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**Working Paper**

## Getting the Best out of Regional Integration: Some Thoughts for Rwanda

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# Getting the Best out of Regional Integration: Some Thoughts for Rwanda\*

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## Executive Summary

Rwanda has made much progress towards integrating into the world economy, with yearly export growth rates close to 20%. However, largely because of being landlocked, Rwanda is still isolated from many trading partners and, because of the low share of trade in GDP, exports do not contribute much to overall growth. In its Vision 2020, the GOR decided to push for the "Promotion of Regional Economic Integration and Cooperation". This paper argues that this was, and continues to be, the right strategy to pursue. ... / ...

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## Executive Summary

Rwanda has made much progress towards integrating into the world economy, with yearly export growth rates close to 20%. However, largely because of being landlocked, Rwanda is still isolated from many trading partners and, because of the low share of trade in GDP, exports do not contribute much to overall growth. In its Vision 2020, the GOR decided to push for the “Promotion of Regional Economic Integration and Cooperation”. This paper argues that this was, and continues to be, the right strategy to pursue. At a deep level, a regional trade bloc like the EAC is good politics as it provides security and helps countries develop greater trust in each other. Rwanda will derive two benefits from the greater trust that goes with the promotion of regional economic integration and cooperation. First, the importance of the potential political benefits of pursuing preferential regional integration should not be underestimated in the light of the conflicts in the region’s recent history. Second, when countries trade more, as they do when they are engaged in preferential trading relationships, they are more likely to accept the necessary delegation to a regional body to set up the institutions at the regional level that will help deliver much-needed regional public goods. In the EAC, regional public goods include the management of Lake Victoria, and for Rwanda, the management of the region’s transport infrastructure.

Improved politics and enhanced delivery of public goods are the benefits to be expected from Rwanda’s choice to promote regional integration by membership first in COMESA, then in the EAC. These benefits extend beyond ‘market access’. So far, however, regional integration has not gone beyond granting reciprocal market access through the elimination of tariffs and the adoption of a Common External Tariff (CET) with membership in the EAC. This is normal because building the trust necessary to develop regional institutions takes a long time. Notably, limited success has been achieved in eliminating non-tariff-barriers (NTBs), even those that all members agree should be easy to eliminate (those classified under category 'A' by the EAC). In sum, so far regional integration has involved the ‘easy’ first stage: exchange market access which has benefits (access to the partners’ markets) and costs (access by partners to your markets when, as in the case of the EAC, the partners are not efficient trading partners). Rwanda being a small player in COMESA and in the EAC has benefitted little from access to its partners’ markets because it is a high cost producer once transport to its partners’ markets are taken into account. When the CET and the accompanying exceptions (the so-called ‘sensitive items’ list) was established for the EAC, it reflected mainly the interests of producers in Kenya, the country with the most developed, yet largely inefficient, manufacturing sector, which grew under protection to supply the internal market. In the end, protection is high in the EAC: profitability in exporting beyond the region is limited and as a result, the EAC has one of the lowest shares of internal and external intra-industry trade. This serves as evidence that the region has not taken part in the global outsourcing of economic activity.

Because Rwanda can expect little from the exchange of market access under present conditions, 'deep' integration is necessary for regional integration approach to live up to expectations and deliver measurable economic benefits for Rwanda in the medium term. The report argues that Rwanda should push for 'deeper' regional integration. That strategy could be built under three high-returns pillars, the first two involving largely all-round gains for EAC members because they mostly involve reductions in costs.

First, all EAC partners, and Rwanda in particular, should push for the removal of NTBs within the EAC Community and also prevent the imposition of new ones, as has happened recently. Removal of NTBs include those at the border such as non-automatic licensing, but also 'behind-the-border' measures such as the lack of recognition of mutually agreed technical standards by partners, mutual recognition of standards where they are different or harmonization (axle weights on trucks). Some of these NTBs like non-automatic licensing can be removed unilaterally, but others like standards require cooperation at the regional level and it is here that pushing for 'deep' integration at the regional level will bring greatest benefits in the form of reduced transport costs, and transaction costs for all partners.

Second, opening the regional market to trade in professional services would be beneficial to all members in the Community because of the possibility of reducing many existing barriers to increase competition, and exploit economies of scale and comparative advantage in what is a small market at the regional level. Particularly relevant is that the dominant mode of cross-border supply in many services is commercial presence (mode 3), which means that services continue to be produced locally, thereby reducing adjustment costs and making liberalization less politically costly. For Rwanda, which already has relatively few restrictions on services trade in the EAC, the expansion of services trade is particularly appealing because remoteness in itself is not a severe handicap as it is in the market for goods where transport costs are high. While the expansion of trade in services in the EAC is contingent on the removal of barriers in partner countries, developing regulatory cooperation at the regional level to reduce the current regulatory heterogeneity would produce large gains.

Third, because protection is still high and because Rwanda has a small market, it needs to push for lower tariff protection. A first step would be to push for a lower common external tariff (CET) and fewer exceptions that largely benefit other EAC partners. A second step would be to make up for the missed opportunity when the interim EPA (the Framework EPA – FEPA) was negotiated. The EPA calls for tariff elimination on 80% of imports from the EU to be completed by 2033. Moving this completion date forward by at least a decade would foster much needed competition in the EAC goods market.

## ***1. Introduction***

In 2000, the GOR launched “Vision 2020”, an ambitious development strategy aiming at moving the country up the development ladder from low-income to lower-middle income status. The strategy is articulated around six pillars, one of which calls for the “Promotion of Regional Economic Integration and Cooperation” (GOR, July 2000, p. 2). In this paper, we review Rwanda’s progress with its regional integration strategy, taking as point of departure that the recent history of political conflicts in the region are sufficient to warrant elevating regional integration to the status of a pillar in Rwanda’s development strategy.

Two main conclusions and one recommendation emerge from our review (other findings are also summarized as numbered conclusions throughout this report). Our first-- hardly surprising--conclusion is that, for a small landlocked economy with one of the highest trade costs in the world, exporting is essential. Nurturing its economic relations with its geographically close partners that are themselves integrated on a preferential basis is necessary, if only not to deny oneself market access, and more importantly to reduce transport costs within the region and with the outside world.

Our second conclusion is that, so far, the regional strategy has yet to live up to expectations. With respect to membership in the EAC, integration has not been very ‘deep’, extending only to the removal of tariffs. Little progress has taken place on non-tariff barriers (NTBs) whose trade-reducing effects are stronger than those coming from the tariffs that have been eliminated on regional trade as part of implementing the COMESA and EAC FTAs. But this integration comes with administrative obligations and their associated costs that this paper spells out. With respect to the interim EPA negotiated by the EAC with the EU, through the negotiations at the Community level, Rwanda has missed the opportunity to liberalize its trade with the EU while, in terms of market access, it is gaining negligible access to the EU since it was already benefitting from duty-free, quota-free access under the EU’s Everything but Arms (EBA) initiative.

Our recommendation is that Rwanda should push for ‘deeper’ regional integration. Three aspects of that strategy would have high payoffs. First, all EAC partners, and Rwanda in particular should push for the removal of NTBs within the EAC Community. This will reduce transport costs and transaction costs in general. Second, opening the regional market to trade in professional services would be beneficial to all members in the Community, but particularly for Rwanda since remoteness in itself is not as severe a handicap as it is in the market for goods where transport costs are high. Third, if possible, Rwanda should push for a lower CET. The first two aspects of this strategy will benefit all EAC members since they would result in a reduction in costs. This last recommendation will be opposed by the vested interests of producers in other EAC countries that benefit from the rents associated with the CET, particularly the higher tariffs on the “sensitive items” list which are costly to Rwanda.

Section 2 reviews the many reasons, including diplomacy that may lead a country to enter into a preferential trade agreement. Having acknowledged the importance of these (largely non-quantifiable) reasons for Rwanda entering into an agreement with its trading partners, the report then focuses on the economic aspects of Rwanda’s membership in multiple trade agreements. Section 3 reviews the web of regional trading arrangements (RTAs) Rwanda is engaged in, noting some of the extra administrative burdens and costs associated with these agreements and the need to pursue ‘deep’ integration at the regional level. While these costs do not justify abandoning the regional approach to integration, it serves to remind the authorities that the gains from

‘deeper’ integration are necessary to offset some of the costs associated with the regional approach. Section 4 elaborates the point that in Rwanda the bias against exporting activities is significant. Producers have an incentive to produce for the domestic market as opposed to the export market because of very high trade costs, some due to policy-imposed NTBs. Section 5 reviews the state of non-tariff measures (NTMs) in the EAC. Section 6 carries out a cursory cost-benefit appraisal for Rwanda of belonging to the EAC customs union (as opposed to the alternative of belonging only to the COMESA FTA). Finally, section 7 explores ways in which ‘deep’ regional integration would bring the promised benefits of this RTA strategy.

## ***2. The Politics and Economics of Regional Trade Agreements (RTAs)***

Traditionally, RTAs have been analyzed in terms of the effects that tariff preferences have on trade flows between partners and non-partners. However, regional trade blocs always have multiple objectives, here summarized under the rubric of politics. These objectives include democracy and human rights (SADC and MERCOSUR Treaties) regional cooperation and coordination (ASEAN), expanding foreign direct investment (COMESA) and the development of least-developed members (SACU).<sup>1</sup>

Establishing a regional trade bloc also extends beyond security: if countries know each other better, notably because they trade more, they are more likely to have greater trust in each other (even if it is neighbouring countries that typically go to war). As a result, countries are more likely to accept the necessary delegation to a regional body (referred to as the principle of subsidiarity in EU law) to build institutions at a regional level that will help deliver regional public goods.<sup>2</sup>

Recent developments in FTAs around the world support the view that economics and politics are complements rather than substitutes, as argued by the defenders of multilateralism - e.g. Bhagwati (2008). The reasoning is simple: because FTAs augment the volume of trade, they should reduce the probability of war. As political scientists have argued, when FTAs are sufficiently ‘deep’ in the sense that they go beyond the elimination of tariffs among partners, institutions are created within which countries not only negotiate trade issues, but also attempt to diffuse political disputes that could escalate into political conflicts. In addition, if there are trade gains, the opportunity cost of conflict is higher (and conversely multilateral trade openness that reduces trade dependence on neighbours reduces the opportunity cost of conflict).<sup>3</sup>

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<sup>1</sup> See the discussion in Schiff and Winters (2004, chp. 1). The most famous example of the primacy of politics is the establishment of the European Steel and Coal Community (ESCC), established between France and Germany in 1951 as a precursor to the European Common Market with specific objective to prevent France and Germany from entering into another conflict. Shortly before the signing of the ESCC, Robert Schuman, then French Minister of Foreign Affairs said “Through the consolidation of basic production and the institution of a new High Authority, whose decisions will bind France, Germany and the other countries that join, this proposal represents the first concrete step towards a European federation, imperative for the preservation of peace.”

<sup>2</sup> Subsidiarity indicates that decision-making jurisdiction should coincide with a public good’s spillovers (multilateral institutions for transnational public goods, regional institutions for regional public goods (like infrastructure especially for landlocked countries) and national institutions for national public goods. Sandler (2006) provides many examples of regional public goods.

<sup>3</sup> The supporting evidence is in Martin et al. (2008) who also show that countries that had a recent conflict are less likely to enter into an FTA as confidence needs to be rebuilt.

Given the prevalence of conflict in the region's recent history, the political benefits of pursuing preferential regional integration should not be underestimated. This is why an introduction to a forthcoming handbook on preferential trade agreements is entitled "Beyond Market Access" (Chauffour and Maur eds, 2011) or, as put by GOR in Vision 2020, promoting 'regional integration and cooperation' (underline added).

This paper recognizes the importance of the politics of FTAs, which are often diffuse and take a long time to show visible signs in the form of the provision of effective regional institutions. It takes these benefits for granted and instead concentrates on the nearer term. The objective is to identify the policy decisions that are likely to insure that economic integration goes sufficiently beyond simple preferential market access to reap positive economic effects.

Cooperation at the regional level is necessary for the provision of public goods in the region that require subsidiarity. For Rwanda, the development of the rail and road transport networks is the most essential. The provision of these regional public goods requires the provision of both 'hard' infrastructure and supportive 'soft' infrastructure in the form of an appropriate regulatory framework that can only be developed at the regional level.

### ***3. Rwanda's Multiple Membership in Regional Trading Arrangements***

Since the mid-1990s, Rwanda and other countries in the East and Southern Africa region have entered into a number of Regional Trading Arrangements (RTAs) while at the same time reducing their barriers to trade. Kenya, the second most advanced industrialized country in the region, has progressively turned away from the inward-oriented policies that had hitherto stifled growth. As of July 2000, along with Tanzania and Uganda, Kenya entered into a revival of the East African Community (EAC) which, as shown below, is very close to achieving full customs union status, with a three-band tariff of 0% for raw materials and capital goods, 10% on intermediate goods and 25% on consumer goods, albeit with some national and regional exceptions (the so-called "sensitive items", SI list).

Burundi and Rwanda joined the EAC in July 2007. As explained in section 6, this implied changes in the rules governing Rwanda's trade policy, and the adoption of the CET. As Rwanda had much lower tariffs on the products included on the SI list, joining the EAC meant an increase in tariffs on these products, which amounted to close to 25% of the value of Rwanda's imports in 2006.

Rwanda and the other EAC members (except for Tanzania) are also members of the COMESA Free Trade Area (FTA), which achieved free trade status among most of its members by 2008. In 2007, the COMESA secretariat declared it would also move to a customs union, with a four-band tariff. However, it is generally agreed that a COMESA customs union will not be operational in the foreseeable future. Additionally, member states are discussing the creation of the COMESA-SADC-EAC Tripartite FTA, which will present additional challenges as SADC joins with very different rules of origin.<sup>4</sup>

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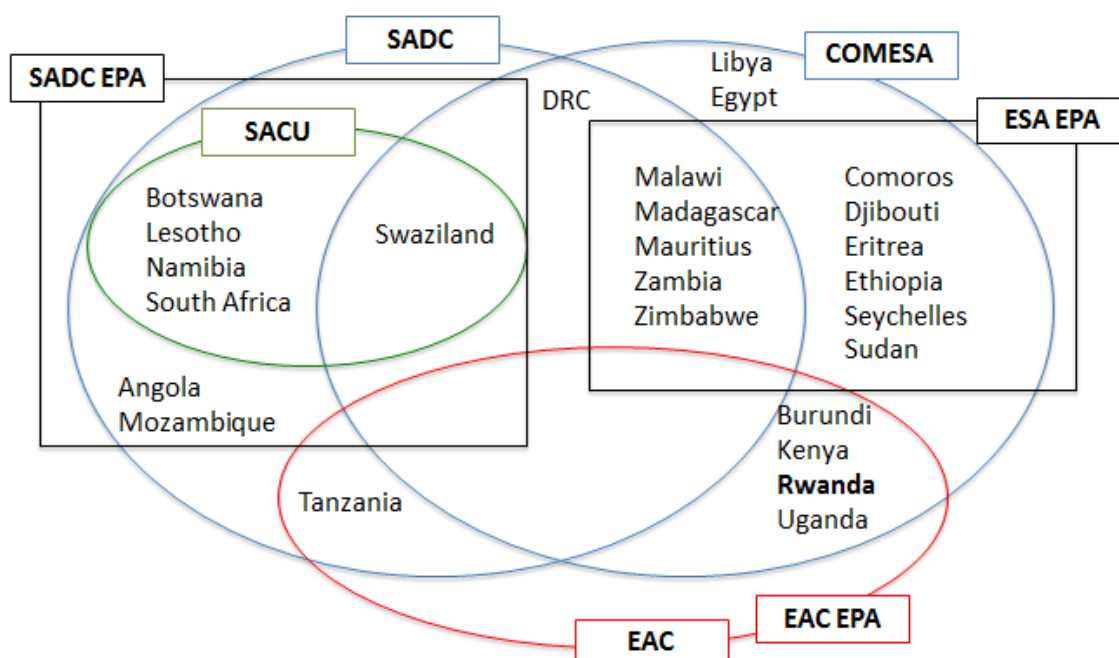
<sup>4</sup> There is no region-wide exception list for COMESA's planned CU, though this is the ultimate goal; each country has been asked to submit a list of exceptions. The allocation of products to product categories was concluded in 2009. For all practical purposes, the EAC is in effect a Customs Union while COMESA is still an FTA.

Indeed, while the COMESA CU was officially launched by Heads of State and Government in July 2009, the common tariff nomenclature (CTN) and common external tariff (CET) have not



Figure1 shows the web of RTAs in the Eastern and Southern Africa region. It is clear that there is much overlap and potential for inconsistent policies, notably for the EAC-5 since all but Tanzania are also COMESA members. Being part of a customs union, at the most basic level these members should apply the CET to all non-members, and if COMESA members are somehow given preferential access to the EAC, customs officials will have to check that goods entering from COMESA members are really originating in COMESA. While the free circulation of goods has not yet been achieved by the EAC as the CET is levied by the country of final destination, the move to collection at first point of entry would make it difficult for EAC countries to maintain divergent trade policies with third parties, including SADC and COMESA.

**Figure 1: Overlapping PTAs in the ESA Region**



Source: Authors

Figure1 also shows that Rwanda has participated in the interim Economic Partnership Agreement (EPA) negotiations with the EU, discussed in further detail in section 7.4.<sup>5</sup> There is great diversity across African countries in the outcome of the different EPA negotiations with respect to timing, the speed of tariff reduction, and products excluded from liberalization. At one extreme, Mozambique and Côte d'Ivoire started to liberalize

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yet been implemented by any country. Observers agree that the COMESA CU rhetoric (and its potential implementation) will continue until a politically palatable way to shelve the CU is found. This could be the Tripartite FTA (COMESA-EAC-SADC), but it is not clear how this will proceed, in part because SADC FTA Rules of Origin (ROO) are far more restrictive than COMESA/EAC FTA ROO. As argued by many and as evident from the differences in interests among members (eg. Egypt with high protection and Mauritius with low protection), it seems unlikely that the EAC countries will join the COMESA CU as the two CETs differ, though COMESA Secretariat insists that the two CETs have been harmonized.

<sup>5</sup> The EAC-EU interim EPA was initialled in November 2007 - <http://www.acp-eu-trade.org/index.php?loc=epa/background.php>. However, it was not concluded by the self-imposed deadline of November 2010 as several divergences of views prevail.

immediately in 2008 with most liberalization up-front, the ‘cold-shower’ approach. At the other extreme, the EAC does not start reducing tariff on EU imports until 2014, with tariff reductions taking place over 19 years ending in 2033.

These differences in the timing of liberalization across groupings likely represent the strength of private sector interests that want to maintain a status quo that is favourable to them. While tariff-reductions are typically spread over less than 10 years (NAFTA, MERCOSUR, various enlargements of the EU), EPA tariff-reductions are usually spread over twice as long a period, while at the same time excluding a significant portion of bilateral trade. This calls the credibility of liberalization under the EPAs into question.

It is highly probable that the EPA schedules will be interpreted as ‘the indefinite future’, and it is hard to believe that the EAC viewed these negotiations as an opportunity to speed up their integration into the world economy. This is despite the fact that the abolishment of the triple transformation rule on textiles and clothing would probably not have occurred without the EPA negotiations, and this clearly represents market access for all countries engaged in the EPA negotiations.

As developed further in section 6, belonging to RTAs presents benefits and costs. On the benefits side, RTAs allow countries to progress more rapidly towards free trade with their partners. This is certainly the case for Rwanda, for whom EAC members account for 25-30% of Rwanda’s trade.<sup>6</sup> More importantly, an RTA allows countries to pursue “deep integration” i.e. to implement a host of behind-the-border measures that facilitate trade, measures that range from the removal of non-tariff barriers (NTBs), to the harmonization of standards and investment measures and the removal of barriers to trade in services (movement of persons and of other services)<sup>7</sup>. Thus if integration is “deep”, i.e. if it goes beyond the reduction of tariffs that were already achieved by the COMESA FTA by reducing transaction costs among members, the benefits from regional integration could be greater than the benefits obtained from multilateral negotiations. Indeed, because Rwanda is landlocked, a regional approach is necessary to reduce transport costs.

However, if regional integration is “shallow” i.e. mostly confined to the removal of tariffs, the risks of efficiency losses are substantial since this may result in tariff revenue and welfare losses as low-cost imports from the rest-of-the-world are replaced by higher cost imports from the partners that do not pay duties. Such efficiency losses can be important when the trading partners account for a large share of total trade, as is the case for Rwanda. When Rwanda joined the EAC, EAC members accounted for close to half of its total trade.

This last observation about the costs of “shallow” integration raises the issue of how to best allocate the country’s scarce human knowledge on trade policy to defend Rwanda’s trade interests. Indeed, a recent estimate by the High Level Trade Experts Group (2011) estimates that the benefits from the successful conclusion of the Doha Round would be equivalent to 2% of GDP for SSA countries, half the annual flows of ODA. For landlocked countries, the negotiations on article V about the right of Transit are of particular interest, and the resources that land-locked countries have not devoted to the negotiation in

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<sup>6</sup> According to RRA figures for 2010.

<sup>7</sup> Rwanda was the first EAC member to abolish working permits for citizens of the EAC to promote free movement of labour.

Geneva to defend these interests might result in a missed opportunity.<sup>8</sup> While the full conclusion of the Doha Round now seems unlikely, it is important to ensure that Rwanda's interests are secured in any partial agreement reached.

**Conclusion #1: Rwanda is party to many overlapping RTAs. The EAC CU does not lead to greater market access for Rwanda than what it had under the COMESA FTA. Likewise, the interim EPA is not providing more market access to Rwanda (beyond simpler rules of origin for textiles) than what it already had under the EU's "Everything but Arms" (EBA) preferences. Rwanda needs to factor in the costs associated with implementation (e.g. rules of origin) of the multiple RTAs it is engaged in. To fulfill its promise, the regional integration strategy has to be 'deep', extending beyond the reduction in tariffs already achieved under the COMESA FTA.**

#### ***4. Why Producing for Export is Less Profitable in Rwanda***

Being landlocked makes it unprofitable to produce for export relative to producing for the domestic market. This makes it difficult to implement export strategies. Leaving aside the traditional exports (tea, coffee and minerals), when a Rwandan producer makes a decision about production, he compares the profitability of alternatives and chooses the most profitable. Typically, this will be between producing for the domestic market, the regional market (EAC), and for sale overseas.

##### **4.1 The Bias against Exports**

A simple stylized example illustrates how tariffs, NTBs and transport costs combine to create a powerful bias against production for export in Rwanda. The first column of table 3 below shows how notional levels of tariffs, NTBs (shown in ad valorem equivalent) and transport costs conspire to allow local producers to charge a price 65% above the price at the border. The price calculated in this column is essentially the price that international competition would be able to offer.

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<sup>8</sup> The legal aspects of trade facilitation are covered in GATT 1994 under Article V (Freedom of Transit), Article VII (Fees and Formalities Related to the Import and Export) and Article X (Publication and Application of Rules Related to International Trade) The ongoing negotiations on trade facilitation (TF) at the WTO, especially those around Article V on Freedom of Transit, are of great interest to LLDCs. Implementation of these principles is one way to overcome "landlockedness." Article V requires each WTO member to allow free movement of goods, vessels, and other means of transport through its territory, destined to or coming from any other WTO member. Such transit must be allowed via the routes most convenient for international transit. GATT Article V also requires equal treatment of traffic in transit, independent of the flag of the vessel, the point of origin or departure, entry, exit, destination, or ownership of the goods and vessels. Traffic in transit must not be subject to unnecessary delays or restrictions, and must be exempted from customs and transit duties (countries can charge fees for administrative expenses incurred by the transit).

The Freedom of Transit is, however, limited by the right of the State to set the conditions or requirements for granting transit rights. LLDCs are especially concerned about Article V, which recognizes that Freedom of Transit is compromised by burdensome and lengthy procedures. Article V rules have never been interpreted by a WTO panel, so the current trade facilitation negotiations at the WTO represent an opportunity to clarify and improve the provisions "to further expedite the movement, release and clearance of goods, including goods in transit." The negotiations aim to make Article V operational and to address the special needs of the LLDCs adopted in the 2003 Almaty Program of Action. A successful outcome to these negotiations would offer an opportunity for LLDCs and transit countries to benefit from technical assistance, capacity building, and in some cases support for infrastructure development, which will assist members to comply with new WTO commitments. Rwanda may carry little weight in these negotiations, yet, along with other LLDCs, it would benefit greatly from successful negotiations at the WTO.

**Table 3: Comparing Domestic and Export Incentives**

	Local market	Export market
World price	100	100
Tariff (25%)	25	
NTB ad valorem equivalent –		
AVE (20%)	20	-20
Transport (20%)	20	-20
Total	<u>165</u>	<u>60</u>

Source: Authors

The second column shows the contrasting position of exporters, who receive only 60% of the border price as a result of NTBs and transport costs. This is a generous estimate since it assumes a zero import tariff in the export market. Furthermore the NTB and transport costs used for simplicity here are far below those that have been estimated to hold in reality.

In this conservative example an exporter receives only 36% of the revenue that the producer for the local market does. As such, selling on the regional market relative to selling at home is not particularly attractive. It is also likely to be the case that, in spite of preferential access, the Rwandan exporter may still be at a disadvantage relative to foreign MFN competitors because market access over MFN suppliers is small relative to the other barriers to trade described here.

The importance of trade costs for African countries, and for landlocked countries in particular, have been brought to light in a recent study by Freund and Rocha (2011) based on the World Bank's Doing Business data. The study compares the costs in terms of time of shipping a standard 20 foot container from 147 countries with the same categories of goods that do not require special conditions (e.g. phytosanitary or environmental standards).

The importance of trade facilitation comes out clearly from the statistically significant and robust estimates in their study: a one day increase in transit time reduces a country's export value by 7 percent (the estimate is higher for time-sensitive products). Alternatively, a one day reduction in inland travel time is equivalent to a 2 percentage point decrease in all importing-country tariffs. Furthermore, their estimates show that travel time related to distance (measured by GPS) has no effect on trade volumes, but that the time delays due to bureaucratic and other institutional delays reduce the value of trade significantly after having controlled for the usual variables (e.g. distance), illustrating that it is institutional quality rather than geography that represents the greatest barrier to trade for African countries.

These crude estimates calculation based on some of the estimates given below lead to four observations:

- Preferential market access in the EAC is of small value relative to other costs
- The high trade costs explain the low trade shares in GDP for the landlocked EAC countries (a point we return to below)
- Reducing policy-imposed NTBs regionally is win-win since costs are reduced for the EAC partners exporting to Rwanda and for the Rwandan producers

exporting to EAC partners, benefits that are not extended to MFN partners that would still face at least some of the NTBs

- Continuing to reduce trade costs will have a high payoff in terms of increasing the attractiveness of producing for the export market.

Even compared with other landlocked countries, Rwanda's transports costs are extremely high. The results of the Corridor Development Study (table 4 below) confirm this fact – importing a container to Kigali costs roughly twice as much as Kampala, and three times as much as Nairobi.

**Table 4: Northern Corridor Performance for Imports by Cargo Type and Destination, 2010 (via road)**

Destination	Distance (km)	Price (US\$)				Time (hours)		
		Containers		Bulk		Containers		Bulk
		Light	Heavy	Dry	Liquid	Light/Heavy	Dry	Liquid
Nairobi	480	1396	1895	1530	1365	396	181	145
Kampala	1180	2099	3448	3511	3316	323	276	240
Kigali	1661	3901	6595	6658	6463	376	329	293
Bujumbura	1903	4950	8448	8511	8316	411	364	328
Nimule	1526	5383	7697	7760	7565	381	334	274
Kasindi	1623	4825	9635	9698	9503	372	325	289
Goma	1811	4822	8137	8200	8005	537	490	454

Source: Nathan Associates (2011)

As a result, in Eastern Africa, landlocked countries exports per capita are, on a weighted average, only 24 percent that of their maritime neighbours owing greatly the dependence on other countries' transit routes for access to overseas markets.

However, as noted above, if EAC members decide to reduce NTBs, for example via harmonization of standards or administrative procedures, this will make it more profitable for Rwandan producers to produce for exports for the regional market relative to producing for the domestic market.<sup>9</sup>

**Conclusion #2: Rwanda has one of the highest trade costs in the world (48% of export value compared to 14% averages for landlocked countries and 17% for LDCs). These extremely high trade costs contribute to the low profitability of traded activities which results in the low share of trade in GDP. Reducing these trade costs should continue to be the top priority for GOR.**

<sup>9</sup> For example, axle weight limits remain unharmonized within the EAC, an issue which fortunately has attracted attention as of late.

According to Hoffman (2004, table 17), axle weight limits are stricter on the Central corridor than on the Northern corridor and Tanzania has adopted axle load limits from SADC which are different from those on the NCTA (Northern Corridor Transit Agreement). Weight limits below 60 tons through static and mobile weighbridges (but also high interest rates of up to 18%) make it unattractive to invest in trucks with a payload capacity of 60 tons capable of transporting TEUs contributing further to high transport costs.

## 4.2 Tariffs and Tariff Escalation

The EAC's CET is defined at the eight-digit code of the Harmonized System (HS) as transposed to the EAC level. The EAC CET, adopted as of January 1, 2005 by Kenya, Tanzania and Uganda has two non-zero bands: 10% for intermediate goods and 25% for final products. Rates above 25% apply to the items on the SI list. These high tariffs are related to lines covering dairy goods (60%), wheat (35% to 75%), sugar (100 %) and a few consumer goods - (cigarettes 35%), matches (50%), worn clothing, and other worn articles<sup>10</sup>. These are activities for which Rwanda (and Burundi) had lower tariff rates. Because of the high protection of agricultural activities (19.7%), the EAC displays reversed escalation by degree of processing: 13.5% for raw materials; 10.1% for semi-processed products, and 14.4% for fully processed products. This pattern of protection is unusual. It is likely that as manufacturing activities grow, there will be pressure to raise the CET towards non-members while maintaining the already high protection for agricultural activities rendering the tariff system more distortionary.

Further disaggregation of the tariff at ISIC (Revision 2) two-digit level shows positive escalation mainly in the textiles and apparel industry, with average tariffs of 2.3% for products at the first stage of processing, 19.9% for semi-processed goods, and 24.2% for fully processed goods. This tariff escalation implies a very high rate of effective rate of protection for the final product clothing. If semi-processed materials (textiles) account for 60% of the final price and raw materials (yarn) for 30%, the effective rate of protection in clothing is around 130%.<sup>11</sup>

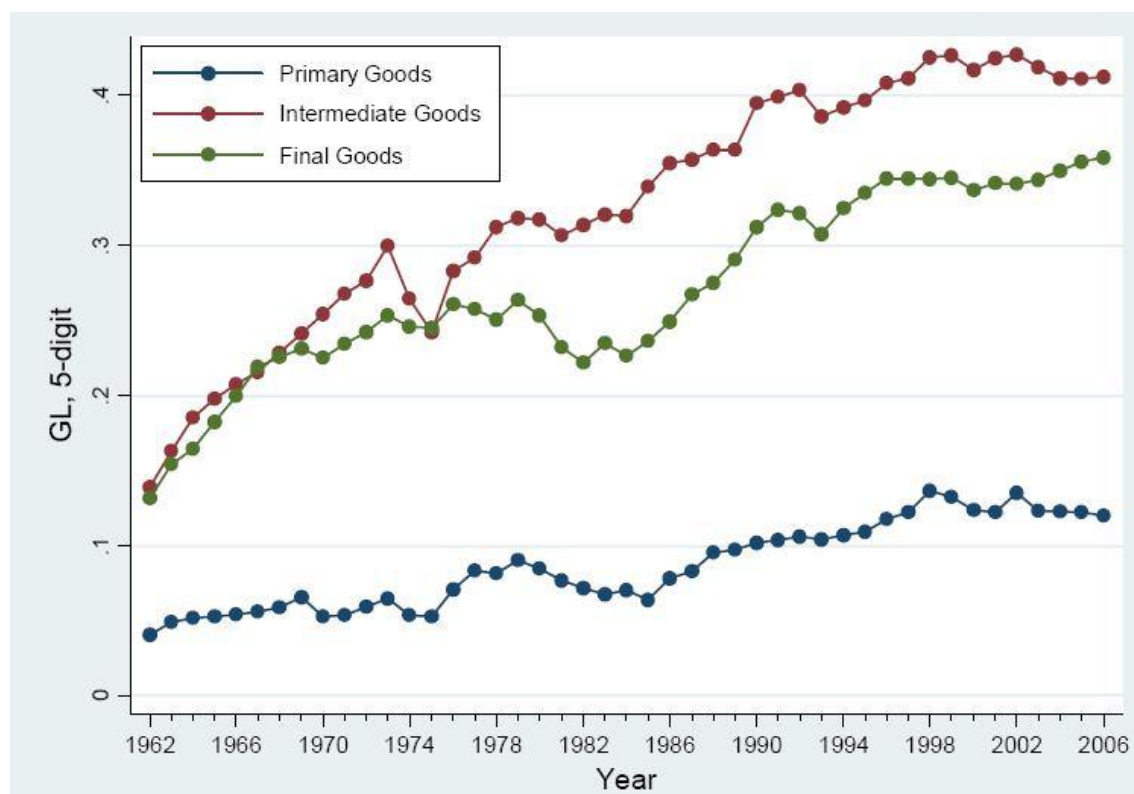
Figure 2 below illustrates that outsourcing has been growing rapidly over the past quarter century, and, since 1962, intra-industry trade (IIT) in semi-processed goods has been growing faster and has surpassed IIT in final goods (Brulhart, 2009). The global slicing up of the value chain means that to be successful, countries must be able to participate in the resulting intra-industry trade. This is why the ASEAN countries have generally reduced protection unilaterally and adopted simple rules of origin that have led to high rates of intra-industry trade.

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<sup>10</sup> For more details, see the Common External Tariff Handbook that reports the Nomenclature established under the International Convention on the Harmonized Commodity Description and Coding System, approved by the Customs Co-operation Council in June 1983, amended as of 1<sup>st</sup> January 2007. It comprises Schedule 1 with duty rates under the three-band tax structure and Schedule 2 with duty rates of sensitive items - <http://www.eac.int/CustomsU-CET-Tariff-Handbook.pdf>

<sup>11</sup> The ERP is given by the formula:  $ERP = (VA^D - VA^W) / VA^W$ . Taking a tariff of 25% on clothing, 20% on textiles and 0% on yarn gives:  $VA^W = 100 - 60 - 30 = 10$  and  $VA^D = 125 - 72 - 30 = 23$  and an ERP of 130%.

**Figure 2: Evolution of Global Intra-Industry Trade, 1962-2006**



Source: Brulhart (2008), GL = Grubel-Lloyd index<sup>12</sup>

However, as shown in table 5 below, intra-industry trade is not universally important across RTAs and is particularly low for the EAC. Note that most intra-industry trade of the EU is internal because the trade in parts and components tends to be regionalized to reduce the costs and difficulties of managing complex manufacturing processes at great distance. For the EAC-4 and SACU, the figures are very low reflecting the still marginal role of manufacturing in these nations' exports. It is interesting however, that SACU participates in the general trend of increased outsourcing as external intra-industry trade is quite high. The all-round low figures for the EAC partly reflect the very small sized of the regional market, but also high trade and transport costs and the escalation of the tariff structure, leading to high effective rates of protection and a vertical (rather than horizontal) production chain.

<sup>12</sup> "Intra-industry trade can be measured using Grubel-Lloyd indices. The Grubel-Lloyd index for each country is calculated as:  $GL_i = \frac{[(X_i + M_i) - |X_i - M_i|]}{(X_i + M_i)}$  where  $i$  is an industry with exports  $X_i$  and imports  $M_i$ . For each product the index is then weighted by the share of each country's exports of the product to the region in total exports to the region  $\frac{X_i}{X_{tot}}$  (so all weights sum to unity) and then averaged across all products. The Grubel-Lloyd index varies between zero (indicating no intra-industry trade) and one (indicating full intra-industry trade)." World Bank (2010a).

**Table 5: Intra-industry trade for internal and external trade of selected RTAs**

	Internal	External
EU-15	46.6%	24.8%
EAC-4	0.3%	0.4%
SACU	0.3%	9.0%

Is this tariff structure (an average tariff of 21 percent on processed goods relative to 14 percent on semi-processed goods and 9 percent on unprocessed goods) the appropriate incentive system? For a low-income country like Rwanda, one can question the policy of favouring processed goods relative to agriculture and other manufactures, especially in view of the sectoral priorities of the National Export Strategy.<sup>13</sup> Tariff escalation not only discourages intra-industry trade in semi-processed goods, but also favours industrial activities relative to agriculture (even if the CET is 25% for meat, fish, fruit and most milling products) and processed goods (for whom the market will be small if only because of the low purchasing power) relative to semi-processed and unprocessed goods that might be competitive, at least on regional markets.

Another comparative indicator of the incentive system is to fit a simple model of tariff determination over a sample of all countries in the UNCTAD-TRAINS data base with a population above 0.5 million and below 15,000\$ in PPA in 2005 in which the average tariff is regressed on per capita income,  $yc_i$ , to capture the well-established stylized pattern that tariffs are lower in high per capita income countries. The results (t-statistics in parenthesis) for the most recent data on applied MFN tariffs (2008) gives the following fit:

$$t_i = 11.8 - 0.44yc_i \quad N=115 ; F= 19.8$$

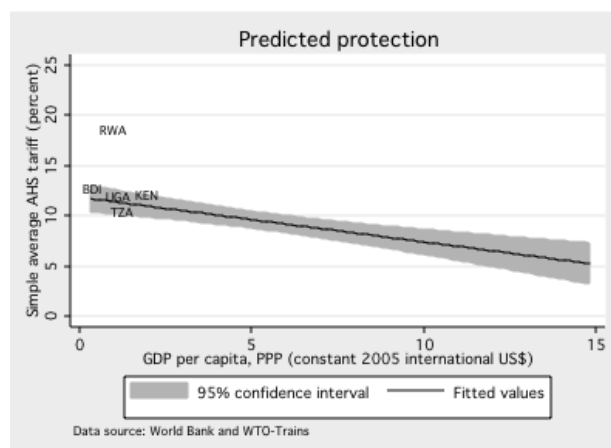
(17.3) (4.45)

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<sup>13</sup> Two reasons explain this pattern of escalation of nominal tariffs by degree of processing. The first is simply the desire to industrialize. In many instances, finished goods are labor intensive and countries can develop a comparative advantage in these activities if they are protected. Semi-processed goods often serve as intermediate inputs into finished commodities. Protecting these activities permits these industries to develop, while at the same time penalize the finished goods industries that use these as inputs. The other reason (which also applies to developed countries) is that finished goods industries oppose the protection of industries that provide them with inputs.



**Figure 3: Predicted and Actual Average Protection**



Source: Authors estimations from most recent WTO-TRAINS database

A plot of the residuals for the EAC (Figure 3 above) shows that Rwanda had relatively high protection for its per capita income before the adoption of the CET in 2009.<sup>14</sup> While the adoption of the CET, inclusive of the SI list, likely yields a residual close to the 95% confidence band, it gives further support to the observation that, once NTBs (discussed below) are taken into account, the overall incentive system is biased against exports. This review of the prevailing tariffs and the resulting tariff escalation by level of processing raises doubts that the current tariff system is conducive to the discovery of new exports.

**Conclusion #3: The incentive system is biased against exports. This bias against exports is not compensated by lower tariffs, as average tariff protection is either at, or above, the norm at that level of development. The variance in tariffs across activities is still high and may represent a handicap for the drive to increase exports.**

### **5. Non-tariff Measures (NTMs) in the EAC**

With the reduction in tariff barriers, non-tariff and behind-the-border measures (NTM and BTB) have increased in importance and have become the most important component of trade costs. NTMs are often defined by what they are not (i.e. as all measures except tariffs). Some are covered in the WTO agreements<sup>15</sup>, but these are measures for which disciplines are minimal (countries only have to notify changes to the WTO to increase transparency, and many countries do not notify these measures).<sup>16</sup>

<sup>14</sup> For all countries the estimates are based on simple (unweighted) tariffs. Using trade-weighted tariffs, protection would be lower for all countries. For example for Rwanda, the average tariff would be 16% instead of 19% and for the Kenya 6% instead of 12%.

<sup>15</sup> NTM provisions covered in the WTO agreements are : (i) article VII on customs valuation ; (ii) TBT agreement ; (iii) SPS agreement ; (iv) rules on import-licensing procedures ; (v) rules of origin ; (vi) PSI ; (vii) TRIMs ; (viii) State-trading enterprises ; (ix) Trade remedies.

<sup>16</sup> Sometimes the literature also refers to behind-the-border (BTB) measures to distinguish those trade costs that are not the result of trade policies. The terminology 'BTB measure' was first used to distinguish between 'deep' and 'shallow' integration in Regional Integration Agreements, 'deep' integration occurring

Even though it is difficult to measure the impediments to trade created by NTMs, let alone whether or not they reduce welfare, there is a consensus that NTMs are now a greater source of distortion to international trade than tariffs.

The successive rounds of multilateral tariff reductions have been mirrored by the rise in prominence of NTBs that have become the ‘security valve’ for domestic producer interests. This is why the WTO has focused on developing core principles for addressing NTBs that apply to all WTO members (i.e. they apply to all EAC members) with the Doha negotiations to address the issue of NTMs that function as NTBs. These principles include:

- Transparency (through publication, notification and prior consultation)
- Non-discrimination and national treatment
- Proportionality (implemented in the least trade-distorting manner)

Note that all these principles could be applied without being a member to an RTA, though arguably being a member of an RTA might bring about their application more rapidly than through the multilateral system.

Tables 6 and 7 gives two set of estimates of the restrictiveness of NTMs in the EAC. Table 6 reports the tariff equivalent estimates of administrative NTMs (some of which have a legitimate purpose) on the tariff lines where a single NTM applies (this is the case for almost all NTMs in the EAC). For example, for Kenya, the average tariff on the lines with an NTM is 14%, but the average tariff equivalent (AVE) of the non-automatic licensing or prohibitions on these lines is estimated at between 40% and 58%. In Rwanda, for the tariff lines with an NTM, the average tariffs are lower (around 5%). However, the estimated AVE of these NTMs (non-automatic licensing and prohibitions) is estimated at between 30% and 50%. Table 6 below highlights the restrictiveness of NTMs in the EAC compared to other regions.

Because the estimation method controls for other measures that restrict imports (such as extra costs associated with transporting goods along the Central and Northern Corridors) by the use of dummy variables, these estimates only capture the gains in terms of increased imports that would occur from removing the three types of NTMs currently applied in the EAC<sup>17</sup>. While these estimates are at best rough orders of magnitude, they suggest sizeable gains from a removal of these specific NTMs in the EAC, and support the resolution by partner states not to introduce new NTBs.

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when integration extends beyond the removal of protection (i.e. integrating factor markets, combining regulatory institutions, harmonizing standards and cooperating intensively on trade facilitation, e.g. reducing ‘red tape’ for crossing borders). While it is difficult to get an informed appraisal about the relative importance of NTMs vs. BTBs as barriers to trade, there is general agreement that BTBs are increasing in importance and that BTBs are the most important barrier to trade for many small landlocked or isolated economies (see Shepherd and Wilson, 2006, and Hoekman and Nicita, 2008).

<sup>17</sup> The three types of NTMs found in the EAC are non-automatic licensing (6100), prohibitions (6300), and technical regulations (8100).

**Table 6: NTMs and Tariff Equivalents of NTMs in the EAC**

	<b>Class (1)</b>	<b>Frequency (number of tariff lines affected by NTM) (2)</b>	<b>Percent of import value of affected tariff lines affected by NTMs (3)</b>	<b>AVE (%) (4)</b>	<b>Average Tariff ( %) (5)</b>
Kenya	6100 – Non-automatic licensing	98	84%	40.3%	14.2%
Kenya	6300 – Prohibitions	16	16%	58.6%	29.0%
Rwanda	6100 – Non-automatic licensing	52	87%	50.3%	5.8%
Rwanda	6300 – Prohibitions	8	13%	31.5%	4.9%
Tanzania	8100 – Technical regulations	4296	100%	58.2%	15.7%
Uganda	6300 – Prohibitions	5	14%	9.9%	14.6%
Uganda	8100 – Technical regulations	30	86%	60.7%	7.0%

**Table 7: Extra Transfer Costs due to NTBs (beef and maize)**

	<b>Transfer cost per km/beef/ton\$</b>		<b>Transfer cost per km/maize/ton\$</b>	
	No NTB	With NTB	No NTB	With NTB
Nairobi-Namanga (170km)	0.17	0.34	0.37	0.46
Busia-Kampala (500km)	0.09	0.40	0.29	0.44
Dar-Namanga (772km)	0.20	0.43	0.24	0.35

Sources: Karugia et al. (2009)

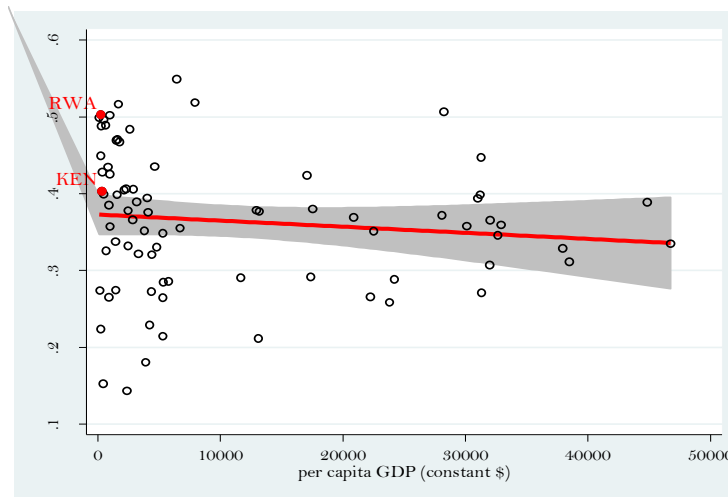
Table 7 gives another estimate based on comparisons of transfer costs along roads for two standard products, beef and maize, along several corridor segments. Here the NTBs capture the cost-raising effects of all controls and road blocks, legal and illegal. According to the comparison, the estimated transport costs are at least doubled as a result of the NTBs.

According to the 2008 MINICOM/PSF NTB report, the exportation of tea along the Northern Corridor in 2008 cost \$85 per ton (\$70 without insurance). The study also highlights that the consignment was stopped at 4 borders, 22 roadblocks, and 10

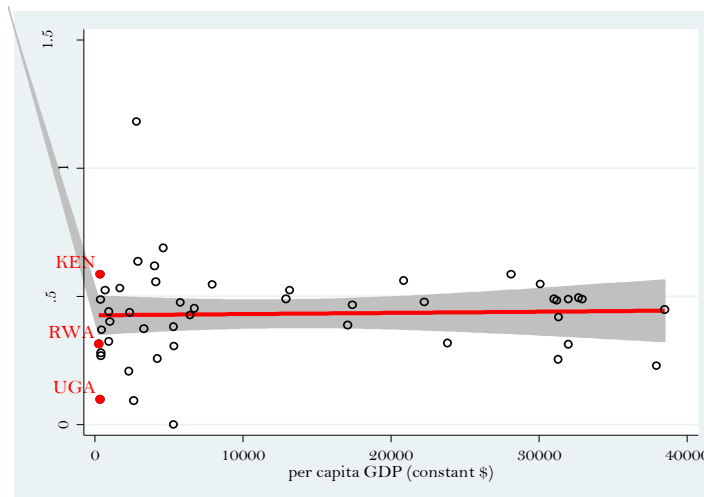
weighbridges, and paid \$864.23 due to corruption – a figure which according to MINICOM’s 2010 NTB report remains accurate. The total journey took 93 hours and 8 minutes (Kigali to tea bonded warehouse). An importer along the Northern Corridor was stopped at 10 weighbridges and paid \$1182.77 due to corruption. This report also highlights problems associated with the privatization of weighbridges and Kenyan regulations limiting trucks to 3 axles.

**Figure 4. Ad-valorem equivalent of NTMs and per capita income**

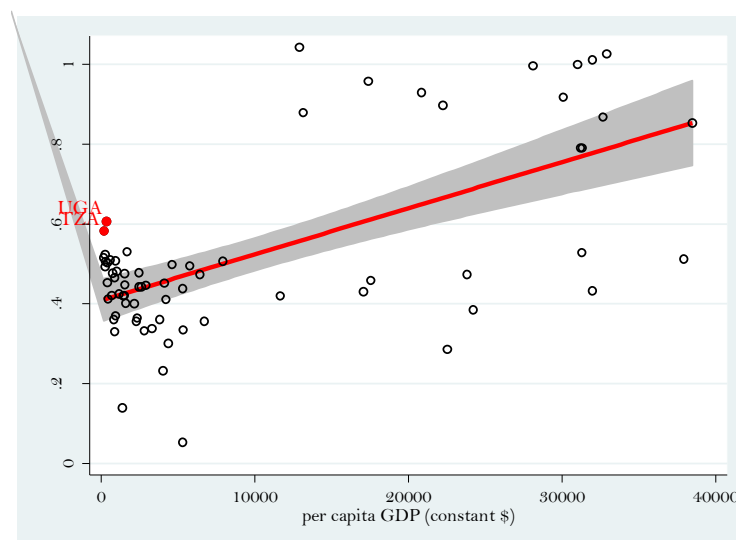
Non-automatic Licensing (6100)



Prohibitions (6300)



## Technical Regulations (8100)



Source: Adapted from Carrère and de Melo (2010b).

**Conclusion #4: Estimates of the costs of the tariff equivalent of NTMs in the EAC are high. So are the estimated costs of various NTBs--formal and informal--that impede the transport of goods across the community. Rwanda should refrain from adding NTBs and push for the removal of NTBs across the EAC community to reap the benefits of “deep” regional integration.**

## 6. The Benefits and Costs of Membership in the EAC

The preferential approach to trade integration, now pursued by many countries, involves several adjustments to a country's trade policy compared to a non-discriminatory approach, some raising trade costs over those that would be incurred by a non-discriminatory trade policy. In the case of Rwanda, membership in COMESA implies the application of rules of origin (RoO) which are necessary to prevent trade deflection (i.e. imports from partner countries in an FTA with lower tariff protection), and which must continue to be applied in the EAC Customs Union (CU). Integrating into the EAC customs union involved two important changes for Rwanda: (i) the adoption of the customs laws and regulations of the EAC-3 (ii) the adoption of the CET (the elimination of tariffs on imports from EAC members had already taken place for all countries except for Tanzania as part of becoming a member of the COMESA FTA).

Rules of Origin (RoO). The set of RoO applied for a preferential trade agreement stipulates what requirements must be met to qualify as originating in the region, and hence qualify for preferential access (i.e. not paying duties and selling in the partner's market at the higher tariff-inclusive price). So far, the RoO adopted by the EAC are similar to those applied by COMESA, that is the product must satisfy one of the following criteria:

- (i) wholly obtained;
- (ii) non-originating inputs cannot exceed 60% of the final product price;
- (iii) local value-added should add up to at least 30% of the product;

(iv) A change of tariff classification.

Furthermore, the estimates of the associated administrative costs for both customs authorities and companies (see Box 1 below) are high.<sup>18</sup>

Even though the current RoO are relatively simple (they could be simpler if only a change of tariff classification or local value-added minimum with a low threshold were adopted), the Rwandan government should be aware of the complexities that have accompanied the application of RoO in FTAs that have been captured by the interest of powerful producer interest groups. Application gets even more complicated when countries are members of multiple FTAs.

The experience in FTAs around the world shows that RoO have largely been captured by the most powerful members of the FTA (South Africa in SADC, the US in NAFTA, etc.). The preferences of the most powerful members have generally led to more stringent rules for those goods where marginal preferences are highest, so that preferential access cannot be utilized. Additionally, the higher trade costs associated with the application of RoO can easily wipe out any efficiency gains from the elimination of tariffs and NTBs. Interestingly, in the case of SADC, the RoO were initially relatively simple and the same as those in COMESA and the EAC, but have evolved into complex rules, reflecting the lobbying power of protected industries, under the guise that these RoO requiring the use of regionally produced inputs serve as a tool for industrial development.<sup>19</sup> If necessary, Rwanda should be the ‘guardian’ of simple RoO in the EAC.

Customs Administration. When Rwanda joined the EAC, it replaced its customs law with the Customs Management Act (CMA) already in place for the EAC-3. This meant applying value declared at customs (article 112 and fourth schedule of the CMA which is in accordance with article VII of the GATT signed in 1994). Equally important, Rwanda had to harmonize its customs exemptions with the rules described in the Fifth Schedule of the CMA. The Schedule specifies which products/importers qualify for an exemption (typically the “classical” exemptions - Vienna Convention, International Organizations, personal effects).<sup>20</sup> Although the Council of Ministers of the EAC may modify the rule (according to Article 114, paragraph 3), and some exceptions have been made in exceptional cases, the CMA states that no member country may choose exemptions not detailed in the Fifth Schedule.

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<sup>18</sup> According to a survey administered by the World Customs Organization to customs officials in developing countries, 67% of respondents in sub-Saharan Africa agree that dealing with RoO under overlapping trade agreements cause problems and a majority also agreed that RoO required more manpower. It is safe to state that administering RoO detracts from other objectives of tax collection and trade facilitation (see Cadot and de Melo (2008) for elaboration).

<sup>19</sup> See the case studies in Cadot et al. eds. (2006), in particular the case study by Erasmus et al. on SADC which comes to the conclusion that the stringent RoO imposed on producers is not a sensible industrial development strategy. The narrative on the case of the lobbying for a restrictive RoO by the protected wheat and wheat flour industries is illuminating. Cadot and de Melo (2007) provide suggestions on how to simplify RoO across FTAs. See also World Bank (2010), boxes 3 and 4 on a recent confirmation of the restrictiveness of RoO in SADC as they have evolved from being relatively simple (similar to those in COMESA) into a set of product-specific RoO reflecting the lobbying interests of protected industries.

<sup>20</sup> Calculations by Geourjon and Laporte (2008) for Burundi suggest that if the CMA is taken seriously, revenue loss could be substantial. According to their estimates for Burundi for 2007, a loss of 35% of tariff revenue was attributable to exemptions (excluding petroleum products)

EAC membership also implies that the tariff rate is now applied on the cif value at the first point of entry in the EAC. This amplifies revenue loss for Rwanda since almost all goods enter either through Tanzania or Uganda.<sup>21</sup>

The issue of revenue sharing in the EAC will need to go beyond the temporary compensation for revenue losses accorded to Rwanda and Burundi via the COMESA Fund. The experience across agreements shows few examples of operational arrangements. The most important, but long term, recommendation is to improve the collection of domestic taxes and to shift away from trade taxes as a source of government revenue.<sup>22</sup>

**Box 1: Obstacles facing the utilization of tariff preferences in SADC - the case of Shoprite**

*Shoprite is a South African-based retail and fast food company that operates over 1,200 stores under various names (e.g. Shoprite, OK Furniture, Checkers, Hungry Lion, Usave, House & Home) in 17 African countries as well as in India. The company accounts for 30 percent of South African retail trade.*

*In 2009, over 15% of Shoprite's revenues came from stores based outside of South Africa. In securing these a key challenge has been administering compliance with the rules of origin to qualify for SADC preferences on consignments sent to its stores outside of SACU. In particular:*

- The value of SADC preferences to Shoprite was US\$13.6 million in 2009 on US\$550 million of exports to the region (implying an average margin of preference of 2.4%).*
- The cost of proving eligibility for preferences on this trade was US\$5.8 million in the same year. These costs comprised: 40% for staff to maintain customs data for shipments; 40% on in-house clearing and forwarding; and, 20% on the maintenance of a library to demonstrate compliance with rules of origin for suppliers.*

Source: Charalambides (2010), as cited in World Bank (2010a).

**Conclusion #6: Implementing RTAs is administratively demanding. Rules of origin (RoO) are complex and cost-raising in all RTAs. Experience (e.g. SADC and elsewhere) shows that they can be captured by protectionist business interests. Replacement of Rwanda's custom law by the Customs Management Act of the EAC implies applying tariffs at the point of entry in the EAC and eventually the need to set up an operational arrangement for tariff revenue allocation across members.**

Applying the CET By joining the EAC, Rwanda has moved from a 4-band tariff structure to the prevailing 3-band in the EAC (0% for capital goods and raw materials, 10% for intermediates, and 25% for finished goods) and higher tariffs for a list of 41 sensitive items. The sensitive items (SI) products benefitting from higher protection in the EAC-3 had low rates of protection in Rwanda, and accounted for over 20% of the

<sup>21</sup> According to the latest figures from the RRA for 2010 for the value of trade (export percentages are followed by import percentages in brackets: 45% (40%) through Rusumo (Tanzania); 43% (41%) through Gatuna (Uganda) and 3% (17%) via Kigali airport.

<sup>22</sup> For more discussion of the issue of lost revenue from RTAs and how to devise rules for revenue sharing agreements, see Walkenhorst (2006)

value of imports in 2006, prior to the adoption of the CET. Simulations undertaken prior to Rwanda's adoption of the CET suggested substantial tariff revenue loss (as a percentage of initial tariff revenue prior to joining the CU). These simulations also indicated that moving to the CET with the current SI list would result in welfare loss because of the increase in tariff variance ( $\Delta W$  – welfare - expressed as percentage of initial GDP):<sup>23</sup>

- Moving to CET without the SI list: Tariff revenue loss of 8% ( $\Delta W=+0.004$ )
- Moving to CET with current SI list: Tariff revenue loss of 18% ( $\Delta W=-0.0032$ )
- Moving to CET with SI list set at 25%: Tariff revenue loss of 17% ( $\Delta W=+0.016$ )

These results highlight the importance of variance in tariffs in the overall costs of protection. Prior to joining the CU, Rwanda had a higher average tariff (19% vs. 12% for the EAC) but with its 4-band tariff schedule not exceeding 25%, there was less variance in the tariff schedule. Moving to the CET thus implied a discriminatory tariff change for Rwanda, and thus there is a risk of trade diversion if the preferential tariff reduction on imports from the EAC-3 leads to the replacement of cheaper imports from non-partner members by imports from partners. In this case, moving to the CET could not only lead to revenue loss, but also to a reduction in welfare if the consumer surplus does not increase sufficiently to compensate for revenue loss. On the other hand, there will be trade creation if the tariff reduction is on goods that were already imported from EAC partners, due to increased competition between partners and non-partners. With trade creation, welfare rises, and with trade diversion, it may rise or fall.

Table 8 below illustrates the disproportionate prevalence of SI list products in Rwanda's import basket compared to the original three EAC members. While SI list products comprise less than 1% of tariff lines, these products accounted for 22% of Rwanda's imports in 2006, compared to less than 6% for the existing EAC members. Fifty percent of Rwanda's imports were products with CET rates of at least 25% in 2006, while for Kenya and Tanzania this figure was 15% (Uganda was 23%).

The important conclusion to draw from these estimates is that for newcomers, from a resource allocation point of view, joining the EAC is only worth it if adopting the CET is accompanied by a removal of the SI list, i.e. by setting the tariff on the items on the SI list at 25% or less. There is, however, one caveat. The welfare gain comes at the expense of a loss in tariff revenue.<sup>24</sup>

**Conclusion #7: When Rwanda adopted the EAC CET, it ended up raising tariffs on goods that were produced by its partners because of the SI exemptions list, effectively subsidizing their production. As a result, this was a step in the direction of a less efficient allocation of resources and may be costly for Rwanda unless integration gives rise to the dynamic gains that would occur from 'deep' integration.**

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<sup>23</sup> Estimates from Carrère and de Melo (2008a) based on the application of the World Bank's SMART package. Welfare estimates are always small when expressed as a percentage of GDP, but especially so for a closed economy like Rwanda with a low share of trade in GDP.

<sup>24</sup> The revenue loss has however been dampened by the EU-funded adjustment facility administered by COMESA which gave 12.3€ million to Rwanda in compensation for lost tariff revenue from moving to the CET.



**Table 8: MFN Tariff Structure at the HS6 Level, 2006**

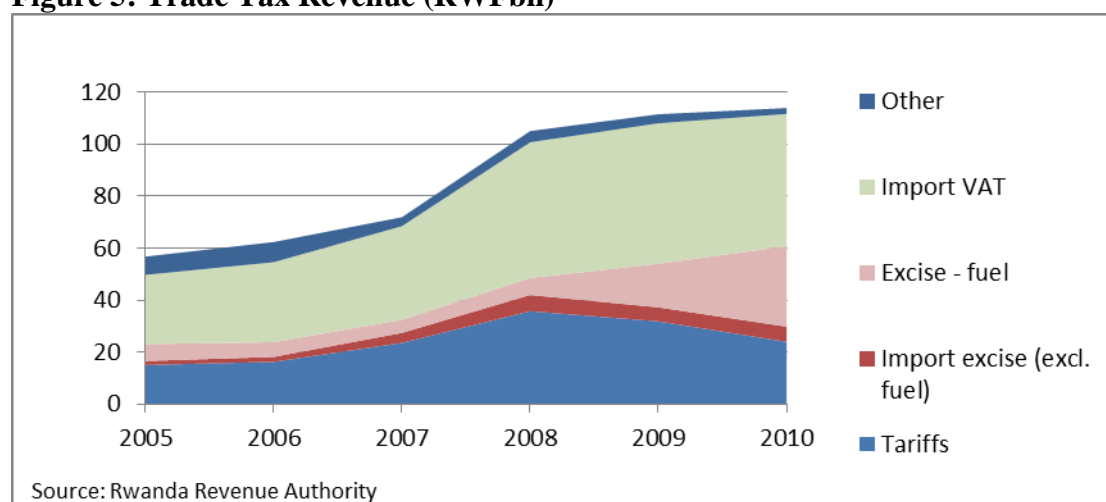
Total number of lines			Number of lines with strictly positive imports													
EAC Tariff Schedule (CET>25% correspond to items on the SI list)			Kenya			Tanzania			Uganda			Rwanda				
	No. lines	Share	No. lines	Share	Import value	No. lines	Share	Import value	No. lines	Share	Import value	No. lines	Share	Simple average MFN tariff	Weighted average MFN tariff	Imports value
Total	5,212	100%	4,280	100%	100%	4,320	100%	100%	4,044	100%	100%	2090	100%	21.35	16.7%	100%
With CET=0%	1,871	36%	1,524	36%	52.1%	1,519	35%	39.6%	1,368	34%	40.0%	629	30%	15.16	13.3%	12%
With CET=10%	1,258	24%	1,033	24%	32.8%	1,039	24%	44.5%	998	25%	36.8%	577	28%	21.36	16.5%	37%
With CET=25%	2,042	39%	1,683	39%	10.8%	1,722	40%	12.7%	1,637	40%	17.8%	853	41%	25.15	21.7%	28%
With CET>25%	41	1%	40	1%	4.2%	40	1%	3.2%	40	1%	5.4%	31	1%	23.71	17.7%	22%

Source: Author's calculations from COMTRADE/TRAINS via WITS.

Revenue Loss. In developed countries, governments must raise \$1.3 for every dollar transferred. Given the weak tax base and less developed fiscal system in low-income countries, it is not clear that alternative means of raising the same amount of revenues (say by increasing non-distortionary sales/VAT and excise taxes) will be easily implemented. One must therefore question whether Rwanda can relatively efficiently collect the equivalent of the government revenue lost by implementing the CET. In any case, revenue losses are likely to be sufficiently large to justify accompanying accession to the EAC with fiscal reform.

This said, it is possible to replace lost tariff revenues with revenue from excise taxes on products such as automobiles, generators, alcoholic beverages and cigarettes, as has been demonstrated by Rwanda's replacement of lost tariff revenues with excise duties on petroleum (see Figure 5 below). However, for such a scheme to work, there should be convergence in excise tax rates at the EAC level to prevent smuggling and fraud among members.<sup>25</sup>

**Figure 5: Trade Tax Revenue (RWFbn)**



Source: Rwanda Revenue Authority

**Conclusion #8: The loss in tariff revenue for Rwanda from joining the EAC was substantial. These losses were offset by fuel excise taxes, and short term payments from the COMESA Compensation Fund. Beyond this, joining the EAC provides an additional reason to carry out fiscal reform to enlarge the tax base and replace lost revenue by raising taxes from a larger base, resulting in less distortionary costs, a task the government is undertaking.**

<sup>25</sup> The detailed calculations in Carrère and de Melo suggested that the following products should be excluded from the CET for Rwanda:

190190 "Malt extract; food preparations of flour, groats, meal, etc."

870323 "Motor cars and other motor vehicles for the transport of persons"

850211 "Electric generating sets and rotary converters -output < 75 kVA"

870212 "Electric generating sets and rotary converters -output > 75 kVA"

## ***7. Making the most of the Regional Integration Strategy***

Rwanda has opted for the regional approach to deepening its integration into the world trading system which, as discussed above, has costs and benefits. On the other hand, the very trade costs impeding the growth of Rwanda's trade justify the emphasis on a regional approach to trade integration. The areas singled out for progress are restructuring the CET, deepening integration in the EAC by removing NTBs, promoting services trade, and using the EPAs to spur increased competition in the EAC.

### **7.1 Restructuring the CET to reduce disincentives to “made in Rwanda”**

Rwanda could use the opportunity of the five-year periodic review of the CET to develop its own proposal for reforming the CET. This proposal should be built on key principles:

- Lowering the average CET to help Rwanda access to cheaper products, both inputs and consumer goods, and reduce the anti-export bias inherent in the current CET. It will also reduce the subsidy Rwanda is bestowing on its EAC trade partners.
- Reducing the variance in the tariff structure to minimize the distortions facing Rwanda producers, and reduce effective protection.
- Refraining from adding (and letting other countries follow suit) items to the sensitive list, to prevent the tariff structure from becoming ‘business owned’ as opposed to ‘business friendly’.

### **7.2 Eliminating NTBs in the EAC**

This is the most important source of potential gains, but also the most difficult to execute. It is all about eliminating the “width of borders”, which are thick relative to other parts of the world. This is in great part because NTMs are often justified, but equally often they represent protection in disguise, in which case they usually qualify as NTBs (non-tariff barriers). Case studies providing the knowledge necessary to classify NTMs and be better informed as to which ones are appropriate (NTMs that should be kept from a welfare point of view, e.g. certain prohibitions or technical regulations for health, security or environmental reasons, or that provide information for the consumer, such as product labelling). In sum, the problem with NTMs is double: first determining those that are justifiable, then designing measures to meet justifiable objectives that are appropriate for the region. The design of appropriate standards has to be carefully thought out, as is clear from the case of the EAC's milk standards, given that milk is a potential export for Rwanda in the EAC (see Box 2 below)

## **Box 2: Case Study of EAC Milk Standards as an NTM**

Jensen and Keyer's (2010) study of the EAC milk industry highlights how the adoption of unrealistic standards may provide an opportunity for protectionist interests to restrict trade.

The EAC milk standards have recently been updated and harmonized with the International Codex Alimentarius standards, a process driven by donors and public agencies, with limited focus on the private sector or public health concerns. The microbiological levels set by the standard are the same as OECD levels, and remain unreachable by almost the entire EAC milk industry.

The East African Community produces a quarter of Africa's milk. In Rwanda, 95% of milk is produced and sold by the informal trading sector, as is the case in Kenya (80-85%) and Uganda (95%). Most consumers in the region prefer low cost raw milk, which is far from meeting the EAC microbiological standards, but is usually boiled before consumption.

While EAC milk exports are currently low because of low production volumes and the challenges of transporting raw milk in warm temperatures, there is a risk that future trade will be hindered by the inability of small or large producers to meet the EAC standards. The study highlights other areas of concern as well – while EAC members have agreed to recognize each other's national quality seals, standards bureaus often demand additional testing. Additionally, the authors note that veterinary certificates are issued by both importing and exporting countries and, these certificates are usually issued separately for each shipment.

The report recommends withdrawing standards that do not meet public health or market demands, and considering developing a much simpler standard for raw milk that will be boiled before consumption.

There are several approaches to reducing NTMs.<sup>26</sup> In the EU, treaties are legally binding and the right to market access is legally enforceable, with the EU making it illegal to apply quantitative restrictions on imports or exports, or any other measures having equivalent effect. The EU approach is based on three broad principles:

1. Non-discrimination, prohibiting different treatment for 'similar' goods
2. Mutual recognition of the regulatory objectives of the different States
3. Direct harmonization via legislation

In order to increase transparency, since 1983 member states are required to notify each other of any new technical regulations, and wait three months before proposed legislation becomes law (ex-post will not do).

ASEAN took another approach. Since all members were also WTO members, they decided to eliminate GATT-inconsistent measures and to reduce them on a preferential basis if they were consistent, an approach that could be adopted by the EAC (rather than the current one based on categories which take into account both political and economic criteria). The rationale for the ASEAN approach is that the ASEAN secretariat came to the conclusion that it was impossible to define an independent standard for validating the legitimacy of NTMs, so they chose the WTO taxonomy and adopted WTO-consistent criteria for their examination.<sup>27</sup> The

<sup>26</sup> The following is largely based on Kirk (2010). Also see Carrère and de Melo (2010a).

<sup>27</sup> The WTO classification criteria are : (i) TBT; (ii) SPS; (iii) Security and environmental measures; (iv) import licensing procedures and other administrative measures .

initial approach was sector specific for the elimination of NTMs classified in the red, and then the amber boxes (the green box NTMs could be maintained). However, little progress was achieved with the sector approach, so a more legal approach is being adopted.

In the EAC, article 13(1) of the EAC Protocol states that Partner States must refrain from imposing new NTBs, and must eliminate existing ones (the Protocol defines NTBs as “administrative and technical requirements imposed by a partner State in the movement of goods”. Partners have pledged to eliminate NTBs, but so far have only focused on developing national-level focal points and publicizing specific NTBs. They have classified NTBs along the dual criteria of ‘political complexity’ and ‘intra-regional trade impact’ into four categories (A,B,C,D) where category A NTBs would be least politically-sensitive (i.e. a low-hanging fruit) that could be rapidly eliminated by consensus, and category D the most contentious. Though based on different criteria, the approach is similar to the one pursued by ASEAN. So far, however, as pointed out by Kirk (2010), even removing NTBs in category A has proven elusive. This may in part be due to the difficulty of reaching agreement on how to meet legitimate regulatory objectives in a less trade restrictive manner (see table 2 in Kirk’s paper for a list of NTBs identified for immediate action).

What could be the next steps? Kirk (2010) suggests four:

1. Implement commitments under GATT (1994) for articles V, VIII and X and the TBT and SPS agreements, all difficult to do in the EAC member states with limited human and material resources
2. Ensure that the NTM satisfies the three principles of transparency, non-discrimination and proportionality, with removal within a year when not satisfied
3. Immediate notification of all new proposed measures
4. Undertake a regulatory impact analysis before modifying or introducing a new technical regulation
5. Publicize all the policies and ensure a dispute settlement provision

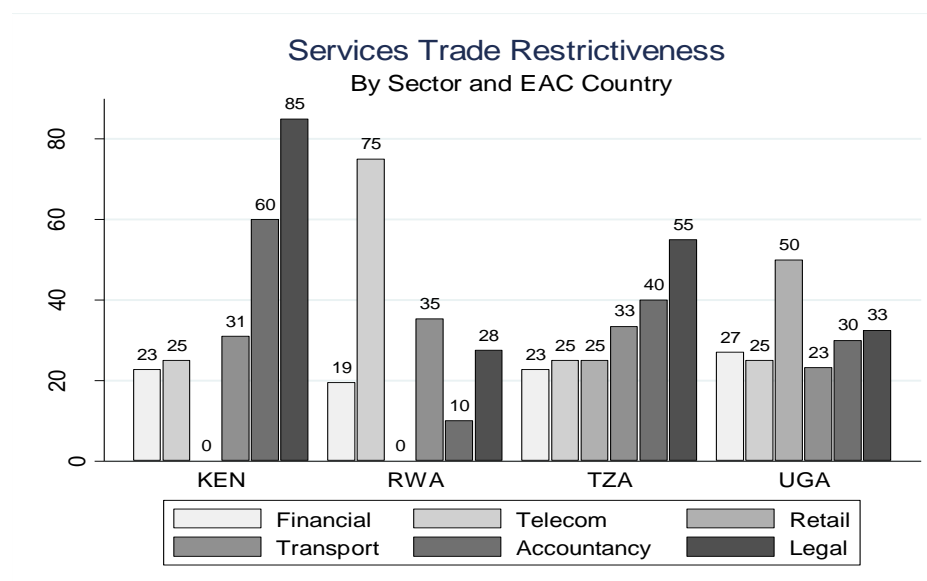
To these generic recommendations, one should add

1. Quarterly monitoring reports to be widely disseminated (for example at the EAC level) of the progress at eliminating the NTBs in the categories A,B,C,D
2. Regular update of new NTBs (e.g. Rwanda’s ban on imports of used undergarments) and whether these NTBs meet the criteria set in article 13(1) of the EAC Treaty
3. Advocacy at the presidential level to show the willingness to move towards deep regional integration

### **7.3 Services**

Regional integration of services sectors in the EAC provides a great opportunity for Rwanda to benefit from regional integration, since services avoid the transport costs associated with the trade of goods. Over the period 2001-07, business services were stagnant in Rwanda, while growing at 8% per annum in Kenya, 14% in Tanzania and 18% in Uganda (World Bank, 2010b, p.ii). This is particularly worrisome for Rwanda, since it is widely documented that professional services are an important source of overall productivity growth.

**Figure 6:**



Source: Borchert, Gootiz and Mattoo (2009)

Rwanda is well aware of this and, overall, it is the EAC member with the least restrictive services trade environment (Figure 6). However, as detailed in a recent World Bank report on professional services in the EAC (World Bank 2010b), there are multiple restrictions on conduct (price regulations, advertising regulations, demanding service standards) and openness to trade, both hampering competition. Cross-border trade is restricted by all countries, while Rwanda is the only member that does not impose barriers on the movement of persons, nor on the procurement of professional services across modes of supply. However, skill shortages and mismatches are the highest in Rwanda, so education and skills need to be improved.

Liberalizing services trade is more complex than liberalizing goods trade, and thus requires technical capacity that is often absent in the EAC. For Rwanda, which is relatively open, the often-advocated MFN approach (compared to the regional approach) would be both easiest to pursue (since barriers to services trade are already low) and also avoid the drawback of the regional approach to liberalization – giving a first-mover advantage to regional members that turn out to be second-best providers.

Developing regulatory cooperation at the regional level to reduce the current regulatory heterogeneity would give large gains. First steps have already been taken with mutual recognition agreements (MRA) in professional services (academic and professional qualifications). A full-fledged MRA would, however, have to cover education which would also benefit from developing common institutions for professional services at the regional (rather than national) level. Cooperation would also be desirable in developing appropriate standards (which may be different for the EAC than the more expensive and restrictive international standards).<sup>28</sup>

<sup>28</sup> The recent World Bank paper (2010b, chp. 6) gives a detailed list of recommendations to help integrate professional services in the EAC.

## 7.4 Going beyond the Interim EAC EPA

It is difficult not to conclude that the interim EPA was a missed opportunity for the EAC to carry out a credible reduction in protection as the opportunity to rely on the external restraint (the EAC would not have subsequently raised its tariffs against the EU) to initiate all-round reductions in protection. Table 9 below shows the schedules that were negotiated for each interim EPA. The EAC does not start reducing tariff on EU imports before 2014 (no reductions in phase 1), with tariff reductions taking place over 18 years. For Rwanda (and the other EAC LDCs), the only real benefit is the elimination of the triple transformation RoO on textiles and clothing, a significant gain in market access for all signatories.

Except for CARIFORUM for which a full EPA was concluded, all other interim EPA negotiations concentrated on trade in goods, with much negotiating energy going to the development of the exclusion list to reach 80% tariff-free imports from the EU along with the corresponding timetable to allow non-LDCs to continue benefitting from preferential access. In the end, the ‘development objectives’ of these partnerships was forgotten and, because of numerous exemptions (see column 5 in table 9 below), tariff structures will often be more dispersed by the end of the adjustment period than at the beginning.

As the negotiations continue, the EAC cannot rely on the standard mercantilist approach of exchanging market access used in the EPA (and multilateral) negotiations. This is because there is no new market access of the EAC in the EU. EAC sectors such as finance, telecommunications and information technology are already open to all service suppliers, and the EU is very restrictive and *not* prepared to make offers in the area of greatest potential benefit for Africa – the temporary movement of unskilled workers. This means that, instead of focusing on shallow exchanges of market access, the negotiations should focus on providing necessary aid-for-trade resources. This includes providing trade in services knowledge platforms and technical assistance, such as learning from previous services sector integration experiences to ensure that the appropriate regulatory framework is adopted in each EAC services sector. Additionally, the EU should support EAC countries in pursuing openness in services whether on a regional or multilateral basis, and provide technical assistance that is delinked from the EPA negotiations.<sup>29</sup>

Regardless of the results of the negotiations in the ‘unfinished’ agenda, the EAC should fast-track the removal of tariffs on EU imports, perhaps concluding by 2020, and certainly before 2033, as is currently the case under the interim agreement.

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<sup>29</sup> The lessons from the CARIFORUM EPA suggests that the EAC could push for cooperation between competition authorities, especially for specific commitments in tourism which would discipline anti-competitive behaviour by EU firms in African markets. Brenton et al. (2010) provide further suggestions.

**Table 9: The Phasing of Tariff Eliminations in the Interim EPAs**

Country (Number of years to eliminate tariffs)	Phase 1 (% EU imports)	Phase 2 (% EU imports)	Phase 3 (% EU imports)	Number of excluded HS6 tariff lines (% EU imports)
Cameroon (13)	2010-13	2011-17 (24.3)	2014-23 (30.2)	1217 (21.0)
Cote d'Ivoire (14)	2008-12	2013-17 (10.6)	2018-22 (9.9)	517 (20.0)
Ghana (13)	2009-13	2013-17 (42.6)	2018-22 (8.3)	1085 (20.3)
EAC (18) <i>a/</i>	2010-14 <i>b/</i>	2015-23	2023-33	1323
Burundi		(29.7)	(28.1)	(23.0)
Kenya		(18.3)	(4.2)	(19.4)
Rwanda		(18.6)	(3.2)	(25.4)
Tanzania		(17.6)	(2.4)	(20.2)
Uganda		(20.4)	(2.5)	(17.3)
ESA (9)				
Comoros	2013 (21.5)	2014-22 (25.0)	2014-22 (34.0)	93 (19.3)
Madagascar	2013 (37.0)	2014-22 (26.1)	2014-22 (17.6)	575 (19.3)
Mauritius	2008 (24.5)	2013-17 (29.1)	2013-22 (42.0)	185 (4.4)
Seychelles	2013 (62.1)	2013-17 (15.1)	2013-22 (20.4)	131 (2.5)
Zimbabwe	2013 (44.9)	2015-23 (14.7)	2015-22 (20.3)	716 (20.1)
SACU (BNLS) (4)	2008 (55.0)	2008-12 (12.4)	2011-13 (0.8)	181 (16.7)
Mozambique (10) <i>c/</i>	2008 (50.8)	2018 (2.6)		(37.8)

**Note:**

For the ESA EPA, data on imports provided in the EPA schedule. For Cameroon and Cote d'Ivoire, COMTRADE data reported by these countries. For all other countries, 'mirror data' estimates. In all cases, average value of imports over 2004-06.

In some cases, there is overlap in the phases indicating that some tariffs in a previous phase are still being reduced while new tariff reductions have started in the next phase.

*a/* All countries have identical schedules

*b/* Phase 1 only involves goods with a CET of 0% so any liberalization involves moving to the CET

*c/* Negative (rather than positive) exclusion list



## ***8. Policy Recommendations***

Rwanda has rightly decided to emphasize regional integration and cooperation. This strategy should give political benefits by reducing the probability of conflict in the region, and help build the trust necessary to provide public goods, notably to reduce the cost of transport by improving the region's transport infrastructure, currently a great handicap for Rwanda.

Focussing on the near term, Rwanda's regional strategy should expand in three directions. Firstly, all EAC partners, and Rwanda in particular, should push for the removal of NTBs within the EAC Community, and discourage the imposition of new ones (as has happened recently). The removal of NTBs should include 'at the border' measures, such as non-automatic licensing, and also 'behind-the-border' measures, such as the lack of recognition of mutually agreed technical standards by partners, and the lack of harmonization standards, such as truck axle weights. Some NTBs, like non-automatic licensing, can be removed unilaterally, but others, like harmonized standards, require cooperation at the regional level. It is here that pushing for 'deep' integration at the regional level will bring the greatest benefits in the form of reduced transport costs and transaction costs for all partners.

Secondly, opening the regional market to trade in Professional Services would be beneficial to all EAC members because of the possibility of reducing many of the existing barriers to increased competition, and exploiting economies of scale and comparative advantage in what is a small regional market. It is particularly relevant that the dominant mode of cross-border supply in many services sectors is commercial presence (mode 3), which means that services continue to be produced locally, thereby reducing adjustment costs and making liberalization less politically costly. For Rwanda, which already has relatively few restrictions on services trade in the EAC, the expansion of services trade, contingent on the removal of barriers in partner countries, is particularly appealing particularly because remoteness is not as severe a handicap as it is in the market for goods, where transport costs are high. Developing regulatory cooperation at the regional level to reduce the current regulatory heterogeneity would produce large gains.

Thirdly, because tariff protection is still high and Rwanda has a small market, Rwanda needs to push for lower tariff protection. A first step would be to push for a lower CET and fewer exceptions, which largely benefit the larger EAC partners. A second step would be to make up for the missed opportunity when the interim EPA was negotiated. The EPA calls for tariff elimination on 80% of imports from the EU to be completed by 2033. Moving this completion date forward by at least a decade would foster much needed competition into the EAC goods markets.

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