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INTERNATIONAL MONETARY FUND

KENYA, UGANDA, AND UNITED REPUBLIC OF TANZANIA

Selected Issues

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Approved by the African Department

December 1, 2006

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INTRODUCTION

This selected issues paper—prepared within the framework of coordinated Article IV consultations—**focuses on critical aspects of economic growth and development in three members of the East African Community (EAC): Kenya, Tanzania, and Uganda.** The paper analyzes harmonization of investment incentives, promotion of credit to the private sector, and trade liberalization.

Chapter I argues that a coordinated approach to providing investment incentives—possibly through a Code of Conduct—would be in the interest of all EAC members. The Code would specify what incentives the EAC countries could offer and would provide a framework for consultation and coordination. It would be advisable to set up a transparent rules-based system of investment incentives, which would limit the room for discretion and thus the scope for misuse. Moreover, the policy on incentives should be guided by a realistic assessment of costs and benefits, to avoid undermining other policy objectives. Failure to agree on a common approach could lead to a "race to the bottom" and entail significant costs to all countries in terms of budget revenue loss and a weaker fiscal position. It needs to be recognized, however, that harmonization of tax and investment incentives is not a panacea and that other conditions—such as adequate infrastructure and good business climate—must be in place to promote strong investment and economic growth.

Chapter II recommends a strategy to augment credit to the private sector. Even though the EAC members have stabilized and strengthened their banking systems, credit to the private sector remains low. In such an environment, the first steps are to improve financial intermediation through the removal of obstacles to lending and to support competition in the banking system. Improvements in financial intermediation need to be sustainable and thus cannot be forced by direct government intervention.

Chapter III concludes that the EAC members stand to gain through unilateral trade liberalization by lowering their Common External Tariff. This would lead to trade creation, improved efficiency of resource allocation, and welfare gains. The tariff reform, however, is a long-term undertaking. As such, it needs to be complemented by measures alleviating both non-tariff impediments to trade and the supply response constraints, as well as by measures offsetting the potential loss of revenue associated with tariff reduction.

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I. Investment Incentives Harmonization in the East African Community[1]

I. Introduction

1. **In line with the 1999 Treaty establishing the East African Community (EAC), Kenya, Tanzania, and Uganda established, in February 2005, the EAC customs union.** The customs union has eliminated internal tariffs and established a three-band common external tariff. The customs union is an important step toward closer regional integration. At the same time, the formation of the customs union has increased the urgency of a closer harmonization of investment incentives policy.

2. **The customs union has created a larger market, and firms can be located in any EAC country to service this market.**[2] As a result, the EAC members could be tempted to offer further investment incentives to attract FDI, in order to capture most benefits in terms of jobs, higher exports and tax revenues. Increased competition over FDI and growing pressure to provide tax holidays and other investment incentives to attract investors could result in a "race-to-bottom" that would eventually hurt all three EAC members. Left unchecked, such an uncoordinated contest could result in revenue loss and, particularly in Tanzania and Uganda, threaten the objective of improving revenue collection.

3. **This paper argues that a coordinated approach to providing investment incentives should become a priority in the EAC.** To facilitate closer regional economic integration and to avoid the damaging uncoordinated contest to attract foreign investors, the EAC members should seek a closer coordination of investment and tax policies and the creation of an EAC-wide legal framework for foreign investment.

4. **In principle, policies at promoting private investment are welcome.** Private investment co-determine the rate of accumulation of private capital and productivity growth. Given that many countries in Africa, including the EAC countries, are at a disadvantage with respect to the so-called "gravity factors" (size of the host market, geographical and cultural proximity to source countries), offsetting measures to attract foreign investment, including investment incentives, may appear as an attractive alternative. However, care must be taken to ensure that investment incentives are well-targeted, easy-to-administer, and do not undermine other policy objectives, including domestic revenue collection and macroeconomic stability. While there are different ways to achieve these objectives, this

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[1] Prepared by Jiri Jonas.

[2] The EAC customs union has created a market of more than 90 million people and US$30 billion GDP.

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chapter suggests that one possibility would be to agree on a Code of Conduct on Investment Incentives and Company Income Taxation.

II. Tax and Investment Incentives Harmonization

5. **For countries that seek closer economic and financial integration, harmonization of tax regimes and investment incentives should be an important objective.** In recent years, the EAC members have made progress in tax harmonization (Table 1). The EAC members have harmonized the corporate tax rate and the top personal tax rate. The introduction of the customs union in February 2005 resulted in an abolition of internal tariffs and a unification of external tariffs.[3] Each country has also a single-rate VAT, though rates differ. Even more significant differences remain in excise taxes on petroleum products, alcoholic beverages and cigarettes, with Uganda generally having the highest rate.

6. **In contrast, depreciation rules and other elements of the corporate tax regime continue to differ among the EAC members.** The effective tax rate is a function of not only a statutory tax rate, but also other provisions that affect taxable income and tax liability, such as investment incentives and depreciation rules. For example, in manufacturing and hotel tourism, Kenya enjoys a significant investment advantage over Tanzania and Uganda due to generous capital recovery rules.

7. **More limited progress has been made in the harmonization of investment incentives.** While Kenya and Tanzania continue to provide tax holidays to companies operating in their export processing zones (EPZs), Uganda eliminated tax holidays in 1997 (Table 2).[4] In Kenya and Tanzania, companies operating in the EPZs are exempted for the first ten years from income tax and withholding tax on payments to nonresidents; after ten years, they pay a 25 percent corporate tax rate (compared with 30 percent for companies outside the EPZs.). In addition, and consistent with best international practice, exemption from customs duties, VAT and excises applies on imports used to produce exports.

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[3] Tariff reductions on Uganda's imports from Kenya are to be phased in over five-year period.

[4] In Kenya, EPZs have been in place since 1990, while in Tanzania, EPZs have been introduced only in 2002. In Uganda, companies that enjoyed holidays before 1997 were grandfathered.

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Table 1. EAC countries: Tax systems, FY 2006/07 Budget
(In percent, unless otherwise noted) 1/

	Kenya	Tanzania	Uganda
Corporate Income Tax	30	30	30
Investment/initial allowance (in %)			
Industrial machinery	100	50	50
Industrial buildings/hotels	100	20	20
Mining	40	100	75
Depreciation allowance			
Machinery and vehicles (DB)	12.5-37.5	25.0 – 37.5	20.0-40.0
Building and structures (SL)	2.5-4	5.0	5.0
Personal Income Tax (# of brackets)	0-30 (5)	0-30 (4)	0-30 (4)
VAT	16	20	18
Excise gasoline (in $, per 1000 liters)			
Premium	271	140	394
Regular	266	129	394
Diesel	140	122	246
Kerosene	98	52	110
Alcoholic beverages	(In KSh per liter)	(In TSh per liter)	(In USh per liter)
Beer	24-49	274	60 (30 local)
Wine	45 (percent)	878	70 (percent)
Spirits	65 (percent)	1302	70 (percent)
	KSh per 1000	TSh per 1000	
Cigarettes	495-1540 2/	4462-19195 3/	130 percent
Motor vehicles			
Engines over 3000cc	40	10	10
Engines 2000cc-3000cc	40	10	10
Engines < 2000cc	30 4/	0	10

Source: IMF; authorities.

1/ For Kenya FY 2005/06.
2/ Up to 1500 at 450 Ush, more than 3500 at 1400 Ush.
3/ Depending on length and domestic content.
4/ 20 percent for engines below 1800cc.
DB – declining balance depreciation method.
SL – straight-line depreciation method.

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Table 2. EAC countries: EPZs: Investment Incentives and Other Features

	Kenya	Tanzania	Uganda
Established:	1990	2002	None
Income tax exemptions	Exemption from income tax and withholding tax on payments to nonresidents for first 10 years in EPZs; 25 percent corporate tax rate for the next 10 years	Exemptions from corporate tax for first 10 years and then payment at a rate not higher than 25 percent	
Transaction tax exemptions	Exemption from customs duties, VAT and excises on imports for exported goods.	Exemption from customs duties, VAT and excises on imports for exported goods.	
Export requirement	80 percent	70 percent	
Employment	30 000	2000-5000 ?	
Export (US$ million)	130	8-9	

Source: FAD TA report; authorities.

8. **The prevailing sentiment in the EAC countries is to expand investment incentives further.** In addition to the 2002 decision to establish export processing zones, Tanzania is now considering to supplement five EPZs with Special Economic Zones (SEZs). The SEZs are supposed to provide a special economic environment to selected economic activities. According to the proposal, investors (both domestic and foreign) are to be classified into three categories and provided different tax incentives, including a corporate tax exemption.

9. **While Uganda has abolished tax holidays, a perception exists that the EPZs and associated tax holidays provide an advantage to Uganda's EAC partners in attracting foreign investment.** As a result, pressure is strong in Uganda to establish its own EPZs and provide more generous incentives to investors, to match the investment incentives provided by Kenya and Tanzania.[5] To some extent, the pressure for tax holidays in EAC countries is also in response to competition for foreign investors from non-EAC countries.[6]

[5] Many potential foreign investors come from India, China and other Asian countries where tax holidays have been a widespread practice. Thus, these investors seek a similar treatment in Uganda.

[6] For example, in Uganda, local businessmen complain about the unfair competition that Ethiopian exporters enjoy because of subsidized air freight.

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III. Investment Incentives: Theory and Evidence

10. **In theory, providing investment incentives would be justified if the expected social return of the investment exceeded the risk-adjusted private return.** For example, if investors cannot fully internalize positive spillovers from the investment, they would undertake less investment activity than would be socially optimal. Often, this argument is implicitly behind the incentives offered to foreign investors. It is argued that foreign investment creates positive spillovers because of diffusion of skills and technology in the local economy.

11. **However, potential spillovers are not an automatic consequence of foreign investment.** Whether or not the spillovers of foreign technology and skills into local economy would materialize depends crucially on local firms investing in their ability to absorb new technologies and skills. Thus, some authors argue that a more comprehensive approach supporting both foreign and domestic investment is needed to better capture the potential for spillovers (Blomström and Kokko, 2003).

12. **Despite the strict theoretical condition that would justify investment incentives, they are being used in an increasing number of both developed and developing countries.** A study by UNCTAD reports that out of 1,185 national FDI legislation changes in 1991-2000, 95 percent were favorable to foreign investors, mostly to promote FDI (UNCTAD, 2000). FDI is expected to improve the skills and technology and thus provide a basis for a stronger productivity growth that would stimulate investment, output and exports, and reduce unemployment. Governments also try to attract foreign investors to specific sectors or activities, or to help address regional economic disparities. It is not unusual that governments resort to investment incentives because other countries do, as they are concerned that by not offering sufficient incentives themselves, they would lose foreign investors.

13. **There are many different forms of investment incentives (see Box 1).** Direct tax incentives reduce the corporate tax rate or alter investment cost recovery (for example, investment allowance, investment tax credit, accelerated depreciation). Indirect tax incentives are usually used to support exports and reduce or exempt export-oriented production from tariffs or VAT. Nontax incentives, too, have multiple forms, either monetary or in kind. These include government grants and subsidies and in-kind incentives, such as land or buildings.

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Box 1. Investment Incentives

Corporate tax incentives
- Tax holidays or reduced tax rates
- Tax credits
- Investment allowanced
- Accelerated depreciation
- Reinvestment or expansion allowanced

Other tax incentives
- Exemption from or reduction of withholding taxes
- Exemption from import tariffs
- Exemption from export duties
- Exemption from sales, wage income or property taxes
- Reduction of social security contribution

Financial and regulatory incentives
- Subsidized financing
- Grants or loan guarantees
- Provision of infrastructure, training
- Preferential access to government contracts
- Protection from import competition
- Subsidized delivery of goods and services
- Derogation from regulatory rules and standards

14. **Often, investment incentives are provided to companies operating in the EPZs.** EPZs are a secured territory where a special tax regime and other conditions are applied to companies operating there. While Kenya and Tanzania provide both relief of transaction taxes (customs duties and indirect taxes) and income tax relief, it should be noted that the latter are not inherent to EPZs. The objective of transaction tax relief is to minimize the tax burden on exports, consistent with best international practice. The provision of income tax holidays cannot be justified by this objective, and is considered to be more costly, in terms of lost revenue and economic distortions, than transaction tax relief.

15. **Despite their widespread use, the usefulness of investment incentives—particularly tax incentives—is often challenged in the literature.** The main arguments against tax incentives include:

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- Tax incentives result in a loss of current and future tax revenue;

- Tax incentives create differences in effective tax rates and thus distortions in allocation of investment between activities that are subsidized and those that are not;

- Tax incentives could require large administrative resources;

- Tax incentives could result in rent-seeking and other undesirable activities;

- Income tax holidays could be a particularly ineffective way of promoting investment. Companies that are not profitable in the early years of operation, or companies from countries which apply a foreign tax credit to reduce the home country's tax on the foreign source income, would not benefit from income tax holidays. In contrast, such holidays would be of less importance to companies that are profitable from the start of their operation;

- Tax incentives attract mainly footloose firms; and

- Tax incentives can be outside the budget and nontransparent.

16. **These theoretical concerns are supported by available empirical evidence, which mostly confirms that investment incentives—particularly tax incentives—are not an important factor in attracting foreign investment.** Countries that were most successful in attracting foreign investors did not have to offer tax or other incentives, and vice versa, offering such incentives has not been sufficient to attract large foreign investment if other conditions were not in place. This conclusion is confirmed both by surveys of investors and by econometric evidence.[7] To be sure, the evidence does not disprove that under specific circumstances, well-targeted investment incentives could be a factor affecting investment decisions.[8] Neither does it imply that investors still would not ask for whatever incentives they could get. But in the end, investment incentives seldom appear to be the most important factor in investment decisions. To quote just one example, in a study of foreign investment in the Caribbean region, the World Bank (2005) found that among 40 areas considered by firms as important for their investment, tax concessions were not even among the top 16 factors.

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[7] For a review of tax incentives, see Zee, Stotsky, and Levy (2002) and Working Group of the Capital Markets Consultative Group (2003).

[8] Basu and Srinivasan (2002) argue that in case of Mauritius, investment incentives within EPZs have played an important role in attracting foreign direct investment. However, the authors also emphasize the unseparable role of other factors, including efficient infrastructure, low costs of skilled labor, and sound legal system.

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17. **Investment decisions are more sensitive to the general economic prospects of the country in question and to institutional and regulatory policies.** The most important conditions include:

- overall macroeconomic situation, including economic growth, wages and productivity, and macro stability;
- tax and other structural conditions, including the overall tax burden on investment projects, predictability and stability of tax regime;
- institutional conditions and availability of infrastructure, including the regulatory regime, licensing requirements, quality of bureaucracy (especially tax administration), and governance.

In the absence of these conditions, providing tax and nontax investment incentives would not be enough to attract investors, while if these conditions are met, most investment would come even in the absence of investment incentives.

18. **Countries that were most successful in attracting foreign direct investment all displayed certain common characteristics.** For example, the report on foreign direct investment in emerging market countries prepared by the Working Group of the Capital Markets Consultative Group documents in detail the motivation and determinants of FDI in the emerging market countries. In countries like China, foreign investors were attracted mainly by domestic market size and growth prospects, low wage cost relative to productivity, available infrastructure, reasonable tax level, and stability of tax regimes.

19. **While tax incentives are likely to bring only limited benefits at best, they could at the same time entail significant revenue loss.** Particularly if a group of countries tries to outbid each other by offering bigger concessions to investors, the costs of incentives could increase significantly. A number of studies have been undertaken to estimate the revenue loss from tax incentives, and they usually show an annual loss of 1-2 percent of GDP (OECD, 2004). However, some studies show much higher revenue losses. In an analysis of tax incentives in the Eastern Caribbean Currency Union, IMF staff estimated than in some countries, tax revenue foregone could reach as much as 91/2-16 percent of annual GDP (IMF, 2005).[9] But for countries like Tanzania and Uganda, even revenue loss of 1-2 percent of GDP would represent a substantial shortfall.

20. **Tax incentives could also produce revenue a loss indirectly through the misuse of the tax concession systems.** Particularly in countries with weak administrative and legal

[9] Recently, the Fund has been active in assisting the Central American countries with the coordination of investment incentives.

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systems, where rent-seeking behavior is less likely to be discouraged and prosecuted, tax concessions can be abused. Countries with a weak administration would have to allocate additional budget resources to prevent such losses, and less money would be available to spend on other priorities. For these reasons, in countries such as Uganda and Tanzania where government revenues remain relatively low compared with spending needs, the costs of losing tax revenues as a result of tax incentives could be rather high.[10]

21. **The loss of tax revenue could undermine governments' capacity to provide solid infrastructure, effective administrative services and other conditions that foreign investors value.** By reducing available government resources, incentives could complicate governments' efforts to maintain macroeconomic stability and ensure adequate provision of other public goods such as reliable infrastructure and well-functioning legal and institutional framework. As observed by Stewart and Webb (2006), companies pay attention not only to the tax burden, but also to benefits that may accrue from government spending financed by taxes.

22. **The EAC's own experience supports the general conclusion that tax incentives are not the most important determinant of foreign investment.** While Uganda abolished tax holidays in 1997, it has continued to attract an increasing volume of FDI, measured in terms of GDP, higher than Kenya though less than Tanzania where FDI increased sharply in late 1990s.[11] On the other side, Kenya has been providing relatively more generous investment incentives, but this generosity failed to attract higher FDI inflows. Similarly, the introduction in Tanzania of EPZs in 2002 has not resulted in a noticeable pickup in foreign investment (see Chart).

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[10] A transparent system of tax incentives could limit such risks. In Uganda, tax expenditures need to be reported by the Ministry of Finance in the annual budget.

[11] The sharp jump in FDI in Tanzania coincides with the program of liberalization, and establishment of the Tanzania Investment Center (TIC) in 1997 (though it could be also explained by the jump of investment in the mining sector which might not have been sensitive to investment incentives). At the Africa Investment Promotion Agencies 2004 competition, TIC was named Africa's best investment promoter.

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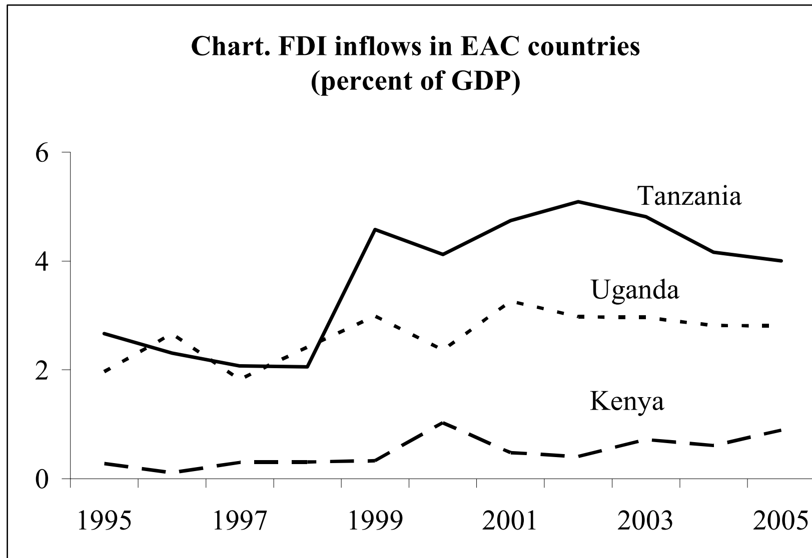

Source: Authorities' data.

23. **A number of studies have concluded that other factors than insufficient investment incentives hamper investment and growth in Africa.** For example, Dupasquier and Osakwe (2005) list a number of reasons behind African's poor FDI record:

- high degree of uncertainty in the region, related to political instability, high incidence of wars and conflicts, macroeconomic instability and lack of policy transparency;
- inhospitable regulatory environment, including high costs of entry of new firms;
- relatively low GDP per capita and small market size that makes it difficult to exploit economies of scale;
- poor infrastructure (telecommunication, transport, power supply) which reduces productivity of investment;
- high protectionism, high dependence on commodities and low integration of Africa into the global economy.

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IV. Moving Ahead: A Cooperative Approach

24. **Two principles should guide investment incentives policy in the EAC countries: a coordinated approach and the provision of well-targeted incentives.** The shared objective of investment incentives policy should be to make the EAC region an attractive place to invest. Therefore, it is important that the investment incentive policy does not undermine other objectives, including macroeconomic stability and domestic revenue mobilization, that are equally important for the attractiveness of EAC countries as investment destination.

25. **A cooperative approach to investment incentives is required to avoid the potentially high costs of a non-cooperation.** A cooperative approach does not mean a complete harmonization of tax and nontax incentives.[12] Rather, it means that the EAC countries would discuss and coordinate their investment incentives policy, and that rules guiding the provision of incentives would be agreed upon. If a country feels that its incentives are insufficient, instead of acting unilaterally, it would be better to raise the issue with its EAC partners.

26. **The benefits of a cooperative approach to investment incentives are increasingly appreciated in other regions where countries are engaged in closer economic and financial integration.** For example, coordination of investment incentives has been pursued in Central America, the European Union, and West African Economic and Monetary Union.[13] Coordinating investment incentives could be a politically difficult process, as it implies giving up part of countries' policy sovereignty. But in the end, increased coordination of investment incentives would promote EAC members' own interests.

27. **Different starting levels of investment incentives in the EAC countries suggest that there could be three different strategies of harmonization.** First, harmonization at the less generous level of incentives (as provided by Uganda). Second, harmonization at the more generous level of incentives (as provided by Kenya or Tanzania). Third, harmonization at some middle level, that is, some reduction of incentives in Kenya and Tanzania, and some increase in Uganda.[14]

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[12] But a coordinated approach would hardly be compatible with large differences in investment incentives. Therefore, coordinated approach also implies a substantial harmonization.

[13] See OECD (1998) and European Commission (2000).

[14] In theory, harmonization at even higher or lower level of incentives than currently prevailing in the EAC countries could also be possible, but this is not a likely alternative.

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28. **The revenue impact of the incentive policy needs to be taken into account when such policy is being formulated.** Revenue implications of tax incentives are relevant particularly in Tanzania and Uganda, where domestic revenue collection is still relatively low, and a large share of budget spending is financed by donors. Thus, too generous tax incentives could undermine the effort to raise domestic revenue. Too generous or ill-targeted tax incentives could delay the effort to wean off from dependence on donors' money and could depress public discretionary spending, including growth-supporting infrastructure investment. This, in turn, could adversely affect economic performance and partly or fully reverse the investment-stimulating effect of tax incentives.

29. **The costs of administering investment incentives, too, need to be taken into account.** Providing investment incentives to some investors creates discrimination and incentives for other to seek similar benefits. For example, offering corporate tax holidays to firms operating in the EPZs could lead to increased effort of firms outside the EPZ to "move in". Thus, authorities' ability to minimize such "leaks" is crucial to limit revenue losses.

30. **Investment incentives should be well-targeted and focused narrowly on the activities they seek to promote.** More effective options could include tax incentives that allow a faster recovery of investment costs (e.g., investment allowances, tax credits, accelerated depreciation). In contrast, the corporate income tax holiday usually does not meet the criterion of a well-targeted incentive.

31. **Corporate income tax holidays could be a particularly costly investment incentive.** The limits of corporate income tax holiday in promoting new investment could be best understood using the simple chart below. Tax holidays only increase the share of gross profits that goes to firms, and reduces the share collected by public sector. In contrast, policies that improve firms' revenues and/or reduce costs increase the number of profitable projects, and could bring much higher economic benefits.

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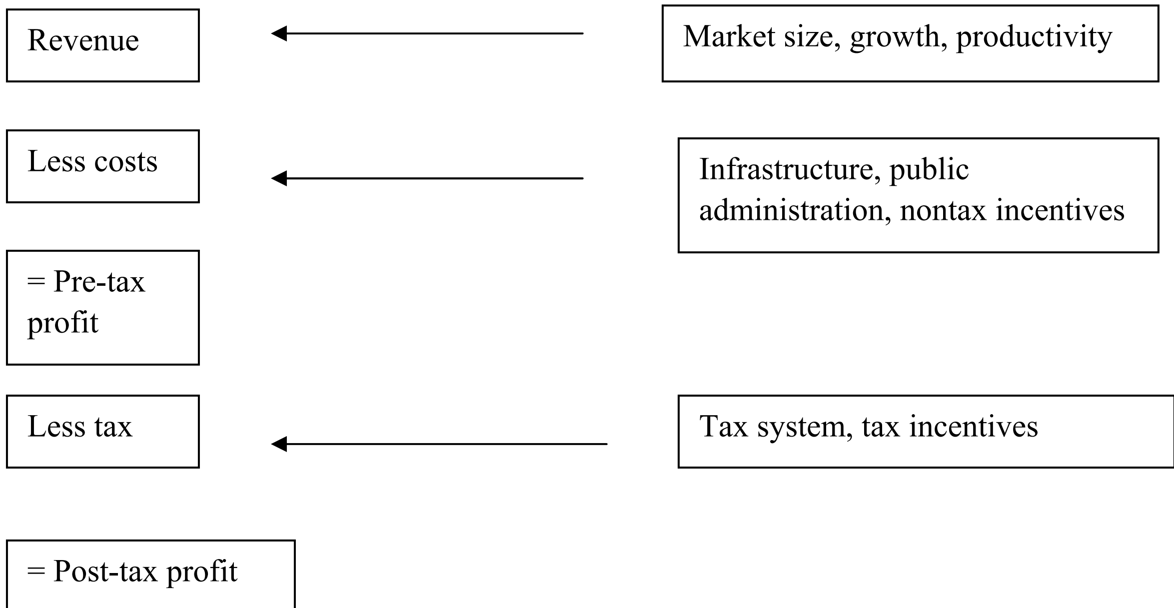
Factors Affecting Profits



32. **If the EAC countries decide to pursue a coordinated approach to investment incentives, one possible solution would be to agree on a Code of Conduct for Investment Incentives and Company Income Taxation (Code).** This Code would place limits on what kinds of investment incentives could be offered and to whom. The CC could also incorporate the standard guarantees to investors, including the freedom to invest, nondiscrimination, national treatment, repatriation and limited expropriation. It would have to specify whether all EAC firms would be treated in exactly the same way and, if not, what differences would be permissible.

33. **If the EAC members were to introduce a Code that scales back the existing investment incentives, they would have to decide whether these incentives should be grandfathered.** With respect to incentives that are extended indefinitely, it would probably be advisable to phase them out. One option would be to let incentives that have an expiration date (either on the existing or accelerated schedule) expire at the end of the incentive period, while gradually phasing out the incentives with no pre-set expiration date.

34. **With respect to the administration of investment incentives, two general approaches are possible: a rules-based system and a discretionary system.** Under a rules-based system, the decisions about whom to, under what conditions and in what form to provide incentives are based on statutory provisions. Under a discretionary system, the

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incentives are granted on an ad hoc basis by government agencies and officials.[15] There are strong arguments in favor of a rules-based system, as it provides a more predictable environment and limits the room for misuse and corruption.[16] The qualifying criteria for investment incentives should be made simple and objective, to minimize the need for subjective interpretation. A rules-based system is also easier to monitor and enforce.

35. **Regardless of which approach is chosen, an important part of a well-managed system of granting investment incentives is transparency.** Ideally, the authorities would publish, perhaps as a part of the budget documentation, an analysis of the revenue impact of tax incentives, or, more generally, the estimate of the budgetary impact of both tax and nontax incentives. This could be done in the form of a tax expenditure budget.

36. **Finally, the EAC members would have to decide about an enforcement mechanism.** The issue is whether the Code would represent a legal or a moral obligation of each country. It is unlikely that a legal status of the Code would be enforceable at this stage, and at least initially, it could be sufficient to start with the latter option. Under the moral obligation option, each EAC member could file a complaint against the practices of another country with the Code of Conduct Committee that could issue a nonbinding opinion. Each country would also be required to inform or consult other EAC members about intended changes in tax regime or investment incentives, to allow the other members to assess whether the proposed changes are in line with the agreed rules.

V. Conclusions

37. **This chapter has argued that a coordinated approach to providing investment incentives—possibly through a Code of Conduct—would be in the interest of all EAC members.** The Code would specify what incentives the EAC countries could offer, and provide a framework for consultation and coordination. It would also be advisable to set up a transparent rules-based system of investment incentives, which would limit the room for discretion and thus the scope for misuse. Moreover, the policy on incentives should be guided by a realistic assessment of costs and benefits, to avoid undermining other policy objectives. Failure to agree on a common approach could lead to a “race to the bottom” and entail significant costs to all countries in terms of budget revenue loss and a weaker fiscal position.

38. **At the same time, it needs to be recognized that tax and investment incentive harmonization is not a panacea and that other conditions must be in place to promote strong investment and economic growth.** Africa’s relatively low intra-regional trade

[15] The law gives the minister or the Board of Investment this discretionary authority to grant incentives.

[16] In this respect, there is room for improvement of investment incentive administration in Kenya and Tanzania.

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integration remains an important obstacle to faster growth. Therefore, the EAC members need to make sure that the potential benefits of a closer regional integration are not undermined by lack of cooperation on tax policies and investors' incentives. In addition, the EAC members need to address, as a matter of priority, other institutional, administrative and physical obstacles to a stronger growth, including lack of good quality infrastructure, high administrative costs of setting up businesses, and bureaucratic obstacles to investment and trade. Last but not least, a simple and transparent tax system with a broad base and low rates would reduce the demand by investors for tax holidays or other forms of special treatment.

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II. Promoting Private Sector Credit in the East African Community: Issues, Challenges, and Reform Strategies[1]

I. Introduction

1. As in most low-income countries in the sub-Saharan Africa (SSA), in Kenya, Tanzania, and Uganda—the members of the East African Community (EAC)—the financial sectors provide relatively little credit to the private sector. While the level of private sector credit in the EAC is around the average of SSA,[2] it is significantly lower, and, with the exception of Tanzania, is growing at a slower pace than in other low-income countries (LICs).

2. **The link between access to credit and economic development and poverty reduction is well documented**. Access to credit promotes growth by enhancing the efficiency of resource allocation and facilitating the exchange of goods and services (Levine, 1997). Low access by the private sector to credit is likely to impede poverty reduction because small firms, which are likely to be drawn from poorer populations, are more likely to be subject to credit rationing (Beck, Demirguc-Kunt, and Maksimovic, 2005). Hence, to fulfill the aspirations of their populations for growth and poverty reduction, the EAC countries need a strategy to promote private sector credit.

3. **This paper explores private sector credit markets in the EAC, identifies the main obstacles EAC members face in promoting credit to the private sector, and suggests a reform strategy.** The main findings of this chapter include:

- Despite strong growth, private lending in Tanzania and Uganda falls significantly short of the levels seen in other LICs. While credit to the private sector in Kenya was generally in line with average levels in other LICs in the late 1990s, it has been lagging behind recently;

- High interest rates, deeper structural weaknesses such as a poor legal system for property and creditor rights, and lack of credit information on borrowers are major impediments to increased private sector lending. In Tanzania, credit to the private sector was also crowded out by government borrowing in the late 1990s.

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[1] Prepared by Kevin Cheng and Richard Podpiera.

[2] Throughout this paper, all reference to sub-Saharan Africa (SSA) exclude South Africa and Nigeria, unless otherwise indicated.

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- A new reform strategy needs to create the opportunity for banks to lend profitably at lower spreads by removing obstacles to lending and forcing them to use newly available opportunities by supporting competition in the banking systems. The authorities should exercise caution and prudence in introducing any new kinds of direct government involvement in the private sector, which should not distract from broader structural reforms.

II. Issues and Challenges

A. Background

4. **The EAC is a low-income region in SSA**. Per capita income there is around 5 percent of the world average—and lower than the average for LICs or SSA. Agriculture is a key sector in the region, accounting for a third of GDP. Kenya is the largest, richest, and most developed economy in the EAC (Table 1).

Table 1. EAC and Comparator Groups and Countries: General Economic Indicators, 2004

	GDP (U.S.$ billions)	GDP per capita (U.S.$)	GDP per capita (world=100)	Agriculture (percent of GDP)
Kenya	16	481	7	27
Tanzania	11	288	4	45
Uganda	7	245	4	32
EAC	**34**	**341**	**5**	**34**
Compared with:				
Mauritius	6	4,889	75	6
Nigeria	72	560	9	17
South Africa	213	4,675	72	3
East Asia & Pacific	2,651	1,418	22	13
Europe & Central Asia	1,770	3,746	58	8
Latin America & Caribbean	2,022	3,704	57	9
Low income	1,239	529	8	23
Lower middle income	4,165	1,706	26	12
South Asia	880	608	9	21
sub-Saharan Africa*	238	432	7	27
Upper middle income	2,992	5,192	80	6
World	41,290	6,487	100	…

Sources: World Development Indicators (WDI)

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5. **There is a significant disparity between the financial sectors in the EAC countries.** Kenya has a well-developed financial sector compared with other low-income countries (LICs); the financial sectors in Tanzania and Uganda are underdeveloped compared with other SSA and LICs. Specifically:

- Total financial assets in Kenya are around 80 percent of GDP, in Tanzania around 30 percent, and in Uganda 26 percent.[1]
- Kenya's financial depth, measured as the ratio of M2 to GDP, is more than twice as much as its EAC neighbors, although it has recently fallen behind the average for LICs; the Tanzania and Uganda financial sectors are considerably shallower than other SSA countries or LICs (Figure 1).
- Kenya's deposit-to-GDP ratio is around the average for LICs, while Tanzania, despite strong growth, and Uganda lag behind considerably (Figure 1).

6. EAC banking sectors, the most prominent segments of financial systems, have low concentration but mixed performance in terms of efficiency and soundness.[2] Their concentration ratios—measured by the share of banking assets held by the three largest banks—are lower than the average in other LICs and SSA generally.[3] In fact, even Tanzania and Uganda, where the financial systems are relatively undeveloped, have banking systems significantly less concentrated than other LICs and middle-income economies like Mauritius and South Africa. Moreover, there is considerable foreign ownership. In Kenya, foreign banks account for 40 percent of total assets, while the banking systems in Tanzania and Uganda are dominated by foreign bank ownership. In terms of efficiency, the banking sectors in Kenya and Tanzania have lower overhead costs and net interest margins than other LICs and SSA countries. Uganda, however, has significantly higher interest margin and overhead costs than the regional standard (Table 2). In terms of soundness, while Kenya has a very high share of nonperforming loans (NPLs), NPLs in Tanzania and Uganda are low compared to other SSA countries (Table 3). Capital adequacy ratios in the EAC are high in international terms, ranging from 17 percent to over 20 percent of risk- weighted assets. The banking sectors are profitable in all three EAC countries, with the return on equity well over 20 percent.

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[1] The Uganda figure may be understated because data on nonbank financial institutions are not available.

[2] Kenya has a relatively well developed nonbank financial system, comprising around 40 percent of the financial assets; in Uganda and Tanzania the banking sectors dominate the financial systems.

[3] Concentration ratios may not necessarily give a good indication of the amount of competition.

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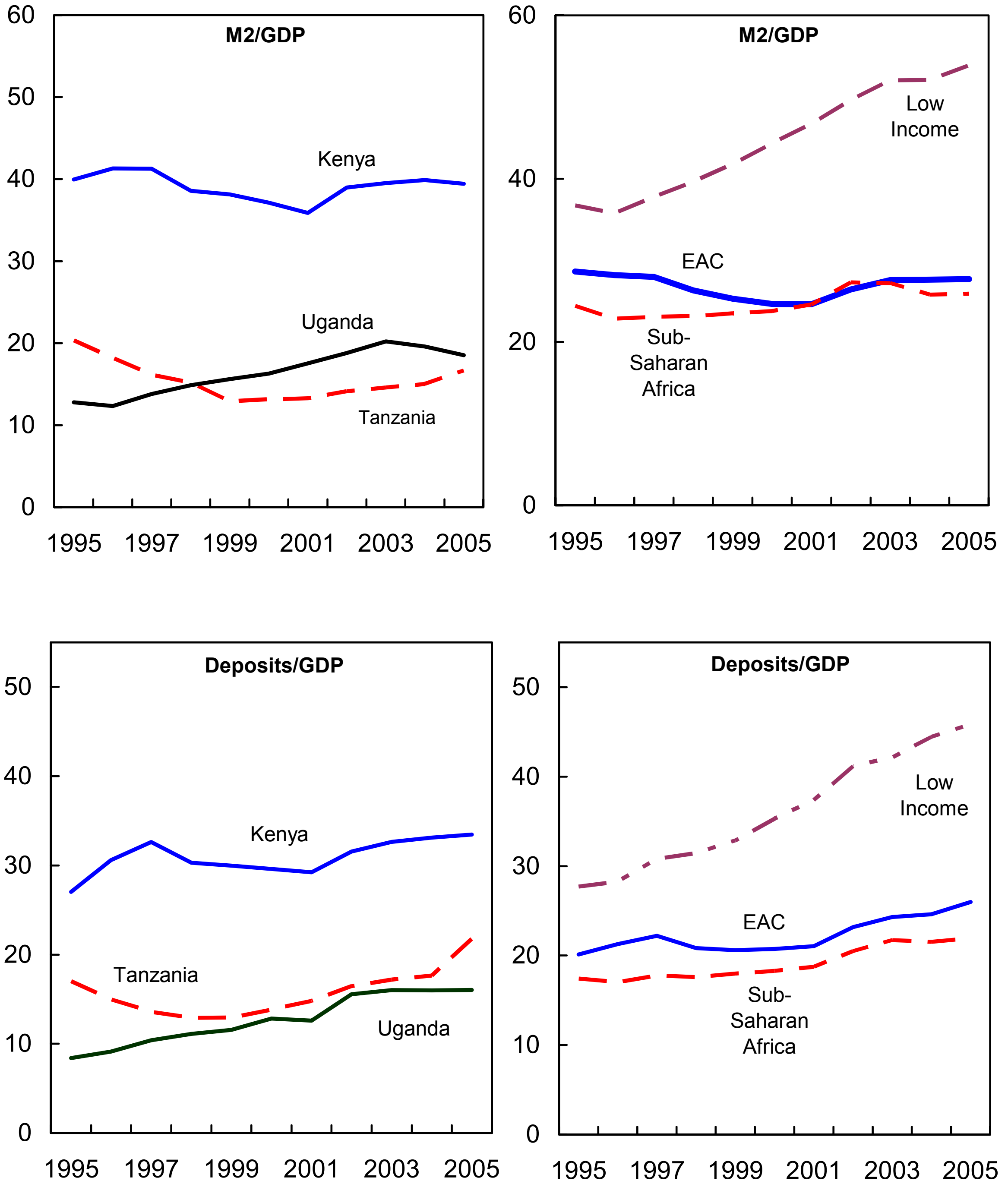
Figure 1. EAC and Comparator Countries: M2/GDP and Deposit/GDP, percent



Source: WEO and staff calculations

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Table 2. EAC and Comparator Groups & Countries: Concentration and Efficiency of the Banking Industry - International Comparison, 2003 (In percent)

	Number of Banks	Bank Concentration [1/]	Overhead Costs [2/]	Net Interest Margin [3/]
Kenya	43	57.6	5.7	6.5
Tanzania	23	57.2	5.7	6.7
Uganda	15	65.4	7.0	11.1
EAC		**60.1**	**6.1**	**8.1**
Compared with				
Mauritius	10	74.3	4.0	2.4
Nigeria	90	43.9	8.6	8.5
South Africa	38	75.0	9.9	6.5
Sub-Saharan Africa		83.0	6.0	8.2
Low Income		77.4	5.9	7.4
Lower Middle Income		62.6	5.9	5.9
Upper Middle Income		63.8	4.5	4.9
Middle Income		63.0	5.4	5.5
High Income		70.6	2.7	2.3
World		69.4	4.8	5.1

Source: World Bank Financial Structure Database; and IMF staff calculations

[1/] Assets of three largest banks as a share of assets of all commercial banks in the system.

[2/] Accounting value of a bank's overhead costs as a share of its total assets.

[3/] Accounting value of bank's net interest as a share of its interest-bearing (total earning) assets.

Table 3. EAC and comparator groups and countries: Non-peroforming loans (in percent of total loans), average of 2000-2004

Kenya	Tanzania	Uganda	EAC	Nigeria	South Africa	SSA	World
28.3	12.8	5.7	15.6	21.0	2.6	14.7	8.0

Sources: WDI and staff estimates.

7. **As in other SSA countries, access to financial services is limited in the EAC.** While Kenyans have more access than people in Tanzania and Uganda, they still have lower access than the average for residents of SSA countries and LICs, as manifested by relatively few bank branches per 100,000 people and large areas per branch (Table 4). In Tanzania and Uganda access to financial services is significantly lower than the averages for SSA countries and LICs.

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Table 4. EAC and Comparator Groups & Countries: Banking Branch Density in International Comparison

	Bank branches (per 100,000 people)	Area per branch (1,000 sq km)
Kenya	1.38	1.26
Tanzania	0.57	4.38
Uganda	0.53	1.65
EAC	**0.83**	**2.43**
Compared with:		
Mauritius	11.92	0.01
Nigeria	1.62	0.44
South Africa	5.99	0.45
Sub-Saharan Africa	2.74	1.22
East Asia & Pacific	2.90	0.30
Europe & Central Asia	6.56	0.78
Latin America & Caribbean	9.92	0.38
South Asia	5.88	0.06
Low Income	4.88	0.26
Lower Middle	4.45	0.36
Upper Middle	7.11	0.73
Middle Income	4.98	0.46
High Income	33.03	0.10
World	9.81	0.21

Source: WDI; WEO; and staff calculations.

B. Characteristics of Private Sector Credit in EAC

8. **Private sector credit in the EAC is limited and is concentrated in the secondary and tertiary sectors.** While at around 28 percent of GDP, private sector lending in Kenya in 1995-2005 was slightly higher than in other LICs and significantly higher than other SSA countries, NPLs account for a large share of total loans. Once NPLs are excluded, private sector credit falls to around the LIC average for 1995-2000 but because it until recently grew more slowly than credit in other LICs, it fell further behind. Excluding NPLs, private lending in Uganda is only around 5 percent of GDP—a third of the SSA average and significantly below the LIC average, and is also low in Tanzania.[1] While agriculture accounts for a third of GDP in the EAC, it only receives about 10 percent of private sector lending (Figure 3).

[1] In the rest of the paper, all private lending figures exclude NPLs.

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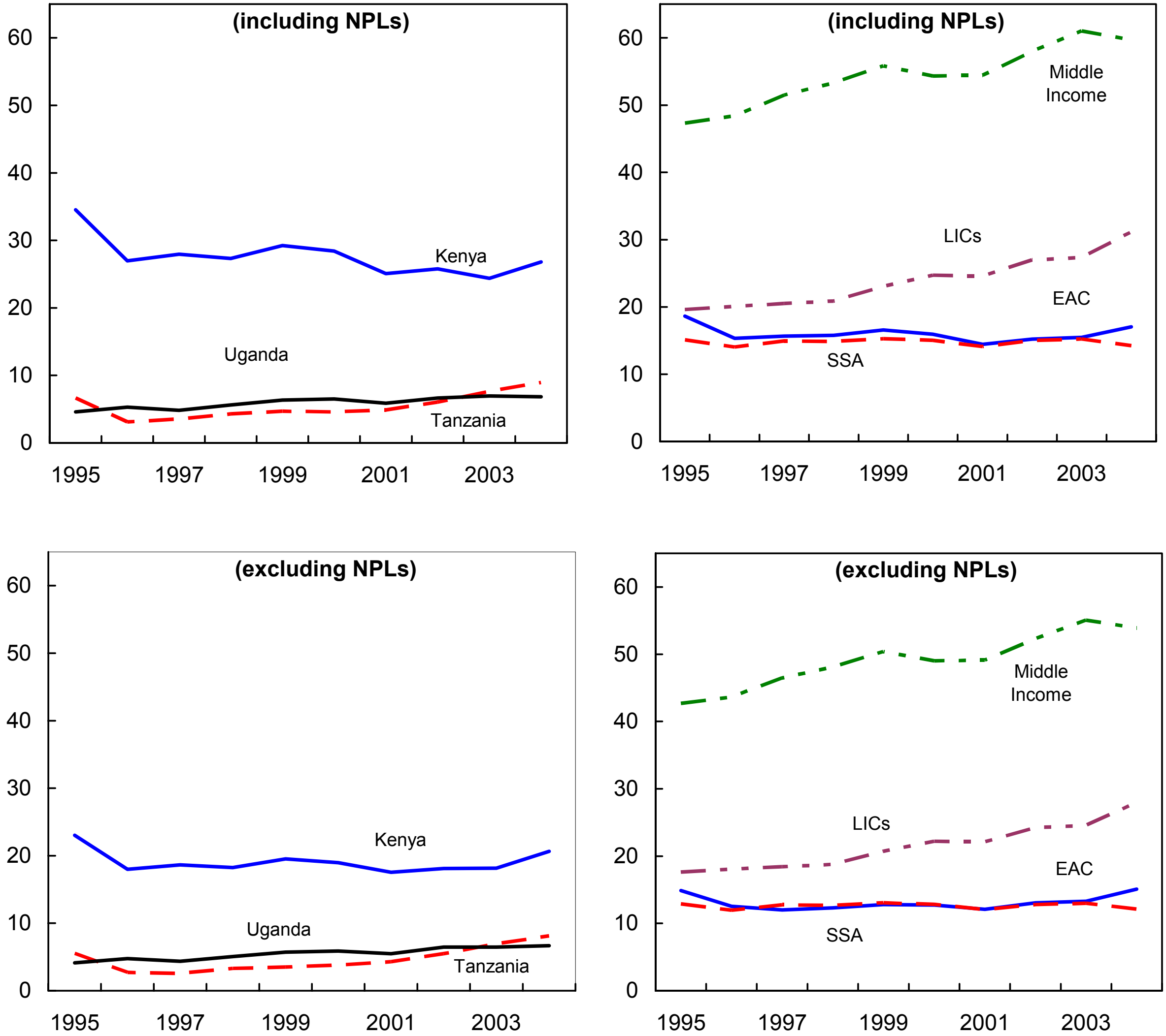
Figure 2. EAC and Comparator Groups: Private Sector Credit
(Percent of GDP)



Source: World Development Indicators and staff calculations.

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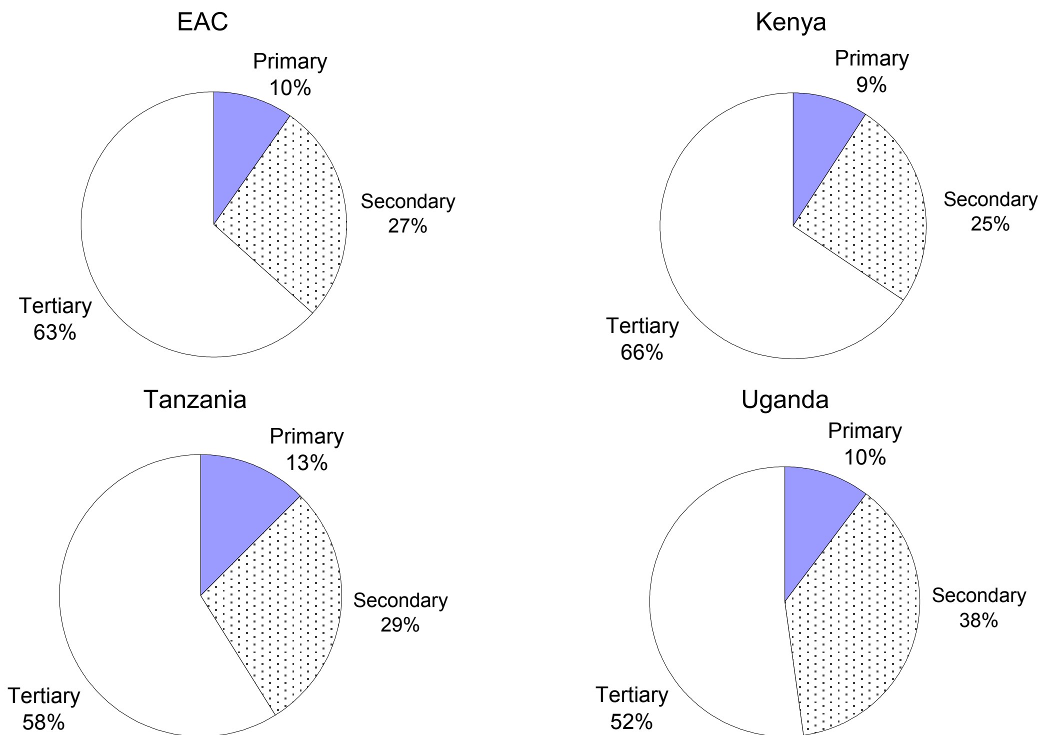
Figure 3. EAC: Distribution of Loans, Most Recent Available Data



Source: Authorities and staff estimates.

9. **Real lending rates and lending-deposit spreads are relatively high in the EAC.** The real lending rate is higher than the averages of LICs and SSA countries. Although the lending-deposit spread in the EAC was slightly below the average of SSA and LICs, it is significantly higher than the average for middle-income countries.

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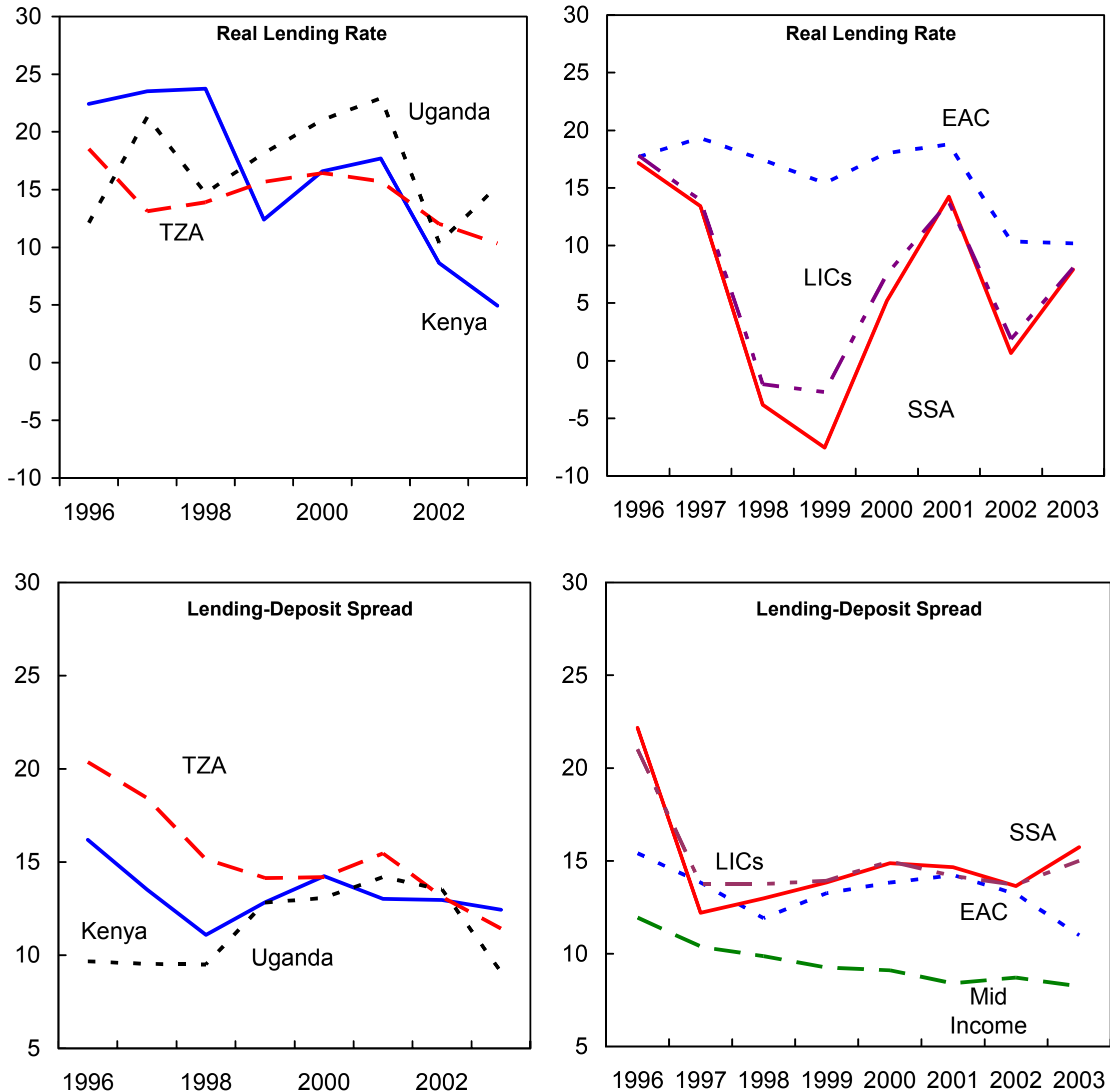
Figure 4. EAC and Comparator Group: Real Lending Rate and Lending-Deposit Spread, percent



Source: IFS and staff calculations

C. Factors that Deter Private Sector Lending

10. **The question of why private sector lending is low in the EAC has two aspects**. First, low private sector credit is itself a function of widespread poverty and a high share of population engaged in subsistence farming, which limits the financial resources available for intermediation. As illustrated in Figure 5, across LICs, private sector credit correlates positively with per-capita income and negatively with the size of the agriculture sector.

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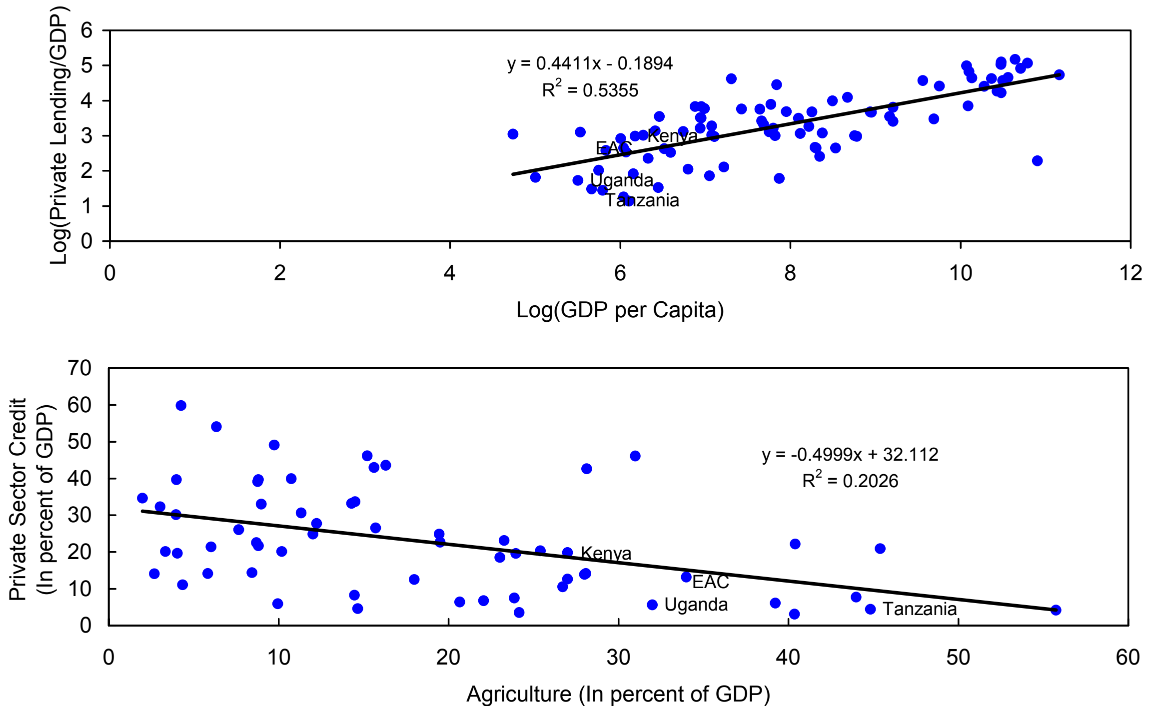
Figure 5. EAC and Comparator Groups: Private Lending and Economic Developments, 2004



Source: WDI and staff calculations.

11. **The second aspect of the question pertains to whether financial resources are effectively channeled into private sector lending**. Figure 6 illustrates the positive relationship between total deposits—a major financial resource—and private sector lending across the globe. It appears that given the level of financial resources available in the EAC, private-sector lending is low relative to the level that would be predicted by the regression line, suggesting that financial resources are not mobilized into lending.

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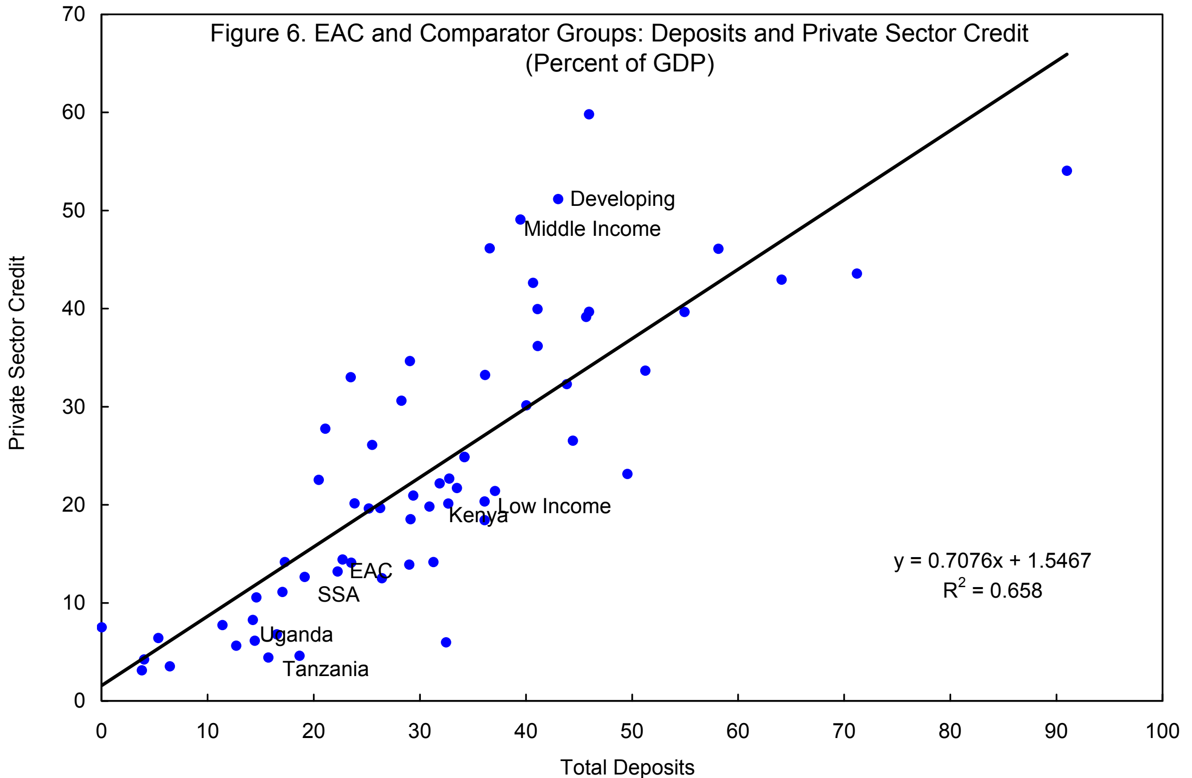

Sources: WEO, WDI and staff calculations.

12. **The remainder of the chapter will focus on the second aspect**. Here, the main impediments to increased private sector lending are high interest rates, weak legal systems for property and creditor rights, and insufficient credit information on borrowers. In Tanzania, excessive government borrowing also crowded out private sector lending in the 1990s.

High interest rates

13. **High real lending rates in EAC make enterprise financing expensive, thereby depressing private lending.** According to the World Business Environment Survey (WBES), firm managers in EAC reported high interest rate to be a major obstacle to financing (see also Table 5).[2] On a scale from 1 to 4, with 1 meaning no obstacle and 4 meaning a major obstacle, the EAC rates 3.46 on high interest rates, slightly higher than the SSA average of 3.38 and the LIC average of 3.40. The survey suggests that Kenya, with a

[2] The World Bank conducted the WBES in 1999 in more than 80 countries. The survey elicited answers from firm managers about their perception of the extent to which various obstacles inhibit the operation and growth of their business, including obstacles to financing.

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score of 3.53, is particularly affected by the high interest rate problem, though scores for the other two countries were also higher than the SSA average.

Table 5. EAC and Comparator Groups & Countries:Main implements to Financing

	High Interest Rates	Collateral Requirements	Banks Lack Loanable funds	Access to Lease Finance	Special Connections	Access to Nonbank equity	Credit Information
Kenya	3.53	2.49	1.60	2.18	1.93	2.18	2.56
Tanzania	3.28	2.96	1.95	2.65	2.35	2.87	2.92
Uganda	3.51	2.87	2.18	2.66	2.54	2.56	2.84
EAC (weighted average)	**3.46**	**2.76**	**1.92**	**2.48**	**2.28**	**2.50**	**2.76**
Compared with:							
Chile	3.05	2.32	1.75	1.53	1.96	1.69	1.98
China	2.06	1.80	2.09	1.65	1.84	1.56	2.29
Colombia	3.66	2.80	2.58	1.90	2.38	2.21	2.30
Ghana	3.24	2.38	1.98	2.23	2.23	2.15	2.53
India	3.25	2.53	1.62	1.74	2.09	1.93	2.04
Indonesia	3.45	2.48	2.66	2.01	2.46	2.03	2.40
Nigeria	3.40	2.27	1.93	2.06	2.13	2.46	2.51
South Africa	3.23	1.86	1.13	1.23	1.48	1.59	1.68
USA	2.54	2.09	1.52	1.67	2.00	1.74	1.82
Zambia	3.71	2.78	2.28	2.36	2.24	2.48	2.51
Sub-Saharan Africa	3.38	2.63	1.98	2.29	2.23	2.38	2.60
Developing Countries	3.30	2.54	2.17	2.12	2.21	2.16	2.33
Low Income	3.40	2.61	2.72	2.26	2.34	2.26	2.45
Lower Middle	3.34	2.55	2.30	2.13	2.26	2.14	2.30
Upper Middle	3.25	2.46	1.95	1.87	2.06	2.00	2.18
Middle Income	3.30	2.51	2.12	2.00	2.16	2.07	2.24
High Income	2.53	2.16	1.61	1.69	1.99	1.68	1.85
World	3.22	2.50	2.11	2.07	2.19	2.10	2.27

Source: World Business Environment Survey (WBES), 2000 and IMF staff calculations
Reported are average scores on scale 1-4 (4 - major obstacle, 1 - no obstacle)

14. **The high interest rates and spreads are symptoms of deeper structural impediments to private lending**. A foremost obstacle in each EAC country is a poor legal system that does not adequately protect property and creditor rights. In particular, an inefficient corporate bankruptcy process is detrimental to increased private lending. An efficient bankruptcy process will decrease borrower moral hazard, increase bank willingness to lend, and decrease the interest charged on loans, which currently must be high enough to cover the onerous costs of collection. Bankruptcy bottlenecks in the EAC, particularly Kenya, are associated with a protracted and costly judicial process. It takes on average 4.5 years to resolve a bankruptcy case in the EAC, compared with 1.8 years in high-income countries and 3.5 years in middle-income countries (Table 6). It also takes 30 percent of the bankrupt estate to resolve a bankruptcy case, compared with an SSA average of 19.5 percent and a world average of 16.4 percent.

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Table 6. EAC and Comparator Groups & Countries: Bankruptcy Procedures

	Time (Years)	Cost (percent of Estate)
Kenya	4.5	22.0
Tanzania	3.0	22.0
Uganda	2.2	30.0
EAC	**3.2**	**24.7**
Compared with		
Chile	5.6	14.0
China	2.4	22.0
Colombia	3.0	1.0
Ghana	1.9	22.0
India	10.0	9.0
Indonesia	5.5	18.0
Mauritius	2.0	14.0
Nigeria	1.5	22.0
South Africa	2.0	18.0
USA	2.0	7.0
Zambia	3.1	9.0
Sub-Saharan Africa	3.4	19.5
Developing Countries	3.5	17.8
East Asia & Pacific	3.4	28.8
Europe & Central Asia	3.5	14.0
Latin America & Caribbean	3.5	17.0
Middle East & North America	3.8	13.4
South Asia	4.2	7.3
Low Income	3.6	19.0
Lower Middle Income	3.5	19.0
Upper Middle Income	3.4	16.6
Middle Income	3.5	18.3
High Income	1.8	8.4
World	3.2	16.4

Source: Doing Business 2005, International Finance Corporation; and IMF staff calculations.

15. **Lack of credit information on the borrowers and high collateral requirements also significantly deter private lending in the EAC.** On a scale of 1 to 4, with 1 indicating no obstacle and 4 indicating a major obstacle (Table 5), the same survey gave the EAC an average score of 2.8 on credit information, compared with the worldwide average of 2.3. Without sufficient information on the borrowers, creditors have to rely on high collateral. Consequently, the EAC gets an average score of 2.8 on collateral requirements as a financing

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obstacle, compared with a worldwide average of 2.5. As Table 7 shows, 90 percent of the loans in EAC require collateral, compared with a worldwide average of 81 percent.

Table 7. EAC and Comparator Groups & Countries: Collateral Requirements [1/]

	Value of collateral needed for a loan (Percent of the loan amount)	Loans requiring collateral (Percent)
Kenya	172.5	86.1
Tanzania	110.6	91.2
Uganda	112.9	93.2
EAC	**132.0**	**90.2**
Compared with		
Chile	106.9	69.0
China	80.8	66.9
Indonesia	116.3	87.2
Mauritius	103.2	87.9
South Africa	123.8	61.1
Zambia	311.3	89.0
Sub-Saharan Africa	139.3	84.0
Developing Countries	142.6	81.6
East Asia & Pacific	106.7	75.9
Europe & Central Asia	154.5	83.7
Latin America & Caribbean	140.5	80.6
Middle East & North America	166.3	84.0
South Asia	90.2	78.2
World	141.4	80.6

Source: Doing Business 2005, International Finance Corporation; and IMF staff calculations
[1/] All data are for 2003, except Mauritius which is 2005; Note: Sub-Saharan Africa excludes Nigeria and South Africa.

Crowding-out by government borrowing

16. **High government borrowings appear to have contributed to low private sector credit in the EAC**. This is particularly true for Tanzania in the late 1990s, as indicated by a high ratio of claims on the government to total domestic claims. For Kenya and Uganda, while government borrowing is not excessive compared to other SSA countries and shows a declining weight in total domestic credit, it is still higher than in LICs outside SSA. As is well-documented, issuance of government debt absorbs domestic savings, potentially exerting upward pressure on interest rates, and crowding out lending to the private sector (Figures 7, 8, and 9).[3]

[3] Christensen (2004) and Adam and Bevan (2004) find some evidence of crowding out in African countries.

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Figure 7. EAC and Comparator Groups: Banking Sector Claims on Government
(Ratio on total claims)

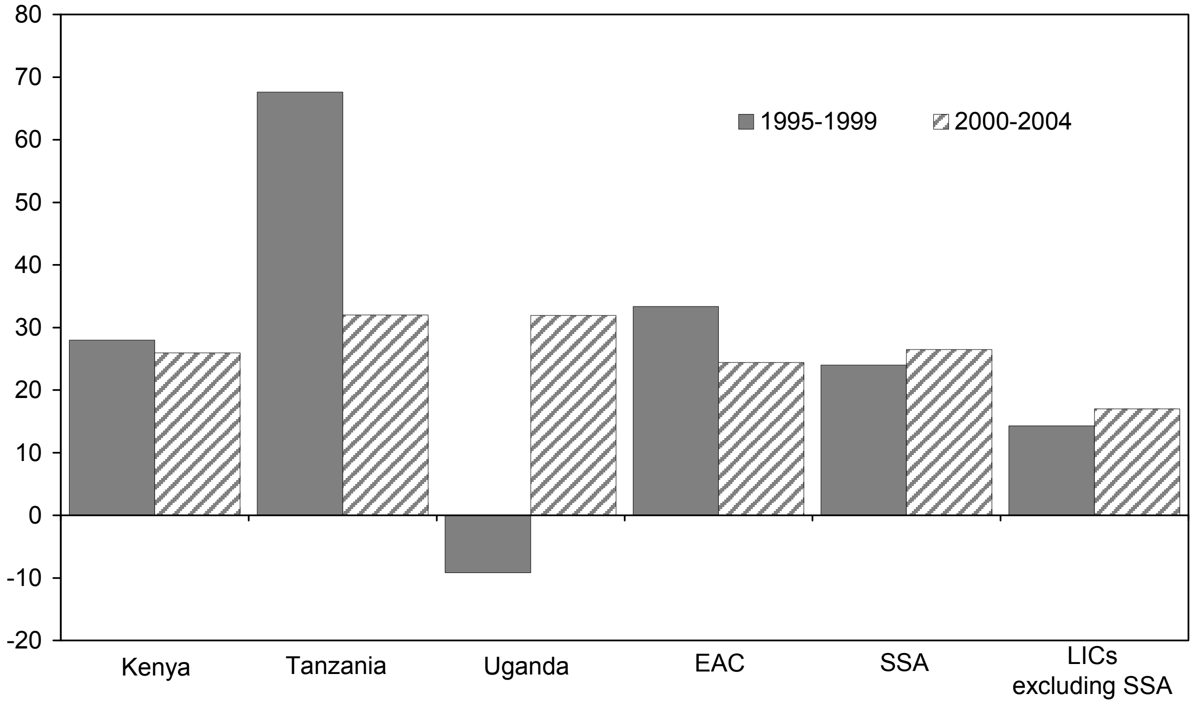

Figure 8. Government Debt and Private Sector Credit (Percent of GDP)

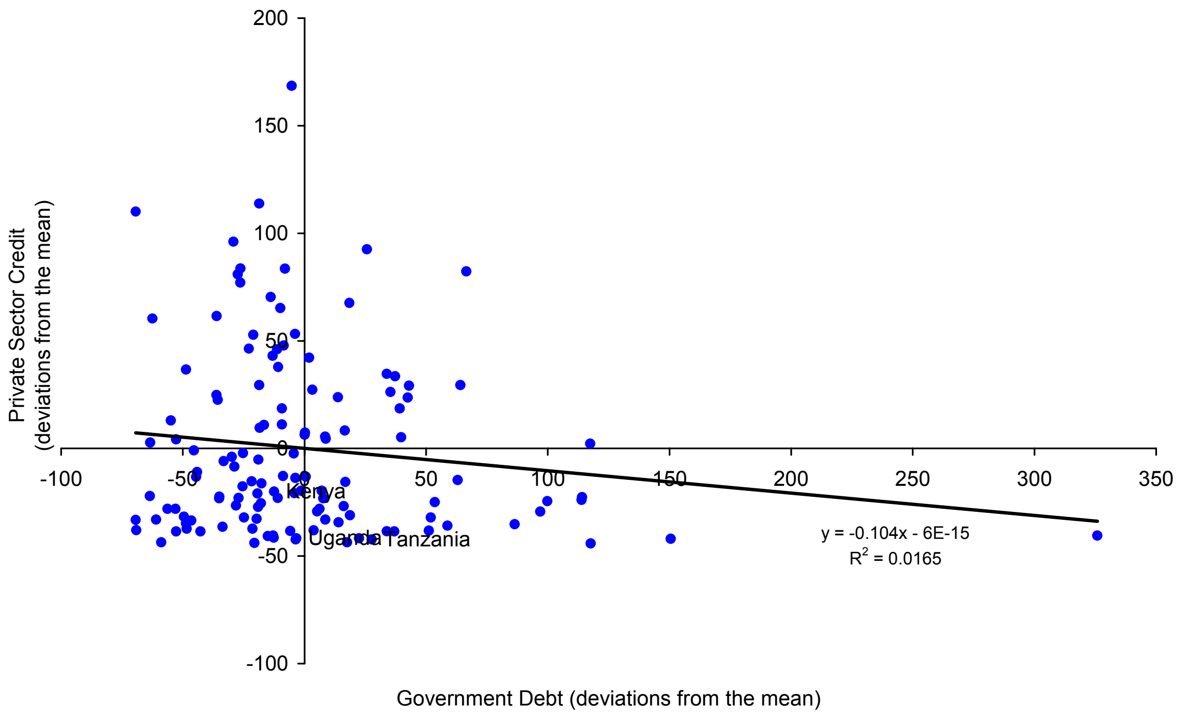

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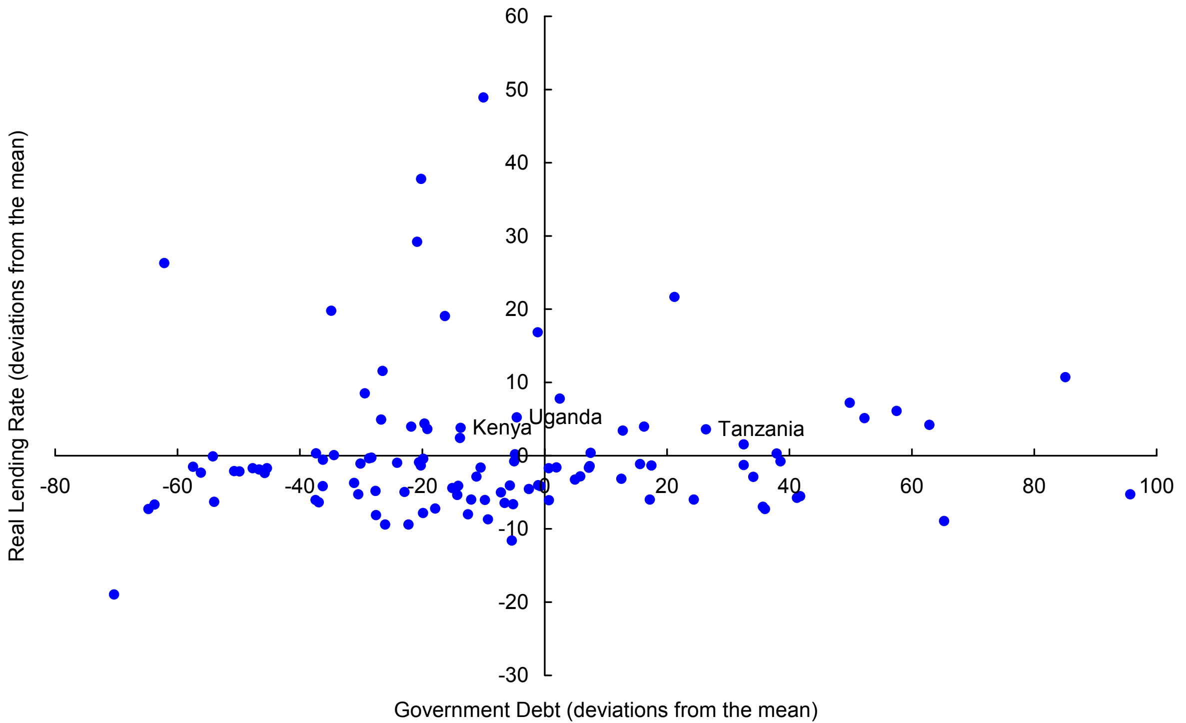
Figure 9. Government Debt (percent of GDP) and Real Lending Rate (percent)



Other macroeconomic factors

17. **Other macroeconomic variables do not appear to have significantly contributed to low private sector credit or high lending rates in the EAC.** As shown in Figure 10, key macroeconomic indicators in the EAC, like fiscal balance and inflation, do not seem to have substantially deviated from the global mean during 1995-2004, suggesting that they have played a relatively small role in contributing very low private sector credit in the region, which was substantially below the global average.

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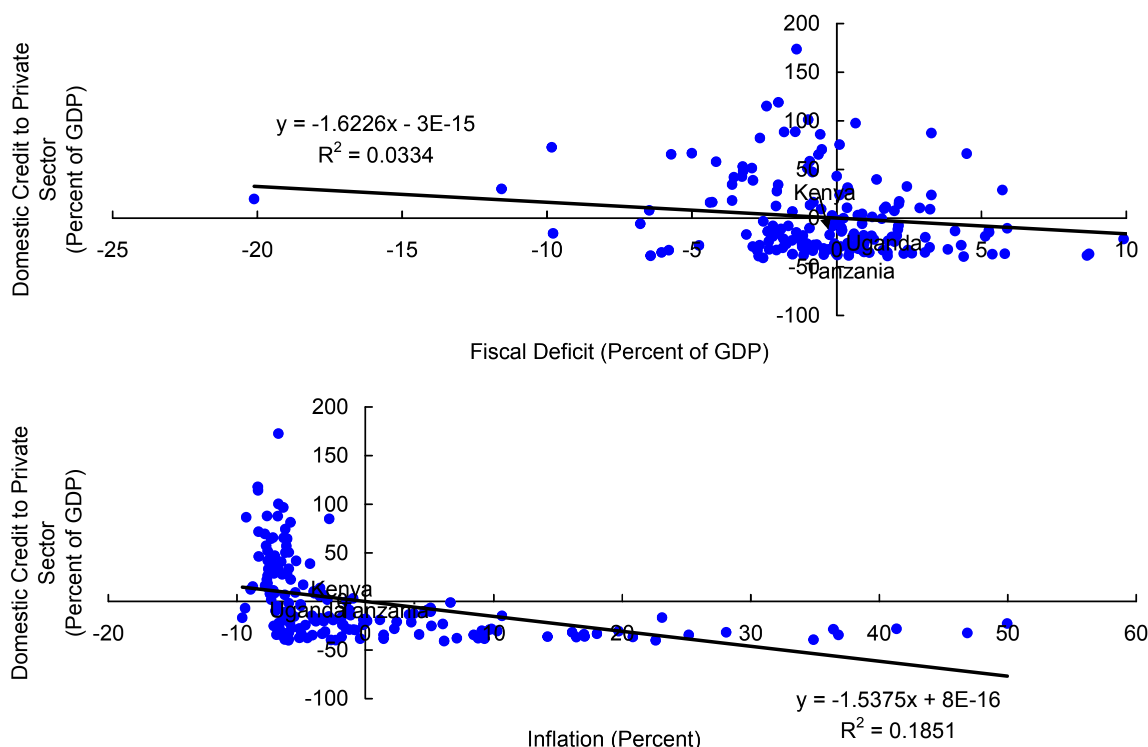
Figure 10. Macroeconomic Factors and Private Lending, Deviations from the Means



Source: WEO and staff calculations.

III. Recent Policies and Reform Strategy Going Forward

A. Recent Policies to Improve the Availability of Private Sector Credit

18. **The EAC authorities have implemented major reforms in recent years in an effort to improve access to private sector credit and enhance financial intermediation generally.** Since many banks had a very weak financial position and poor management capabilities in the early 1990s, in Tanzania and Uganda (and to a lesser extent Kenya) the banking sector was not in a position to provide substantial amounts of new credit to the private sector. The Tanzanian and Ugandan authorities had to rebuild the banking systems, through liberalizing the sector, creating a new prudential framework, opening the system to foreign banks, and restructuring and privatizing state-owned banks. Perhaps because the situation was less pressing, reforms in Kenya were slower and much less radical.

19. **The position of financial systems in the EAC was very problematic in the early 1990s.** Economic mismanagement in Tanzania and civil unrest in Uganda left their financial sectors in a very weak position (Box 1). The main problems were large numbers of NPLs, lack of capital, outdated banking methods, and a decrease in intermediation. Similarly, while Kenya's financial system has been traditionally more open, it had many of the same

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problems—a high ratio of NPLs and a lack of capital in government-owned banks, exacerbated by harmful regulation.

Box 1. Historical Context of Banking Sector Reforms

In Tanzania, the poor performance of the state-owned financial sector in late 1980s forced the government to search for new policy directions. Nonperforming loans (NPLs) accounted for over 65 percent of the loan portfolio, fiscal and financial operations were intermingled, and the regulatory system was inappropriate.

Civil disturbances in Uganda in the 1970s and 1980s led to a significant decline of financial intermediation, so that financial services became concentrated in only a few commercial banks in the capital. Aleem and Kasekende (2001) find that nonprofessional management was common in financial institutions and normal business discipline collapsed. Financial repression in the form of interest rate controls and directed credit contributed to disintermediation; parallel markets evolved in foreign exchange, trade, and credit; and the use of credit instruments declined. The two dominant banks, which accounted for about two-thirds of commercial bank business, were insolvent; they required massive liquidity support from the central bank to operate.

Kenya's banking system has traditionally been more open and modern. The banking system after independence consisted only of foreign-owned banks; while their dominance has since eroded, they still accounted for a substantial part of the system over time. However, the soundness and efficiency of intermediation was also undermined by the presence of large, weak government-owned banks, which accounted for most of the banking system's NPLs. The National Bank of Kenya (NBK, the sixth largest bank) has been insolvent for many years. Though the Kenya Commercial Bank (KCB, the second largest) has fared better, it has suffered considerably from its bad loan portfolio.

20. **The rebuilding of EAC banking systems started with liberalization and introduction of new prudential frameworks in Uganda and Tanzania early in the 1990s.** In both countries, the authorities decided to reduce government's role in the financial sector and allow the market to play a more substantial role in resource allocation. They started a comprehensive program to liberalize interest rates, phase out subsidies, remove directed credit, and license new banks; they also introduced a new regulatory and prudential system. In Kenya, a variety of reforms to the financial system were introduced in the early 1980s through the mid-1990s; monetary policy reforms in the 1990s liberalized interest rates and replaced direct controls on lending with open market operations.

21. **With the reforms in Tanzania and Uganda, all three EAC countries became open to foreign banks, which were expected to make the banking systems more competitive and more active in providing credit.** In Tanzania, the first major foreign bank (Standard Chartered) started operations in 1992; other international banks soon followed—Stanbic (1993), Citibank (1995), and Barclays (2000). Several other smaller foreign banks set up subsidiaries between 1995 and 2002. In Uganda, the number of banks increased from

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nine in 1991 to 20 in 1996. Foreign bank entry was never a major issue in Kenya, where foreign banks have been playing an important role since independence.

22. **All three EAC countries have restructured and privatized their state-owned banks, which were mostly insolvent and unable to allocate credit efficiently.** In Tanzania, the two largest state-owned banks, the National Bank of Commerce (NBC) and the Cooperative and Rural Development Bank, were financially restructured relatively quickly and both were privatized. Partial privatization of the National Microfinance Bank (NMB) took longer, but has also been completed.[1] In Uganda, the government gradually sold most of its shares in financial institutions, most importantly shares in the Uganda Commercial Bank, the largest bank in the system.[2] In Kenya, the Kenya Commercial Bank has been restructured but the government continues to hold a substantial stake in it, and progress in restructuring and privatization of the National Bank of Kenya has been very slow.

23. **The major first generation reforms have strengthened the banking systems in Tanzania and Uganda, but have resulted in a modest increase in private sector credit in Tanzania; in Kenya, progress of reform has been too slow to effect a major improvement (Figure 11).** In Tanzania, major reforms have created a new market-based financial system and limited direct fiscal costs, but have so far yielded only limited improvements in access to financial services. The history of nonrepayment explains bank reluctance to replace the stock of NPLs by new credit. Instead, banks have been accumulating extensive holdings of government paper and off-shore deposits in foreign exchange, further limiting the amount of credit available to the private sector. In Uganda, while the reforms did improve the performance and depth of the financial system, but the amount of private credit remained very small. In Kenya, Brownbridge and Harvey (1998) found some evidence that liberalization in the 1990s led to more vigorous competition among banks for deposits and in providing services. However, the liberalization may not have been able to improve the efficiency of credit allocation because of distortions in the banking system, where weak government-owned banks have been allowed to operate. Therefore, while the level of private sector credit remains higher in Kenya than in Tanzania and Uganda—reflecting Kenya's higher per capita income and smaller subsistence sector—it has exhibited a clear declining trend in Kenya in recent years. Moreover, a significant part of the existing credit in Kenya is nonperforming, as described above.

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[1] The largest bank in the system, the state-owned National Bank of Commerce, was split in 1997 into the new National Bank of Commerce Limited (NBC), with most of the loan portfolio and city branches, and the National Microfinance Bank (NMB), with an extensive branch network outside main cities and virtually no loans. The South African banking group ABSA then bought a majority stake in the NBC.

[2] The Uganda Commercial Bank accounted for half of the banking business and more than 80 percent of the national branch network. The first attempt to privatize the UCB in the late 1990s failed due to irregularities in the transaction, but UCB was at last acquired by the South African bank Stanbic in 2002.

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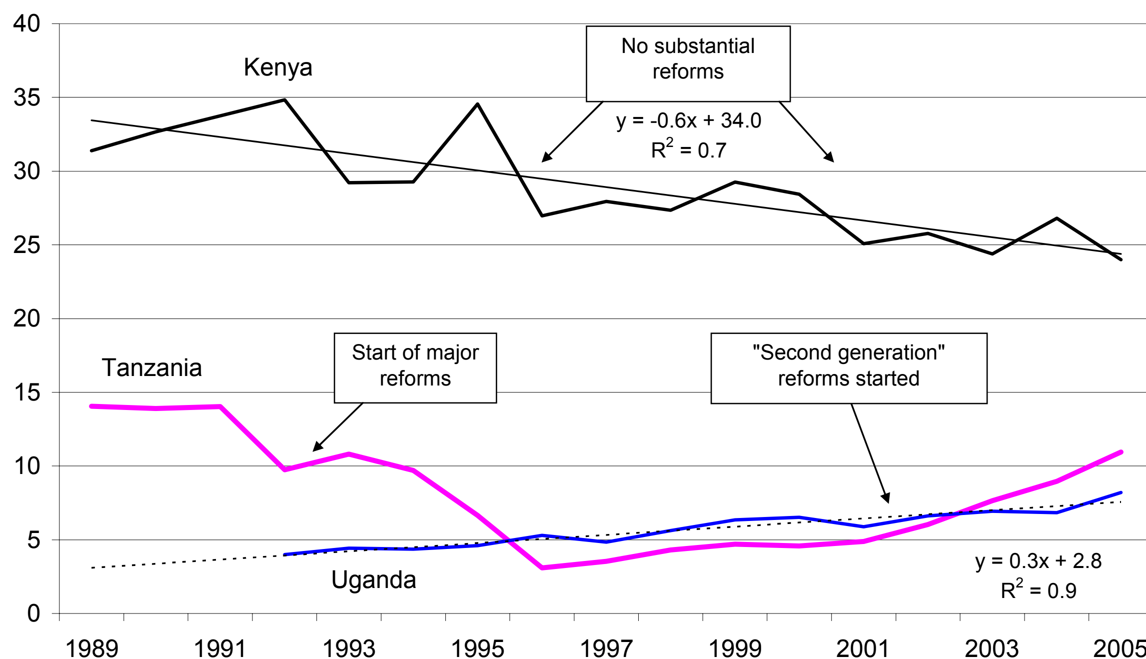
Figure 11. Private Sector Credit (Percent of GDP)



Source: IFS and staff calculations

24. **The relatively slow improvements have had two results: the authorities (i) embarked on further, second generation, reforms; and (ii) started planning limited government initiatives in development finance.** The slow progress brought by the initial reforms led to pressure to deliver more substantial improvements, especially in the availability of term finance and support to the agricultural sector. This led to second generation reforms and new government initiatives.

25. **The second generation reforms, which are still work in progress in all three countries, are mainly directed to removing structural obstacles to lending.** In Tanzania, in an attempt to create an environment more conducive to lending and financial sector development in general, the authorities have introduced reforms in the areas of legal, judicial, and information infrastructure, including the Land Act 1999 and the Companies Act 2002. However, these reforms have not been comprehensive and their implementation takes time. The 2003 Financial Sector Assessment Program found that little progress has been made in judicial reforms: training and facilities still need special attention; and land registries, company registries, and registries of mortgage interests are inefficient and need considerable improvement before they can become a useful information basis for credit decisions. Tanzania is now accelerating its implementation of second generation reforms in the context of its comprehensive FSAP-based financial sector reform plan. Uganda has focused on

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similar issues, but the 2005 Financial Sector Stability Assessment found a number of weaknesses in provision of credit reference information, land and company registries, the commercial court system, and the corporate insolvency regime. Kenya has seen no major reforms to improve the lending environment recently; instead, the authorities tried to spur private sector credit by lowering interbank and T-bill interest rates through a relaxation of monetary policy, which caused inflation to accelerate.

26. **The authorities have also become more active in trying to provide credit to the private sector directly.** The authorities in Tanzania and Uganda are returning to development finance activities, while the authorities in Kenya have never abandoned their direct role in the financial system. In Tanzania, new initiatives include (both operational and planned) the Export Credit Guarantee Scheme, restructuring and recapitalization of the Tanzania Investment Bank, the SME Credit Guarantee Scheme, and the Development Finance Guarantee Facility. The government has committed to following best practices regarding governance and transparency in these initiatives, and to strictly limit fiscal risks. In Uganda, the government has decided to restructure the Uganda Development Bank—currently under a new professional management team—to provide longer-term credit. In Kenya, the government continues to operate development finance institutions in addition to controlling two large commercial banks.

B. Strategy for Further Reform

27. **While the EAC countries have made substantial progress in stabilizing and reforming their financial sectors, more needs to be done.** Though the major first generation reforms and the partially implemented second generation reforms have increased private sector credit in Tanzania and Uganda in recent years, both countries still lag significantly behind other LICs. Although banks have generally become financially sound and profitable, as of 2003 they still charged relatively high spreads and lend relatively little compared with the amounts of deposits (Figure 12).

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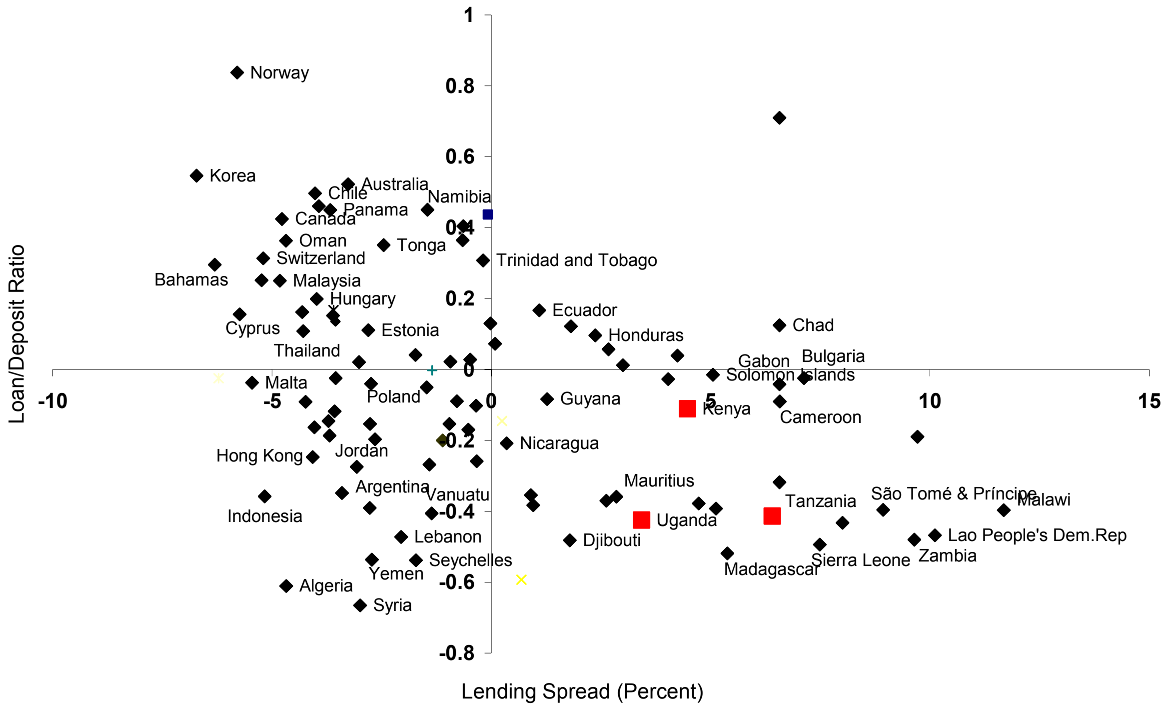
Figure 12. Spread and Loan to Deposit Ratio, 2003 (Difference from Sample Mean)



28. **The main goal of further banking reforms is to improve the intermediation of savings.** The goal would thus be to move the banking systems to the northwest quadrant of Figure 8—for banks to lend more and at a lower spread. However, this shift cannot be forced by direct government intervention (e.g., regulation of interest rates or mandatory lending targets) because the improvement needs to be sustainable, i.e., the banks need to continue to operate on commercial principles and remain profitable. The strategy needs to create the opportunity for banks to lend profitably at lower spreads, by removing obstacles to lending, and force them to use the new opportunities (by supporting competition in the banking systems). The authorities should be very careful about introducing new forms of government involvement in the financial sector that may ultimately impede development of sustainable private lending.

29. **The recent experience of transition economies in Central and Eastern Europe (CEE) can serve as an example of successful structural reforms that led to strong growth of private sector credit.** At the start of transition from centrally planned to market economy, in the early 1990s, banking systems were in a bad shape—banks were burdened with high nonperforming loans, had limited management capabilities, lacked capital and proper governance, and operated in an environment of vaguely defined and poorly enforced creditor rights. These issues were addressed through recapitalization, operating reforms, privatization (mainly to foreign banks), and legal and institutional reforms. Growth of bank

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credit to the private sector picked up substantially since the second half of the 1990s in most CEE countries. For instance, the ratio of private sector credit to GDP increased by 35 percentage points in Estonia and 21 percent in Croatia between 1994 and 2002. Cottarelli et al (2003) analyzed credit growth in CEE and found no clear evidence that the credit growth performance reflected primarily initial conditions in banking intermediation or was driven by financing from abroad. While crowding-in may have been a factor (bank credit to the public sector declined as percentage of GDP), the progress of structural reforms, private sector ownership of banks, and the degree to which legislation protects creditor rights were found to be important.[3]

Remove impediments to lending

30. As discussed, major impediments to lending are insufficient enforcement of already weak creditor rights, lack of information about borrowers, and administrative barriers to using assets as collateral. All three countries recently participated in the FSAP (2003-05), which made specific recommendations in each of these areas. While some progress has been made in implementing these recommendations, mainly in Tanzania and Uganda, virtually none has yet been fully implemented. In Uganda, there should be the foundation of reforms going forward. Tanzania has made its FSAP recommendations the core of its financial sector strategy.

31. **All three countries need to continue improving and enforcing creditor rights.** The FSAPs suggested that Tanzania should give the commercial court more resources for rapid settlement of cases and undertake to strengthen the judicial system generally. Kenya should modernize the insolvency procedures set out in the Company and Bankruptcy Acts, strengthen the capacity of the commercial court to administer cases efficiently, give judges more training , and expand the specialized commercial court to other regions, such as Mombasa. Uganda should overhaul its corporate insolvency regime and supporting taxation system and strengthen the capacity of the commercial court and the Official Receiver.

32. **Information about borrowers should be improved by making credit reference bureaus fully operational and effective and making company and land registries more efficient.** In Tanzania, the FSAP suggested that the company and land registries be modernized and that the central bank take the lead on the credit registry/bureau project and push ahead speedily with a simple—and if necessary compulsory—system of credit reporting by all licensed lenders. Tanzania launched a limited credit reference bureau last year, and its developing a more comprehensive credit information system to be completed in 2007. In

[3] The fast credit growth in CEE has brought a new set of policy issues—i.e., how it should be managed so that it does not create macroeconomic imbalances or jeopardize financial stability. Hilbers et al. (2005) provides a detailed discussion on this.

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Kenya, commercial registries were to be modernized to provide access to current, accurate, and reliable information. At the same time as the legal basis for sharing credit information among financial service providers was established, a fully effective system of credit information should be made operational. In Uganda, a credit reference bureau should start operations soon. Also, the land and companies registry needs to be rehabilitated.

33. **The use of collateral should not be restricted by legal problems and outdated laws.** Land and real estate are important as collateral in most countries, but administrative problems in EAC countries complicate their use as collateral. In Tanzania, the Land Act was intended to allow mortgage financing but technical issues have kept it ineffective. The authorities have made only partial progress in resolving these issues so far. In Kenya, barriers to creating, registering, and enforcing a security interest need to be removed, the land registry systems integrated, hidden liens and excessive registration costs removed.

Increase competition

34. **Further increasing competition is important to force banks to exploit new opportunities, be innovative, and actively identify ways to overcome impediments to lending.** Because banks have recently been very profitable in all three countries, they may be less motivated to innovate and build new business. There are several ways to increase competition; among them are being open to new reputable entrants, restructuring and privatizing state-owned banks completely, improving the transparency of fees and charges, not tolerating the operation of weak banks and possibly raising the minimum capital requirements, and developing professional institutional investors (insurance companies and pension funds) while allowing them to finance the best companies through the capital market.

Some specific recent recommendations in the EAC:

- In Kenya, restructure the technically insolvent NBK and divest the government stake in all commercial banks; the authorities should intervene in any weak bank that fails to develop and implement a time-bound recovery plan, ideally within a prompt corrective action framework; the minimum capital requirement for banks should be raised.

- In Tanzania, liberalize investment requirements for insurance companies, restore public confidence in the insurance market by resolving the National Insurance Corporation (NIC); facilitate the emergence of securitized loans or guaranteed bonds by pension funds, and develop investment guidelines for all pension funds.

- In Uganda, improve the disclosure and transparency of interest and account- related bank charges, restructure the governance of NSSF restructured, including by hiring

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independent professional board members, and issue investment regulations for insurance companies.

Exercise caution about direct government intervention

35. **Since there is an abundance of examples of failed efforts by government to involve themselves directly in the financial system, caution is certainly warranted.** The three EAC countries have themselves had a number of state-owned banks that had to be rescued or closed; none of their development finance institutions was successful. Therefore, recent attempts to revise, redesign, or continue operating government schemes in the three countries risk repeating these failures. On the other hand, other countries have had some recent success with vehicles to support agricultural and rural finance, which are also areas that seem to have priority on the agendas of EAC governments. We therefore attempt to identify factors that contributed to their success.

36. **State-owned agricultural and rural development banks have had the dual objective of operating profitably (or at least covering their costs) and supporting the government in achieving rural development goals.** In the 1970s and 1980s, many countries started state banks with high hopes of establishing permanent access to credit, especially for agriculture, in underserved areas.[4] Often, the banks neglected, or were forced to neglect, the first objective that would ensure their sustainability. The result in many cases was decision-making by and for special interests, high transaction costs, high loan losses, and corruption. Consequently, many of these institutions were closed or privatized in the late 1980s and early 1990s.

37. **Often , the rural branch network significantly contracted or disappeared once the state banks were privatized or closed, prompting attempts to revive them.** While the shortcomings of state-owned banks have been extensively documented, many countries also recognized the disadvantages of the disappearance of agricultural development banks and have tried to set up new banks or reform the remnants of these institutions.

38. **Several formerly state-owned banks have managed to provide services in rural areas on a significant scale while keeping their operations sustainable.** The organizational structure does not appear to be crucial—the successful banks are reformed development banks, start-ups or specialized units within commercial banks. The Agricultural Bank of Turkey, the Agricultural Bank of Mongolia, and BAAC in Thailand were reformed or turned around; for instance. For these, the authorities faced a difficult choice when confronted with large losses caused by subsidized lending and weak management and

[4] For an overview of agricultural development banks, see Agri-Stat, an inventory developed by FAO and the German Agency for Technical Cooperation, available at http://www.fao.org/ag/ags/agsm/banks/index.htm. Siebel, Giehler, and Karduck (2005) describe and analyze the data.

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governance and decided to put the operations on commercial footing, while using the advantages of substantial branch presence, which in turn allowed the focus on rural areas to be preserved. The Agricultural Development Bank of Latvia and the Kyrgyz Agricultural Finance Corporation were startups. The state-owned Bank Rakyat of Indonesia set up a specialized micro finance unit. See Box 2 for more information about some of these cases.

Box 2. Successful Turnaround Efforts in Rural and Agricultural Banks

Agricultural Bank of Turkey (T.C. Ziraat Bankasi). Ziraat, like other state banks in Turkey, accumulated large losses from subsidized directed lending to political constituencies, which were covered by claims on the government. The 2000-01 crisis exposed its vulnerability to liquidity and interest rate shocks when the bank suffered massive losses as short-term interest rates increased sharply. In April 2001 the government took radical steps to restructure Ziraat's finances and operations. The bank was recapitalized; its overnight exposure was eliminated; a new board (joint with another state bank) professional bankers with a strong commercial mandate was appointed; a substantial number of branches were closed; staff was reduced; and lending was temporarily halted (it resumed in 2002). These steps, combined with other reforms, led to a notable improvement in performance, and Ziraat remains the largest bank in Turkey in terms of assets. The government intends to privatize the bank, but progress has been relatively slow.

Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand. BAAC was established in 1966 as a government-owned agricultural development bank. The original mandate was to provide credit to farm households. Over almost four decades BAAC was transformed into a diversified rural bank. In the two most recent phases of reform, the bank strove for viability and self-reliance under conditions of controlled interest rates through savings mobilization, improved loan recovery, and increased staff productivity (1988–96). Since 1997 BAAC has adjusted to central bank prudential regulations and diversified into nonagricultural lending. BAAC has demonstrated how reform can be gradual, but the reform agenda is still unfinished.

Bank Rakyat of Indonesia (BRI). Until early in the 1980s BRI was the main provider of heavily subsidized agricultural credit. The government then decided to reform the bank. Interest rate were fully deregulated and new management decided to commercialize the 3,000 credit outlets and turn them into self-sustaining profit centers. Changes made ranged from introducing new products to making the information system more efficient. The BRI microfinance units reached their break-even point in about 18 months, have been consistently profitable, and supported the whole bank during the 1997-98 crisis. However, the microfinance division accounts for only about one third of the BRI activities, and the other operations have accumulated substantial losses in recent years.

Agricultural Bank of Mongolia (AgBank)**.** After overcoming strong opposition, the government of Mongolia has obtained support from bilateral donors to turn around the loss-making Agricultural Bank of Mongolia (renamed Khan Bank in 2004). In two years, the bank was restructured on sound banking principles, though it kept its mission of providing financial services in rural areas. AgBank is an example of a privatized bank that recognized significant business opportunities in rural areas and took advantage of its competitive position as the only bank with an extensive branch network. It was able to increase its rural penetration by such good practices as offering demand-responsive products based on extensive market research. It also decided to extend its network from 250 to 350 branches. A key success factor was an experienced hands-on international management team, free from loyalties to special interests within the country and backed by government and generous donor support. The new private owners did not change the focus of the bank on rural activities after it was privatized in 2003.

Sources: Nagarajan and Meyer (2005), Siebel, Giehler, and Karduck (2005), World Bank (2005), and company information.

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39. **The success factors in these rural and agriculture bank examples are the following:**

- clear separation of banking operations and decision-making from government influence, and strong political will from all parties for an independent institution;

- a governance structure that included majority private sector representation on the board and political independence of the board and managing director;

- consistent government policies directed to making rural finance sustainable, such as no debt forgiveness, interest rate subsidies, or interest rate caps;

- sufficient no-strings-attached funding for expert international technical assistance to build systems and create products;

- ability to charge full cost-recovery interest rates, net of time-bound technical assistance and initial operating expenses;

- access to local current funding and a long-term approach that recognized that progress may be only gradual.

40. **The recent revival of development finance efforts in the EAC is worrisome.** In Tanzania, the large number of initiatives planned and in operation will require strong management, and continuous commitment to strong governance and transparency, and strict limits on fiscal risks. In Uganda, the decision to strengthen the Uganda Development Bank may prove problematic, unless the bank is independently managed and properly supervised. In Kenya, the government continues to operate development finance institutions even though the recent FSAP recommended that their lending should be suspended and that future development financing be done either through properly supervised financial institutions or in the form of grants rather than credit. These development bank-related activities risk creating new fiscal costs for the government and—perhaps more important— sending the wrong signal to private providers of financial services and potentially stifling their activities.

41. **The most useful role for government is to create the conditions in which the financial system can grow without being directly involved in the provision of financial services; however, when some direct government involvement is inevitable, its structure should minimize risks for the government and the financial sector.** Improving financial sector performance can take time, and political pressure on the government to step in can be very strong. Drawing on lessons from previous failures and successful examples in some countries, the authorities should design their involvement so that the risks, both for the government's fiscal position and financial sector development, are minimized. Some basic principles include:

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- The schemes or institutions should be sustainable and have a well-defined mandate. Sustainability can be achieved by allowing them to charge at least cost-recovery interest rates or fees, net of donor or government financed technical assistance and possibly initial expenses. Any government assistance—start up, product development, or operating expenses, if applicable—should be clearly identified, tied to a specific mandate, and paid from the current government budget.

- The governance and management arrangements should be independent from political influence and minimize the risk of corruption and decision making by and for special interests. This could be accomplished by majority private sector representation on the board. Attracting a private partner would be helpful. In any case, professional management with a performance-based contract is critically important.

- The schemes or institutions need to be properly supervised and their operations transparent. Banking supervisors may be in the best position to the supervisory role even if there is no deposit-taking activity; experience shows that line ministries often fail to properly supervise. Operations should be transparent and independently audited.

IV. Conclusion

42. **The three EAC countries have generally followed sound strategies in reforming their banking systems, but the improvement in private sector credit has been slow.** Tanzania, Uganda, and to a lesser extent Kenya have adopted major reforms and stabilized and strengthened their banking systems. However, the improvement in private sector credit has been relatively slow and credit availability does not compare favorably with other low-income countries. Banks in the EAC countries are generally sound and profitable, but achieve this by charging relatively high spreads and lending relatively little compared with the amount of their deposits.

43. **The main goal of a forward-looking strategy should be to further improve the intermediation of savings, leading to a cheaper and more widely available private sector credit and thus supporting a general strategy of accelerating sustainable growth.** Put simply, the goal should be to facilitate bank lending with lower spreads and to a broader swath of the population. But such a shift needs to be sustainable and therefore cannot be forced by direct government intervention; banks need to continue operate profitably and base their decisions on commercial principles. The strategy needs to create the opportunity for banks to lend profitably at lower spreads by removing obstacles to lending, and force them to use new opportunities by supporting competition in the banking system. While improvements in intermediation will inevitably be gradual, the experience suggests that shortcuts are, in reality, costly dead ends.

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III. EAC CUSTOMS UNION: BENEFITS OF FURTHER TRADE LIBERALIZATION[1]

I. INTRODUCTION

1. **In 2000, the presidents of the three East African Community (EAC) member countries committed to substantially reinforce the community with the aim of enhancing cooperation and strengthening economic ties.** The EAC Treaty that came into force on July 7, 2000 envisages the establishment of a single market and investment area, harmonization of policies to promote cross-border trade and investment, facilitation of cross-border movement of people, development of regional infrastructure, and enhancement of technological and human resource development.

2. **Economic cooperation resulted in the establishment of the EAC customs union (CU) in 2005 with a Common External Tariff (CET).** The EAC Customs Union Protocol came into effect on January 1, 2005, and is to be implemented over a five-year period. It established a customs union between the three partner countries with one three-band CET—a zero percent import tariff on raw materials, 10 percent on intermediate products, and 25 percent on finished goods—and set the stage for the elimination of intra-EAC tariffs and other charges such as suspended duties or discriminatory excise duties.[2]

3. **Despite the significant progress achieved so far, the level of trade protection and tariff dispersion, as well as the potential for trade diversion associated with the CET remain significant and point to the need for further trade liberalization.** This paper analyzes the impact of lowering the CET in EAC countries by using the UNCTAD/World Bank model to simulate reductions of the maximum CET rate from 25 to 20, 15, and 10 percent.[3] The model simulation results suggest that lowering the top CET rate would lead to trade creation, improved efficiency of resource allocation, and welfare gains.

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[1] Prepared by Greetje Everaert, Axel Palmason, and Yuri Sobolev.

[2] There are 36 'sensitive' products at the HS8 classification level where the EAC countries charge tariffs in excess of 25 percent. For about one-third of these products, the special tariff rates are the same for the three countries, while for the other two-thirds the EAC members apply different duty levels. In addition, Uganda and Tanzania, which are still at a lower level of industrial development, chose to gradually liberalize sensitive imports from Kenya by 2010.

[3] The UNCTAD Trade Policy Simulation Model, Laird and Yeats (1986); refined by the World Bank under the name SMART.

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4. **The other critical issue is the need to address overlapping memberships in regional trade agreements (RTAs) and other non-tariff impediments to trade.** The paper discusses the need to complement CET reductions by structural measures to alleviate policy-related and supply response constraints in order to promote further integration and effective functioning of the CU and to ensure that CET reductions yield the expected returns.

II. Current structure of trade in the EAC

5. **Regional trade has gained importance for EAC countries.** While the pattern of trade in the EAC countries continues to be dominated by trade with industrialized countries and the EU in particular, their share in EAC's trade has fallen significantly since the 1980s as regional trade and trade with Asia, especially imports, have risen sharply (Table 1).

Table 1. EAC Main Trading Partners

	exports				imports			
	1980s	1990s	2000-04	2005	1980s	1990s	2000-04	2005
	(percent of EAC exports)				(percent of EAC imports)			
Industrialized countries	62.9	51.0	47.7	41.4	62.7	50.5	39.3	32.5
of which: EU	49.4	43.5	36.2	30.2	44.7	34.7	23.3	20.1
US	8.6	3.7	5.7	6.7	4.9	5.1	7.1	7.2
African countries	17.3	24.8	28.6	30.2	6.3	14.4	19.1	20.1
of which: intra EAC	7.3	14.0	14.3	14.8	4.2	7.6	8.1	7.9
COMESA all	15.1	19.3	25.0	26.4	5.7	8.6	9.5	9.6
SADC	3.5	8.3	8.4	9.2	1.3	6.6	10.7	11.8
Asia	9.4	13.8	13.1	14.9	9.3	16.1	19.5	21.5
Middle East	3.5	6.1	6.0	6.4	18.8	14.2	18.7	21.6
Memorandum Item								
Trade as a pecentage of EAC GDP	8.1	11.4	12.7	14.5	14.1	21.6	24.4	30.6

Source: IMF, Direction of Trade Statistics

6. **However, intra-EAC trade is uneven in direction and intensity, and remains undiversified.** Overall, in line with the rise in intra-African trade, intra-EAC trade has been rising, and accounts to about half of the EAC countries' trade with Africa, but it is dominated by two-way trade between Kenya and Uganda and between Tanzania and Kenya. A few product categories currently dominate intra-EAC trade: Tanzania and Uganda mainly export food to Kenya, while Kenya mostly exports manufactured goods and chemicals to its EAC partners (Tables 2 and 3).

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Table 2. Direction of EAC Intraregional Trade (percent of GDP)

	exports				imports			
	1980s	1990s	2000-2004	2005	1980s	1990s	2000-2004	2005
Kenya: share of trade with								
Tanzania	0.2	1.2	0.7	0.9	0.0	0.1	0.3	0.4
Uganda	1.1	1.8	2.2	2.5	0.0	0.0	0.6	0.7
Tanzania: share of trade with								
Kenya	0.0	0.3	0.4	0.6	0.3	2.1	1.1	1.5
Uganda	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.1
Uganda: share of trade with								
Kenya	0.0	0.1	1.2	1.4	1.9	4.7	5.6	6.2
Tanzania	0.0	0.0	0.1	0.1	0.0	0.2	0.2	0.2

Source: IMF, Direction of Trade Statistics

Table 3. Tanzania and Uganda: Exports to and Imports from Kenya by Product Category, 2004 (HS classification, in percent of total)

	Uganda		Tanzania	
	Exports to Kenya	Imports from Kenya	Exports to Kenya	Imports from Kenya
Food, beverages, tobacco, animals, oils and fats	67.0	5.8	72.9	7.9
Crude materials, chemicals, fuels, and lubricants	20.6	61.4	11.1	59.7
Manufactured goods, machinery and transport equipment	12.4	32.8	15.9	32.4

Source: COMTRADE database.

III. Further Integration

A. The Case for Lowering the CET

7. **Lowering the EAC CET should lead to a reduction in distortions in relative prices associated with high level of protection, tariff dispersion, and trade diversion.** Reducing market distortions would in turn improve the efficiency of resource allocation, result in trade creation, and enhance the basis for sustainable growth and poverty reduction over the medium term.[4] Furthermore, folding the ‘sensitive products' that are subject to special tariffs of up to 100 percent into the CET would benefit the poor, particularly the urban poor who depend heavily on the basic products included in the sensitive list—such as milk, grains, used clothing, and sugar—and result in immediate welfare gains for consumers.[5]

[4] The survey of literature on trade, growth and poverty reduction by Berg and Krueger (2003) concludes that trade liberalization is an important determinant of growth, which in turn leads to poverty reduction as average incomes grow. An OECD study on dynamic gains from trade (TD/TC/WP(2006)34) points to a robust relationship between openness to trade and the level of productivity and GDP per capita.

[5] As noted in a recent World Bank study (Agricultural Trade Reform and the Doha Development Agenda, 2005), if only two percent of agricultural tariff lines in developed countries (and four percent in developing countries) are classified as ‘sensitive', and thereby subject to only a 15-percent tariff cut, the welfare gains to

(continued…)

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Tariff protection

8. **The implementation of the EAC CET simplified the trade systems but did not uniformly reduce protection levels in the EAC countries.** Prior to the CET introduction, Kenya applied 9 tariff bands with 40 percent as the highest tariff level, Tanzania had bands of 0, 5, 15 and 25 percent and Uganda 0, 7 and 15 percent. Thus, following the CET introduction, the average tariff declined in Kenya, remained broadly unchanged in Tanzania, and increased in Uganda (Table 4).

Table 4. EAC Coutries: Simple Average Statutory Tariffs (percent)

	2004			2005			2010		
	Kenya	Tanzania	Uganda	Kenya	Tanzania	Uganda	Kenya	Tanzania	Uganda
Intra-EAC imports 1/	15.5	2.9	3.6	0.0	1.2	0.2	0.0	0.0	0.0
Third-country imports	16.7	12.9	7.8	12.9	12.9	12.9	11.2	11.2	11.2

Source: Stahl (2005) and IMF staff estimates
1/ Applied rates from UNCTAD (TRAINS).

9. **While the CET introduction resulted in an average MFN tariff in the EAC somewhat lower than in sub-Saharan Africa and low-income countries, it is still relatively high compared to other regions and middle-income countries (Tables 5 and 7).** Even though the trade ratios in the EAC countries are comparable to the low-income countries group (Table 6), their higher aid dependency and greater trade imbalances could be viewed as a sign of the lack of integration of the EAC in the world economy—i.e., in the absence of aid financing a large share of imports, including capital goods, the trade ratios in the EAC would likely be lower. Lowering the CET could therefore help to boost trade and exports creation in the EAC and its deeper integration into the world economy.

developing countries from global agricultural reform would virtually disappear. This points to the importance of not exempting sensitive products from liberalization.

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Table 5. Tariffs, Trade Volumes, and Aid Dependency (percent) 1/

	Simple Average MFN Tariff	Exports to GDP Ratio	Imports to GDP Ratio	Aid to Imports Ratio 2/	Share of Capital Goods in Total Imports
EAC	12.9	14.9	29.2	35.3	23.4
Sub-Saharan Africa	15.0	34.2	33.4	13.9	33.2
Low income countries	14.0	19.3	23.6	11.9	26.2
Middle income countries	11.2	31.1	28.6	1.2	29.5
High income countries	5.9	19.4	20.8	...	34.3

Sources: UNCTAD (TRAINS), IMF DOTS, and Word Bank Development Indicators
1/ Based on 2005 tariff rates and 2004 trade and aid data.
2/ Includes services.

Tariff dispersion

10. **Moreover, tariff dispersion has increased with the introduction of the CET, and a small but important group of goods falls outside of the CET.** In addition to the increased number of tariff bands (three within the CET and eight outside), a total of 36 'sensitive' products are subject to tariffs in excess of the maximum CET rate of 25 percent (Table 6). Together with the sizable share of imports falling within the 25 percent band, about a fifth of EAC's imports is subject to relatively high levels of tariff protection with Uganda affected the most.[6] Measured by maximum tariff rates, standard deviation of tariff rates, and coefficient of variation, the EAC countries' tariff dispersion is relatively high compared to sub-Saharan Africa and other regions (Table 7).

Table 6. Distribution of Imports by MFN Tariff Band 1/
(percent of total imports)

	CET bands (percent)			Tariff Bands outside the CET (percent)							
	0	10	25	35	40	45	50	55	60	75	100
Kenya	57.4	25.6	12.7	0.2	0.0	0.0	1.9	0.0	0.3	1.1	0.7
Tanzania	54.2	24.7	16.1	0.1	0.1	0.0	1.9	0.0	0.1	1.8	1.0
Uganda	39.9	27.4	25.5	1.1	0.3	0.1	2.4	0.9	0.3	1.1	1.1
Total	53.2	25.7	16.1	0.3	0.1	0.0	2.0	0.2	0.2	1.3	0.8

Source: IMF staff estimates
1/ Based on 2005 MFN rates and 2004 trade data.

[6] The relatively low value of imports recorded under the high tariff categories is due in part to the endogenous response to high protection rates and in part to customs duty evasion as noted later.

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Table 7. Regional Comparison of Simple Average Tariffs and Tariff Dispersion, 2005

		Tariff Dispersion Measures		
	Average Tariff	Average Maximum Rate	Standard Deviation	Coefficient of Variation
EAC Countries	12.9	100	12.1	0.9
Sub-Saharan Africa	15.0	42	9.3	0.6
Western Hemisphere	11.5	107	9.9	0.9
Middle East and Central Asia 1/	11.2	112	11.5	1.0
Asia and Pacific 1/	10.4	105	10.3	1.0
Europe 1/	7.4	87	9.5	1.3

Source: UNCTAD TRAINS database and Fund staff estimates

1/ Due to outlier problems, Egypt Bangladesh, Korea, New Zealand, Israel, Turkey, Norway, Romania were omitted.

Trade diversion

11. **Adoption of the CET has brought the risk of welfare-reducing trade diversion.** The relatively high level of external tariff protection under the CET together with zero intra-EAC tariffs and the increased tariff dispersion are likely to lead to trade diversion—whereby imports of manufactured goods from the EAC partners are substituted for less expensive higher-quality imports from more efficient producers in third countries.[7] This, in turn, could result in reduced competitiveness of some import-dependent industries and economy-wide welfare losses.

B. Reduction of the CET—Model Simulation Results

12. **To demonstrate the effect of a CET reduction, the paper uses the UNCTAD/World Bank SMART model and World Integrated Trade Solution (WITS) software developed by the World Bank.** The model is a static partial equilibrium model that allows assessment of first-round effects on trade creation and trade diversion as well as the revenue and welfare effects. (See Section III.C below for a discussion of model limitations and potential dynamic effects.) The model utilizes the most recent available trade (2004) and tariff (2005) data at the six-digit HS disaggregation level from the UNCTAD Trade Analysis and Information System (TRAINS) database.

13. **The simulation shows that folding all sensitive goods into the CET and lowering the current CET top rate from 25 to 20 percent would directly lead to a reduction in tariff dispersion and to trade creation and consumer welfare gains in all three countries (Table 8).** These effects are most pronounced for Uganda and least for Kenya and grow at each successive reduction of the maximum CET rate. To derive a measure of how sensitive

[7] Given limited data availability to date since the introduction of the CET, it is too early to establish robust empirical evidence of trade diversion.

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the affected variables are to a reduction in the maximum CET rate, simulations are also performed by capping the maximum CET rate at 15 and 10 percent.[8]

Table 8. EAC countries: Simulation Results of Reduction in Maximum Applied Tariffs

	Simple Average Applied Tariff (percent)		Tariff Dispersion (standard deviation)		Increase in imports (percent)	Loss of tariff revenue (percent of GDP)	Gain in consumer surplus (percent of GDP)
	current	simulation	current	simulation			
	Capping Maximum Applied Tariff Rate at 20 percent						
Kenya	12.1	10.1	11.3	8.5	1.6	-0.4	0.6
Tanzania	12.2	10.2	11.5	8.4	2.2	-0.5	0.6
Uganda	12.3	10.1	12.0	8.6	3.2	-0.6	0.8
	Capping Maximum Applied Tariff Rate at 15 percent						
Kenya	12.1	8.3	11.3	6.5	2.6	-0.6	0.8
Tanzania	12.2	8.4	11.5	6.5	3.3	-0.6	0.8
Uganda	12.3	8.6	12.0	6.6	5.1	-0.9	1.2
	Capping Maximum Applied Tariff Rate at 10 percent						
Kenya	12.1	6.4	11.3	4.8	3.9	-0.9	1.1
Tanzania	12.2	6.4	11.5	4.7	5.1	-0.9	1.1
Uganda	12.3	6.3	12.0	4.8	7.5	-1.2	1.6

Source: IMF staff estimates

14. **The analysis of the impact the CET reduction on trade flows (in terms of change in imports by EAC trading partners) suggests that trading partners whose exports into the EAC are likely to increase are those currently facing relatively high applied tariffs.** These partners are industrialized countries and emerging market economies which currently face either the top CET rate and/or higher rates on sensitive products. The trading partners whose exports into the EAC are likely to decline are mainly developing countries in the region that currently enjoy preferential access to the EAC as well as the EAC members themselves. Conceptually, the expected decline in these trading partners' exports could be attributed to a reverse trade diversion as less efficient producers enjoying preferential tariff treatment are displaced by more efficient producers in third countries due to erosion of trade preferences.

[8] Capping tariffs as opposed to reducing them progressively across all tariff bands (whereby higher tariffs are reduced by more than lower ones) has the advantage of reducing the potential for reclassification of goods from low to high-tariff categories, which would keep effective tariffs high despite the tariff rates reduction.

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C. Revenue Impact

15. **While the calculated loss of tariff revenue based on the model simulations appears significant, the actual impact on total government revenue is likely to be more limited.** First, calculated tariff revenue is concentrated in the upper band of the tariff schedule and assumes no exemptions or evasion.[9] Second, the model does not capture consumption taxes collected on additional imports or any second round dynamic effects which could lead to offsetting increases in tax revenues. Therefore, the model simulations results should be viewed as an upper bound of revenue loss with actual loss likely to be limited to less than half a percentage point of GDP for each country in the baseline scenario.

16. **The loss of government revenue from lowering trade taxes is not necessarily welfare decreasing as it is in principle a transfer from government to consumers.[10]** Nevertheless, the loss of revenue may require offsetting revenue measures—such as eliminating exemptions, broadening the tax base, and increasing the size of the formal economy—and studies have shown that the EAC countries have fared relatively well in the past with respect to replacing lost tariff revenue with domestic consumption taxes (Ter-Minassian, 2005).

D. Model Limitations and Potential Dynamic Effects

17. **The model simulates only the first-round effects of tariff reduction by providing a snapshot of the impact on imports, revenue, and consumer welfare.** The model does not allow to assess second round/dynamic effects of tariff reductions on export creation and growth. Using a general equilibrium model—such as the Global Trade Analysis Project (GTAP)—to capture quantitatively the long-run dynamic effects of tariff reductions was not feasible due to data limitations.[11] The inability of the partial equilibrium model to capture the dynamic gains stemming from increased economic efficiency associated with tariff reduction tends to underestimate welfare gains and to overstate the potential revenue losses in developing countries (Kowalski (2005)). Therefore, the simulation results in this study should be viewed as an indication of the potential benefits from further trade liberalization in

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[9] For example, based on the 2004 data, the estimated ratio of revenue collected from trade taxes to revenue calculated by the model is about 80 percent for Kenya, 60 percent for Tanzania, and 40 percent for Uganda.

[10] See Annex.

[11] Kenya is not separately identified in the GTAP model and the latest available data is for 2001, which does not capture most recent development, including the introduction of the CET.

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the EAC rather than a precise estimates of changes in trade flows, revenue loss, or welfare gain.[12]

18. **Although not captured by the model, CET reductions would also result in exports creation through a reduction in the implicit tax on exports in the form of the cost of intermediate inputs and machinery used by domestic exporters.** According to Tokarick (2006), the implicit tax on exports arising from import tariffs is substantial, equivalent to about 12 percent on average in a sample of 26 developing countries, including Tanzania.[13] The study found that if all tariffs were eliminated in a multilateral context, the value of developing countries' exports would increase by 20 percent (28 percent in the case of Tanzania). Also, Amiti and Konings (2005) show that reductions in tariffs on intermediate inputs can have particularly large positive effects on productivity of manufacturing firms, enhancing economic efficiency and export competitiveness. Carrying out complementary structural reforms along with improvements in infrastructure to ease the supply constraints would enhance the positive impact that a reduction in the CET would bring on exports creation and welfare gains (Section IV.C.)

IV. Barriers To Further Integration

19. A reduction in the CET may not yield the expected returns unless complemented by addressing non-tariff policies and procedures-related impediments to trade, including the issues associated with overlapping memberships in regional trade agreements, EU Economic Partnership Agreements, and the supply response constraints as discussed below.

A. Overlapping Memberships

20. **The current situation where Tanzania is a member of SADC while Kenya and Uganda belong to COMESA prevents the elimination of the transaction costs involved in border formalities, including rules of origin, and would not allow the EAC to become**

[12] The simulation results also depend on the elasticities used in the calculations. In line with the literature, elasticities vary by product but not by country. Elasticity of demand across all products is on average around negative 2.15 (standard deviation 1.3), elasticity of substitution is held constant at 1.5, while elasticity of supply is infinite (constant at 99) corresponding to the price taker notion (Source: World Bank WITS-SMART). The point estimates in Table 8 are sensitive to the elasticity assumptions, which are on the conservative side. Due to the linearity of the model, if the elasticity of demand were doubled, trade creation would double and, if the elasticity of substitution were doubled, trade diversion would double.

[13] Moreover, according to Kee et al. (2004), the export tax equivalent increases substantially when NTBs are taken into account.

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a fully functioning customs union (Figure 1). While the EAC market access benefits were not extended to non-EAC SADC and COMESA partners, the EAC members were allowed to continue with their existing obligations to SADC and COMESA and imports from the respective countries were exempted from the EAC CET. This continuation of member-specific preferences within the customs union could result in trade deflection—whereby, for example, SADC members could use Tanzania as a transit route to Kenya and Uganda—unless border controls are maintained and rules of origin are enforced.[42] The need to maintain intra-EAC border controls and customs checkpoints and to enforce rules of origin effectively precludes the implementation of point of arrival collection of tariff revenues and developing a customs pool system among the EAC members that would make the customs union more effective. This in turn would prevent maximum simplification of customs procedures, limit the positive impact of the common external tariff, and result in foregoing significant efficiency and welfare gains potentially achievable through the EAC customs union.[43]

21. **Administering multiple origin schemes adds considerable complexity to the trading process, which increases the cost of international trade, places a burden on the administrative capacity of the customs services, and absorbs much-needed human and financial resources particularly since the rules of origin vary across the overlapping agreements.[44]** The existence of different rates of import duty from different countries may also breed corruption by providing incentives for false invoicing, so as to show origin in the country subject to lower duties. Also, situations at the border may arise that are open to abuse or subject to excessive bureaucracy, thereby inflicting costs on traders in addition and beyond those related to compliance with the applicable rules of origin regulations.[45] Finally, the persistence of different rules of origin in EAC, SADC, and COMESA may constrain trade creation by forcing companies in EAC member countries to focus on only certain export destinations, given that they might need to produce differently to comply with the rules on sufficient domestic processing and also to keep documentation to prove compliance with rules that vary across different agreements.

[42] The size of Tanzania's imports from South Africa requires careful implementation of EAC rules of origin to prevent re-exportation, primarily to Kenya, of Tanzania's imports effected under SADC preferential tariffs.

[43] According to Yang and Gupta (2005), the limited success of Africa's RTAs in promoting trade and investment could in part be attributed to the problems associated with overlapping memberships.

[44] The EAC partner countries agreed on rules of origin that represent a negotiating compromise between the prevailing arrangements in COMESA and SADC, and do not correspond to either of these preexisting arrangements.

[45] Confusion over which rules of origin apply at borders and their enforcement is one of the main concerns related to the overlapping membership of countries in regional integration initiatives in Southern and Eastern Africa expressed by the private sector (Charalambides (2005)).

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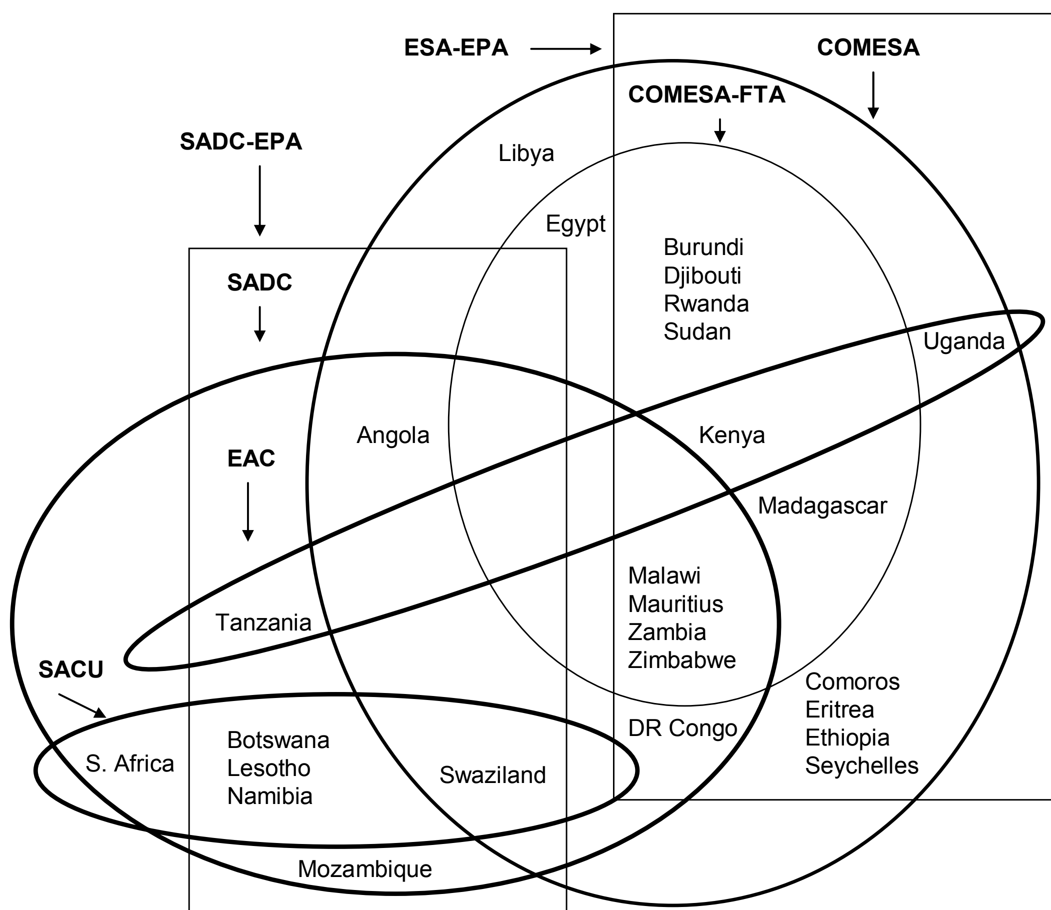
Figure 1. Major Regional Trade Arrangements in Eastern and Southern Africa



22. **Overlapping membership impedes the efforts of EAC member country authorities to effectively address non-tariff barriers to trade, including the harmonization of standards and technical regulations unless there is convergence in standards and implementation across the various groupings.** Addressing non-tariff barriers requires implementation mechanisms, including legal bodies and dispute settlement mechanisms, that would generally involve some transfer of national authority to regional institutions, which cannot be effectively done while SADC and COMESA each retains its own mandate in economic integration. The prevalence of divergent regulations and standards in different regions, particularly between Kenya and South Africa, would especially affect Tanzania if EAC standards converge with those of Kenya while Tanzania remains in SADC.

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23. **Since legally or technically a country cannot apply two different common external tariffs, the current pattern of overlapping membership will become impossible to maintain once COMESA and SADC also become customs unions as mandated by their member states unless COMESA, SADC, and EAC effectively adopt the same common external tariff.** Therefore, the EAC customs union can, in the long run, only be sustained as a fast-track option of a more slowly materializing COMESA customs union,[46] if all EAC Partner States belong also to COMESA. This would require Tanzania to rejoin COMESA and leave the SADC FTA (Stahl (2005)). The private sector in Tanzania has also revealed its strong preference to rejoin COMESA, a position which is now supported by the East African Business Council.[47]

B. Economic Partnership Agreements Negotiations

24. **Unless negotiations of Economic Partnership Agreements (EPAs) with the European Union (EU) lead to a rationalization of RTAs, EPAs could complicate the overlapping membership problems and lead to further trade diversion if not accompanied by MFN tariff reductions.** The EPAs aim to establish WTO-consistent preferential trade agreements with large regional groupings of developing countries. To simplify the negotiating process and to enhance the development impact of the agreements by promoting intra-regional trade, the EU has favored negotiating EPAs with a limited number of groupings centered around the pre-existing FTAs or customs unions, rather than with individual countries. In this context, Tanzania is negotiating the EPA as a member of the ‘SADC group,’ while Uganda and Kenya are under the ‘COMESA group.’ Unless the SADC and COMESA groups’ negotiations with the EU are closely coordinated, the EAC members may face different commitments vis-à-vis the EU which would make the implementation of the EPAs together with the EAC customs union costly and cumbersome.[48] In addition, the establishment of EPAs could result in further trade diversion and welfare losses if not accompanied by MFN tariff reductions with the foregone tariff revenue potentially accruing to producers in the EU rather than to consumers in the EAC. This makes it important to ensure that the pace of the phasing in of the preferences for EU products under the EPAs is complemented by MFN tariff reductions with commensurate or shorter implementation periods.

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[46] COMESA’s stated objective is to establish a customs union by 2008.

[47] Study on the Post-Effects of Tanzania Withdrawal from COMESA on Tanzania Business Developments with COMESA Member States, May 2005.

[48] This could exert further pressure on Tanzania to rejoin COMESA.

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C. Other Measures to Promote Further Integration

25. **While further CET reduction may yield additional benefits, further integration is likely to benefit significantly from addressing non-tariff policies and procedures-related impediments to trade.** NTBs—such as customs and administrative procedures, regulations and licenses, and labor mobility—have not been fully eliminated and continue to adversely affect the cost of doing business and trade in the region. According to a survey carried out among companies trading in Eastern and Southern Africa (Charalambides (2005)), tariffs play a much less important role as a barrier to cross-border trade in Sub-Saharan Africa than inadequate transport and communications infrastructure, poor business environment, weak customs procedures and red tape. To ensure that a reduction in the CET yields the expected returns, it needs to be complemented by addressing non-tariff impediments to trade, and be accompanied by significant capital investments to alleviate the structural supply constraints, particularly in transport, energy, and communication infrastructure.

V. Conclusions

26. **The EAC countries have made considerable progress by launching the customs union five years after the re-establishment of the EAC.** However, to become a fully functioning customs union, the EAC countries should resolve the issue of overlapping memberships in regional trade agreements. While the EAC members should continue to work towards achieving trade liberalization in a multilateral context, they stand to gain through unilateral liberalization by lowering the EAC CET, which should lead to trade creation, improved efficiency of resource allocation, and welfare gains. To ensure that further CET reductions yield the expected benefits, the tariff reform should be complemented by structural measures to address non-tariff impediments to trade and to alleviate the supply response constraints, as well as by measures to offset the potential loss of tariff revenue associated with the tariff reduction. Further tariff liberalization should therefore be viewed as an essential element of the EAC countries' long-term growth strategies. The timing of the expected reconsideration of the level of the CET provides sufficient scope for these measures to be put in place and to become effective in time for the CET reduction.

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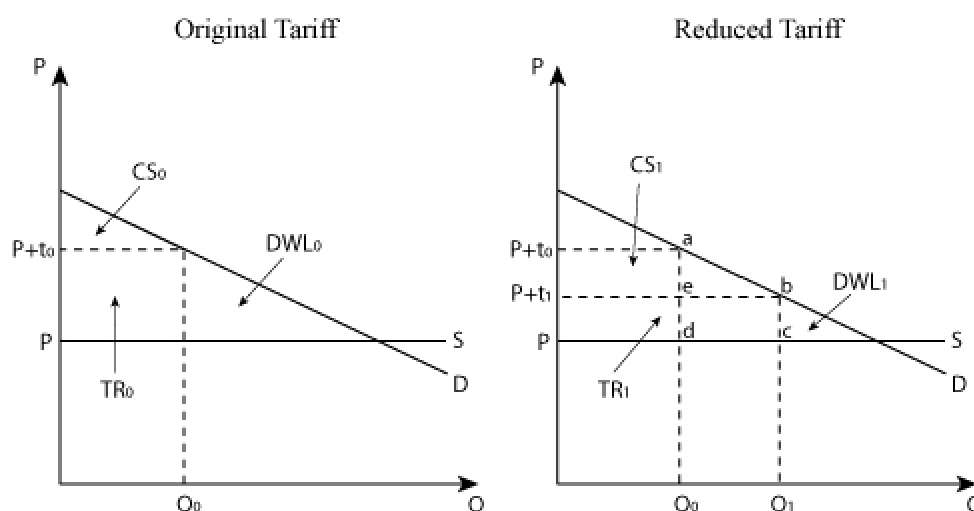
ANNEX. Graphical Presentation of a Tariff Reduction

The first round effects of a tariff cut can be captured in a simple diagram where **P** represents the world price of an imported good, **Q** quantity, **S** a horizontal import supply curve, based on the assumption that a small importing countries (small markets) do not influence world prices, and **D** a downward sloping import demand curve to represent consumers response to changes in the domestic price of the imported good:[49]



The left hand side of the diagram highlights the initial situation before the tariff is cut from t_0. The intersection with the demand curve of $\mathbf{Q_0}$ and $\mathbf{P+t_0}$ shows quantity demanded of the imported good at the domestic price (world price plus tariff). The triangle labeled $\mathbf{CS_0}$ represents consumer surplus[50] while the triangle $\mathbf{DWL_0}$ shows dead weight welfare loss to the economy due to the tariff. $\mathbf{TR_0}$ represents initial tariff revenue. If the tariff is lowered to $\mathbf{t_1}$**,** as shown on the right hand side, the domestic price drops to $\mathbf{P+t_1}$ and quantity demanded increases to $\mathbf{Q_1}$**.** The distance $\mathbf{Q_0\text{-}Q_1}$ along the horizontal axes represents trade creation**.** Importantly, the dead weight loss to the economy has decreased to $\mathbf{DWL_1}$ and consumer surplus has increased to $\mathbf{CS_1}$ **(**triangle from top of demand curve to b to $P+t_1$**).** Increased consumer surplus can be broken into an increase in overall welfare **(**triangle a-b-e**),** and a transfer of revenue from the government to consumers $\Delta t^* \mathbf{Q_0}$ **(**rectangle $P+t_0$-a-e-$P+t_1$**).** The overall welfare gain to the economy is equivalent to the are **a-b-c-d**.

[49] Lower elasticity of demand would result in a steeper demand curve. Elasticity of import supply is infinite.

[50] Producer surplus is not considered.

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