of the Provisions for the Establishment of a Customs Union and a Common Market” (EAC Secretariat, 2000, 52). Similarly, the problem of imbalances was also discussed in the first Development Strategy of the EAC, covering the period ranging from 1997 to 2000. This strategy translated the vision of co-operation among the partner states into a comprehensive action programme including areas such as trade and industry, transport and communications, agriculture, environment, tourism, social and cultural activities and fiscal and monetary policies. In the strategy document, the problem of imbalances is cast in terms of costs and benefits:

... while there are benefits accruing from regional integration, unequal distribution of the ensuing benefits has been a major shortcoming in many integration schemes, including the well-known case of the collapse of the defunct East African Community (Secretariat of the Permanent Tripartite Commission for East African Co-operation, 1997, 17).

The second Development Strategy (2001–2005) again requests the distribution of benefits and costs and underlines the necessity of taking measures to address imbalances arising from the process of establishing a customs union and a common market. The strategy envisages that a study be commissioned to analyse the experiences of other regional blocs, with a view to adopting the most appropriate approaches for the EAC. It also envisages the establishment of a fund to address imbalances (EAC Secretariat, 2001).

In general, the theory of economic integration was founded on the seminal contribution of Viner (1950). He distinguished between two effects, one in which trade between partner countries expands in accordance with international comparative advantage, and the other in which trade between partner countries expands as a result of the preferential treatment given to imports from within the region as compared to those from the rest of the world. Viner named the former effect “trade creation”, where domestic products are substituted by imports of lower-cost goods produced by a country’s partner. The latter he called “trade diversion”, which refers to the shift in imports from the least-cost exporter to the more expensive product from the nation’s partner.

While this categorisation is a helpful description of the effects of the formation of a customs union, it embraces only a part of the economic effects of such an arrangement. Further likely effects of a customs union are, for example, losses in tariff revenues due to the preferential tariff elimination or the exploitation of economies of scale due to an enhanced economic market. In sum, a country that enters a customs union may experience a welfare gain or loss, depending on the circumstances in each case. Moreover, individual firms may also gain or lose under the preferential trade agreement. Due to the possibility of losses at the country or firm level, powerful domestic interest groups may exert pressure on trade-policy formation and demand compensation, for instance, in the form of a temporary transitional fund to compensate for losses that occur due to the EAC customs union.

The administrative mechanisms of such a transitional fund would have to be worked out in the study envisioned in the second Development Strategy. Such a fund would finance infrastructure and private industrial projects in the partner countries that incur the most losses, in order to improve their competitiveness. It would be a transitional fund, meaning that it would exist only for a certain period of time and would be abolished after imbalances are removed. The central question is whether such a transitional fund would be necessary. This would be the case if indeed the EAC were to have a severe impact on trade flows, and significant trade imbalances were to occur. For example, as a result of the trade and production structure of the EAC countries at present, the vast majority of the beneficial trade-enhancing effects of the EAC may occur in only one of the three East African countries. In that case, economic and political imbalances and frictions would be likely to arise.

Against this background, this article will address two questions: (1) What are the likely overall trade effects of the EAC customs union? and (2) Which disaggregated commodities will be affected in particular? Section 2 surveys the structure of EAC trade flows and provides an overview of central features of the EAC in the past and at

present. With this historical background elucidated, section 3 explains the theoretical model used to estimate the trade effects. The results of the trade estimations are then presented in section 4. Based on these results, section 5 examines some aspects of the political economy of the proposed transitional fund and draws some conclusions.

## **2. Historical Background and Achievements of the EAC**

**I**n November 1999, the treaty for the establishment of the new EAC was signed between the three partner states. According to Article 1 of this treaty, the objectives of the community “shall be to develop policies and programmes aimed at widening and deepening co-operation among the partner states in political, economic, social and cultural fields, research and technology, defence, security and legal and judicial affairs, for their mutual benefit” (EAC Secretariat, 2000, 12).

As already mentioned in the previous section, the new EAC is only partly a new organisation. The first attempt to integrate the East African economies was the East African High Commission, established in 1948 with the purpose of controlling the public service in the British colonies of Kenya and Uganda and the British mandated territory of Tanganyika. After the independence of Tanganyika, the High Commission was transferred to the East African Common Service Organisation. Built on these first steps towards integration, the (old) East African Community was established in 1967 (Mair, 2000). The old EAC made progress in creating important institutions and infrastructure, such as the East African Development Bank and the East African Legal Assembly. Moreover, important service facilities, for example the East African Harbours Corporation, East African Railways and East African Airways, became decentralised.

From the beginning probably the most important problem threatening the existence of the old EAC was the industrial dominance of Kenya in the region, leading to growing deficits for Tanzania and Uganda in their trade with Kenya (Mair, 2000). Tanzania in particular was complaining about this situation and made a proposal to mitigate the problem. But attempts to improve the competitiveness of Tanzania and Uganda failed. The persistence of trade imbalances among the three partner states was therefore one of the main reasons for the collapse of the old EAC. Other major contributing factors were the concentration of regional administrative facilities in Kenya and contradictory economic orientations. At that time Kenya had a pure market economy, while Tanzania pursued Ujamaa-socialism and Uganda opted for a mixed economy. Moreover, growing political conflicts among the three countries and rising animosity among their leaders added to a climate of distrust (Mair, 2000).

As a result of these factors, the old EAC broke down in 1977 and Tanzania closed its border with Kenya. It was not until 16 years later that attempts to begin to revive the EAC and clear the way for a new foundation showed tangible results. In the Mediation Agreement, signed in 1984 to address the division of assets and liabilities of the former EAC, there was a provision to explore areas of future co-operation. On the basis of this provision, the heads of state of the three states agreed during a meeting in 1986 in Nairobi to promote the spirit of co-operation among their respective countries. On 30 November 1993, the three East African partner states signed an agreement establishing the Permanent Tripartite Commission for East African Co-operation, with a mandate to identify areas of co-operation and propose appropriate arrangements for regional co-operation.

The EAC Secretariat was launched in March 1996, setting the basis for the adoption of the first EAC Development Strategy 1997–2000. This first development strategy formed the starting point for the establishment of the community in 1999. The strategy defined the guiding principles for co-operation, identified areas for co-operation, defined priorities and made suggestions for strengthening the capacity to improve co-operation among the three partner countries. In addition, sectoral councils and sectoral committees were established to articulate on each agreed area of co-operation.

The subsequent East African Community Development Strategy 2001–2005 is based on the lessons learned from the first strategy and sets out the priority programmes to be implemented during the five-year period to which it refers. Above all, the first strategy was characterised by institutional inertia, a slow decision-making processes, inappropriate sequencing of certain activities and delays in implementation due to resource constraints. It also raised challenges related to managing the distribution and costs of integration (EAC Secretariat, 2001).

In some areas the EAC has already made remarkable progress. For instance, prior to the full establishment of the customs union, intra-regional trade had been liberalised to a large extent. Kenya applied a preferential tariff reduction of – on average – 90 percent on imports from the other two EAC members before the full establishment of the customs union in September 2004.<sup>1</sup> The tariff regimes of Tanzania and Uganda had been liberalised as well (see table 1). Likewise, non-tariff barriers on cross-border trade had been removed.

**Table 1** Import Tariffs of EAC Countries, 2003 (in percentages)

Country	Average tariff rate inside EAC	Average tariff rate outside EAC
Kenya*	1.9	13.3
Tanzania	1.8	8.1
Uganda	3.3	5.5

Figures refer to applied import-weighted averages for the three East African countries prior to the establishment of the full customs union.

\* 2001.

Source: UNCTAD (2004).

Bilateral trade flows of the EAC member countries show that Kenya had significant trade surpluses with both Tanzania and Uganda in 2002, the latest year for which trade data for all three East African countries are available (table 2). All three EAC countries had a large (absolute) trade deficit with the rest of the world. On the other hand, the share of the current account deficit to GDP is particularly large in Tanzania and Uganda. Seen from this perspective, fears in Tanzania and Uganda about a further decline in their trade balances due to EAC tariff removal seemed to be comprehensible to a certain extent.

**Table 2** Trade Balance of EAC Countries, 2002 (US\$ mill.)

Reporting country	Bilateral trade surplus (+) / deficit (-) with				Total current account deficit in % of GDP
	Kenya	Tanzania	Uganda	World	
Kenya		+85.9	+304.1	-1,674.0	-1.1
Tanzania			-4.7	-965.2	-2.7
Uganda				-605.6	-6.1

Bilateral trade figures refer to trade in goods only, whereas the current account data also include imports and exports of services.

Sources: ITC (2004) and World Bank (2004).

Apart from the liberalisation of trade in goods, progress has also been made in the harmonisation of monetary and fiscal policies and in the institutional improvement of capital markets. A court of justice has already been established and a competition law is in the planning process. Other important areas where co-operation has made progress are industry, investment and customs, private-sector development, transport and communication, agriculture, energy, natural resources and the environment. Also,

the EAC has developed an Industrial Development Strategy, a Private Sector Development Strategy and an Agricultural and Rural Development Strategy.

### **3. Analysing the Trade Effects of Economic Integration**

The further elements of the EAC treaty referred to immediately above go far beyond the intended complete internal liberalisation of trade in goods. Due to data deficiencies and the fact that the steps ahead of the customs union are partly planned but not formally implemented in all countries, this section and the following one focus on the trade effects of the EAC customs union only.

Quantitative analyses of the impact of a customs union on trade flows are typically performed in either a partial or general equilibrium framework.<sup>2</sup> By their very nature, partial equilibrium models allow highly detailed studies on the impact of trade policy changes to be made. In contrast, general equilibrium models, or computable general equilibrium (CGE) models, attempt to describe the effects of discriminatory tariff preferences on the economy as a whole and the intersectoral linkages in particular. In most cases, general equilibrium models are thus more suitable to analyse the overall trade and welfare effects; yet they require a social accounting matrix with detailed information on each of the involved economies, such as sectoral production data or substitution elasticities.

Since the required data are not available for all three East African countries, we have to rely on an appropriate partial equilibrium model to analyse the trade effects of the EAC. Using a partial equilibrium model does have certain advantages. For example, it enables us to identify the commodities that will be particularly affected by the customs union. Also, such models require less data and fewer assumptions about key variables in the analysis. However, we have to keep in mind that partial equilibrium models do not take intersectoral linkages and income effects of tariff preferences into account and, hence, exclude some important aspects of trade liberalisation.

Against this background, the model of Verdoorn (1960) will be used to estimate the impact of the EAC on trade flows. Despite its age, it is a suitable partial equilibrium model for the analysis of trade flows in the proposed EAC.<sup>3</sup> In the spirit of the “Armington assumption” (Armington, 1969), this model assumes product differentiation between supplying countries. More specifically, imported goods from different countries are considered to be imperfect substitutes in use. This assumption seems reasonable, since the majority of EAC trade consists of manufactured goods (table 3).

**Table 3** Import Structure of EAC Countries, 2002

Products (SITC no.)	Total imports of Kenya		Total imports of Tanzania		Total imports of Uganda		Total intra-EAC imports	
	US\$ mill.	%	US\$ mill.	%	US\$ mill.	%	US\$ mill.	%
Food, live animals, beverages and tobacco (0-1)	212	6.9	196	11.3	109	10.1	40	8.9
Raw materials (2-4)	752	24.5	334	19.3	254	23.6	220	49.1
Manufactures (5-9)	2,112	68.6	1,198	69.4	711	66.3	188	42.0
Total	3,075	100.0	1,729	100.0	1,074	100.0	447	100.0

Source: ITC (2004).

Verdoorn's model is based on the normal assumptions of partial equilibrium analysis, such as no repercussions on exchange rates or incomes due to changing trade flows, iso-elastic import-demand functions, and infinite supply elasticities. The latter assumption, frequently applied in models of international trade, might be some cause for concern when applied to the case of the three East African countries. In reality, their elasticities of supply are less than infinite. Yet the share of intra-EAC exports in domestic production is not very large (table 4). For this reason, expected changes in total domestic production in Kenya, Tanzania and Uganda are likely to be small, and the assumption of horizontal supply curves seems appropriate.

**Table 4** Exports and GDP of EAC Countries, 2002

Country	Total exports in US\$ mill.	Total intra-EAC exports in US\$ mill.	Total intra-EAC exports in % of GDP
Kenya	1,400	409	3.3
Tanzania	763	44	0.5
Uganda	467	68	1.2

Source: ITC (2004) and World Bank (2004).

To analyse the different trade effects the customs union may have, let us consider a particular commodity category, such as shoes. The consumer wishes to maximise his or her utility and may substitute different sorts of shoes, that is, domestically produced



shoes and imports of shoes from preferred and non-preferred countries.<sup>4</sup> Importantly, the analysis focuses on different sorts of imported shoes only. The consumer allocates expenditure to preferred and non-preferred imports subject to his or her budget constraint.

Consider now the impact of a tariff elimination only on preferred imports. The chain reaction comes in two stages: first the tariff is eliminated only on preferred imports and their prices decline, and then the consumer substitutes preferred imports for non-preferred imports and domestically produced goods. The total trade effect can be separated into trade creation and trade diversion. Trade creation is defined as the change in imports from preferred countries that arises from the displacement of domestic production and an increase in demand due to the preferential tariff elimination. Trade diversion, on the other hand, refers to the replacement of non-preferred with preferred imported goods.

Estimation of trade creation and diversion in the differentiated product model requires estimates of import demand and substitution elasticities, respectively. Since reliable estimates for both elasticities cannot be arrived at for Kenya, Tanzania and Uganda, we are following the standard “Dutch” convention, which is to assume values of 0.5 and 2.0 for the import demand elasticity and the elasticity of substitution, respectively. These values are well within the range of similar elasticities of other countries.<sup>5</sup> Moreover, the assumed values are very similar to more recent estimates of import demand and substitution elasticities by Kee, Nicita and Olarreaga (2004) and Gallaway, McDaniel and Rivera (2003).

#### **4. Empirical Results**

**B**efore we present the estimated trade effects, we will first take a brief look at the data used. Trade and tariff data refer to the base year 2003. The exception is Kenya, since the most recent year for which disaggregated tariff data can be obtained for this country is 2001. The tariffs were obtained from the national tariff statistics of the three EAC countries and the UNCTAD Trade Analysis and Information System (TRAINS), which is a comprehensive computerised information system at the tariff-line level using the harmonised system of product classifications (UNCTAD, 2004). The national tariffs were transformed into the Standard International Trade Classification (SITC, Revision 3).<sup>6</sup> The analysis has been performed at the two-digit SITC level, which allows a detailed specification of different products.

The projections of the impact of the EAC customs union on trade flows can be seen in table 5. Total trade will increase by roughly US\$17 million, or 3.3 percent. Trade creation and trade diversion amount to US\$7.0 and US\$9.8 million,

respectively. In comparison with Kenya and Tanzania, trade effects in Uganda can be expected to be a little bit larger with respect to both absolute and relative size. This outcome was to be expected, since intra-EAC tariff rates in Uganda are higher in comparison with Kenya and Tanzania. Yet for all three East African countries, trade diversion exceeds trade creation. From an economic point of view, trade creation is welfare improving, as consumers substitute lower-cost beneficiary imports for goods produced at home. Trade diversion, on the other hand, will decrease welfare, as a more efficient source of imports will be displaced by a higher-cost producer.

**Table 5** Trade Creation, Trade Diversion and Total Trade Effects of the EAC

Country	Trade creation		Trade diversion		Total trade effects	
	\$ '000	% <sup>a</sup>	\$ '000	% <sup>b</sup>	\$ '000	% <sup>a</sup>
In Kenya	121	0.6	345	0.01	466	2.5
In Tanzania	1,090	0.9	2,894	0.2	3,985	3.2
In Uganda	5,809	1.6	6,607	0.7	12,416	3.4
Total	7,020	1.5	9,846	0.5	16,867	3.3

<sup>a</sup> Of preferred imports.

<sup>b</sup> Of non-preferred imports

To check for the robustness of these results, we could, for instance, double both the assumed values for the elasticities of substitution and import demand to 4.0 and 1.0, respectively. As a consequence, trade creation and diversion would double as well.<sup>7</sup> Hence, we have to keep in mind that the assumptions regarding both elasticities are crucial for the expected trade effects. Even though the assumed values for both elasticities are well within the range of estimates for other developing countries, they are still crude assumptions and may contain a bias.

To see which of the three EAC countries benefits most from the preferential trade liberalisation, trade creation and diversion effects have been analysed at the country level (tables 6 and 7). In both cases Kenya profits most, with shares of 95 and 91 percent of total trade creation and diversion, respectively. This result is clearly due to the relatively high export share of Kenyan exporters within the EAC.

**Table 6** Distribution of Trade Creation Effects of the EAC

Country	Kenya		Tanzania		Uganda		Total trade creation	
	\$ '000	% <sup>a</sup>	\$ '000	% <sup>a</sup>	\$ '000	% <sup>a</sup>	\$ '000	% <sup>a</sup>
In Kenya			97	81	24	19	121	100
In Tanzania	1,042	96			48	4	1,090	100
In Uganda	5,624	97	185	3			5,809	100
Total	6,666	95	282	4	72	1	7,020	100

<sup>a</sup> Of total trade creation.

**Table 7** Distribution of Trade Diversion Effects of the EAC

Country	Kenya		Tanzania		Uganda		Total trade diversion	
	\$ '000	% <sup>a</sup>	\$ '000	% <sup>a</sup>	\$ '000	% <sup>a</sup>	\$ '000	% <sup>a</sup>
In Kenya			277	80	68	20	345	100
In Tanzania	2,782	96			112	4	2,894	100
In Uganda	6,221	94	386	6			6,607	100
Total	9,003	91	663	7	180	2	9,846	100

<sup>a</sup> Of total trade diversion.

Apart from the overall trade effects, there are considerable differences at the product level in all three East African countries (tables 8 to 10). At the two-digit level of the SITC, trade effects of up to 17 percent can be expected. On the other hand, there is no strong pattern of particular commodity groups that are affected most by the agreement. The commodity groups are rather scattered, as a large variety of different products are affected in all three EAC countries.

**Table 8** Products in Kenya Most Affected by the EAC

Product category (SITC no.)	Trade creation		Trade diversion		Total trade effects	
	\$ '000	in % <sup>a</sup>	\$ '000	in % <sup>b</sup>	\$ '000	in % <sup>a</sup>
Furniture (82)	0.5	1.9	1.4	0.0	1.9	7.7
Manufactures of metals (69)	0.8	1.9	2.4	0.0	3.2	7.7
Nonmetallic mineral manufactures (66)	3.3	1.8	9.9	0.0	13.2	7.0
Rubber manufactures (62)	2.2	1.7	6.6	0.0	8.8	6.8
Paper and articles of paper (64)	0.1	1.7	0.3	0.0	0.4	6.8
Sugars, sugar preparations and honey (06)	0.3	1.7	0.8	0.0	1.1	6.8
Articl. of apparel & clothing accessories (84)	0.2	1.7	0.5	0.0	0.6	6.8
Footwear (85)	0.3	1.7	0.8	0.0	1.1	6.7
Dairy products (02)	0.3	1.7	0.9	0.0	1.2	6.7
Miscellaneous manufactured articles (89)	3.0	1.7	9.0	0.0	12.0	6.7

<sup>a</sup> Of preferred imports.

<sup>b</sup> Of non-preferred imports.

**Table 9** Products in Tanzania Most Affected by the EAC

Product category (SITC no.)	Trade creation		Trade diversion		Total trade effects	
	\$ '000	in % <sup>a</sup>	\$ '000	in % <sup>b</sup>	\$ '000	in % <sup>a</sup>
Beverages (11)	7.6	4.3	22.4	0.3	30.0	17.1
Oilseeds and oleaginous fruits (22)	0.1	2.4	0.3	0.0	0.4	9.5
Travel goods, handbags (83)	1.1	2.4	3.1	0.1	4.2	9.5
Fish (03)	0.2	2.4	0.6	0.1	0.8	9.4
Furniture (82)	8.0	2.4	23.2	0.2	31.1	9.3
Sugars, sugar preparations and honey (06)	19.6	2.4	56.9	0.2	76.5	9.2
Cork and wood (24)	0.1	2.3	0.3	0.1	0.4	9.1
Vegetables and fruit (05)	3.3	2.3	9.7	0.2	13.1	9.0
Articl. of apparel & clothing accessories (84)	6.9	2.2	20.4	0.1	27.4	8.9
Coffee, tea, cocoa, spices (07)	2.6	2.4	6.9	0.9	9.5	8.6

<sup>a</sup> Of preferred imports.

<sup>b</sup> Of non-preferred imports.

**Table 10** Products in Uganda Most Affected by the EAC

Product category (SITC no.)	Trade creation		Trade diversion		Total trade effects	
	\$ '000	in % <sup>a</sup>	\$ '000	in % <sup>b</sup>	\$ '000	in % <sup>a</sup>
Fish (03)	1.0	2.8	2.8	0.3	3.8	11.0
Travel goods, handbags (83)	6.3	2.8	18.0	0.4	24.3	10.9
Vegetables and fruit (05)	22.9	2.8	61.3	0.9	84.2	10.4
Furniture (82)	22.7	2.8	60.0	1.0	82.8	10.3
Prefabricated buildings (81)	10.8	2.6	30.5	0.4	41.3	10.0
Articl. of apparel & clothing accessories (84)	54.4	2.7	145.0	0.9	199.4	9.9
Sugars, sugar preparations and honey (06)	45.8	2.6	121.5	0.9	167.3	9.6
Footwear (85)	84.8	2.8	199.7	1.8	284.6	9.4
Road vehicles (78)	138.0	2.4	393.4	0.4	531.4	9.3
Dairy products (92)	21.0	2.8	46.7	2.2	67.7	9.1

<sup>a</sup> Of preferred imports.

<sup>b</sup> Of non-preferred imports.

In a further analysis, the trade effects of the new external tariff of the customs union were computed. The new external tariff applies to all three EAC countries, regardless of individual national tariff rates at the moment. It has been agreed to apply a tariff rate of zero percent for primary raw materials, essential drugs, medical equipment, plant and agricultural inputs, 10 percent for intermediate goods/inputs and 25 percent for finished goods for imports. These tariff rates apply for all imports from outside the EAC.

As table 11 illustrates, the new tariff structure will lead to a decline in total extra-EAC imports by US\$211 million, or 4.1 percent. The relative decline in total imports is particularly large in Tanzania and Uganda, where imports will decrease by -4.6 and -5.4 percent, respectively. This outcome is clearly due to the fact that both countries would have to raise their overall tariff levels vis-à-vis the rest of the world considerably.

**Table 11** Total Trade Effects Due to New External EAC Tariff

Country	<i>Total trade effects</i>	
	\$ '000	% <sup>a</sup>
In Kenya	-61,184	-2.0
In Tanzania	-95,371	-4.6
In Uganda	-54,164	-5.4
Total	-210,719	-4.1

<sup>a</sup> Of non-preferred imports.

Finally, both trade projections, trade creation and diversion on the one hand and the introduction of a new external EAC tariff on the other, were put together to see their combined impact on total exports, imports and the respective trade balances of all three EAC countries (table 12). The trade balances of all three East African countries are likely to improve significantly, due to lower imports from outside the EAC and improved exports within the EAC. Interestingly, based on our results, the trade balance of Tanzania will improve even more than that of Kenya, thereby failing to substantiate fears that the implementation of the new customs union could lead to a deterioration of the trade balance in that country.

**Table 12** Changes in Exports, Imports and Trade Balance Due to EAC Trade Liberalisation and New External EAC Tariff (\$ '000)

Country	Exports <sup>a</sup>	Changes in	
		Imports <sup>b</sup>	Trade balance
In Kenya	15,669	-61,063	76,732
In Tanzania	945	-94,281	95,226
In Uganda	252	-48,355	48,607
Total	16,866	-203,699	220,565

<sup>a</sup> Total trade creation + total trade diversion for each country.

<sup>b</sup> Total trade effect due to new external EAC tariff + trade creation for each country.

The main results of this article can be summarised as follows: First, the relative size of the estimated trade effects shows that fears in both Tanzania and Uganda about negative trade balance effects following the completion of the EAC customs union seem to be misguided. Second, Kenya is likely to profit most from the liberalisation of intra-EAC trade. Tanzania and Uganda, on the other hand, will gain less from

completing the customs union. Yet their trade balances will improve overall due to the higher level of the new external EAC tariff. In fact, the relatively high new external tariff will lead not to trade liberalisation, but to more trade restrictions vis-à-vis countries outside the customs union. Third, at the product level there are considerable differences among the three East African countries. There is no strong pattern of particular commodity groups that are affected most by the customs union. The commodity groups are rather scattered, as a large variety of different products are affected in all three EAC countries.

On the face of it, the results with respect to changes in trade balances in all EAC countries are at odds with recent findings by Venables (2003), who analysed the benefits and costs of a customs union for member countries in a Ricardian trade model and a Heckscher-Ohlin framework. According to his results, low-income countries are much better served by “north-south” than by “south-south” customs unions, as integration between developing countries tends to lead to divergence of member country incomes; that is, Tanzania and Uganda may indeed experience a welfare decline. In line with Venables’ results, our results show that Kenya is likely to benefit from the EAC customs union; however, Tanzania’s and Uganda’s trade balances will improve due to the new (higher) external tariff. Nevertheless, individual firms or industries in both countries may lose under the preferential agreement.

## **5. Policy Implications and Concluding Remarks**

Given the results of our calculations, it is not easy to explain the persistence of fears of severe trade imbalances due to the establishment of the EAC customs union or, therefore, to justify the case for a transitional fund. All in all, potential losses due to the establishment of the customs union would be small and could easily be absorbed by proper adjustment mechanisms. Apart from historical experience, one reason a case has been made for a transitional fund may be the influence of stakeholders on the regional integration policy in East Africa.<sup>8</sup> According to Maasdorp (1999), who compiled a report on that issue for the EAC Secretariat, there is a strong perception in both Tanzania and Uganda that their manufacturing sectors would not be able to compete with Kenyan producers in a customs union.

In annex IV of his report, Maasdorp cites a local consultant’s perspective on Tanzania, assessing the perception of Tanzanian business regarding EAC free trade. Major trade imbalances between the partner states, particularly between Kenya and Tanzania are seen as the main problem and challenge facing the EAC. The Tanzanian industrialists share the view that “the imposition of zero internal tariffs would generate trade creation and trade diversion effects in Kenya’s favour which would

further widen the trade imbalance in Kenya's favour" (Maasdorp, 1999, 143). From the Tanzanian industrialists' point of view, a real danger exists that the EAC will collapse if the issue of trade imbalances between Kenya and Tanzania is not properly addressed. The report by Maasdorp does not contradict these views, and it recommends establishing a regional fund.

In general, the envisioned benefit of a transitional fund exists in compensating those who lose from economic integration. In the case of considerable losses such a fund may in fact ease the political and economic process of integration. But even in this case, a transitional fund is not without drawbacks. To begin with, its establishment is likely to increase administrative costs. A bureaucracy has to be set up and transaction costs for all parties involved may rise. This reduces the total amount of money that can be redistributed toward declining sectors. Also, the fund may produce a sectoral bias in favour of uncompetitive sectors and firms. Allowances may be paid under the condition that the respective firms adjust and improve their competitiveness, but in the case where this does not work, scarce funds for economic development would be wasted. Finally, the fund may lead to rent-seeking activities and to an increase in corruption. Even firms not suffering from increased import competition from partner states would be stimulated to use the transitional fund. This would lead to a growth of the fund activities, and the institution might easily get out of control and thus harm economic activities in the East African partner states.

To sum up, based on the results presented in this paper, a transitional fund is not only unnecessary in the case of the EAC, but if established could become a source for rent seeking and corruption. The implementation of the customs union should not be impeded by fears related to the expected trade effects.



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## Endnotes

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1. This applies to customs duties at the tariff line level. Import-weighted tariffs at the two-digit level of the Standard International Trade Classification, however, can differ from the overall level of trade liberalisation, as table 1 shows.
  2. For estimating the effects of dismantling trade barriers, other studies have used gravity models, which focus on bilateral trade flows between partner countries. See Musila (2004) and Ghosh and Yamarik (2004) for more recent studies using gravity models.
  3. It can be shown that Verdoorn's model is a simplified version of the more general partial equilibrium model of Clague (1971, 1972). See Busse (1996) and Busse and Koopmann (2002) for details.
  4. See the technical annex for a more formal explanation of Verdoorn's model.
  5. See Sawyer and Sprinkle (1999) for a survey of trade elasticities.
  6. The concordances can be found in United Nations (1986).
  7. See also the appropriate equations (6) and (7) in the technical annex.

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8. Examples of such stakeholders are the Confederation of Tanzania Industries, the Kenya Association of Manufacturers, Uganda Manufacturers Association and Chambers of Commerce and Industry.

The technical annex to this paper, pages 81-83 is available as a separate document.

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