DISCUSSION PAPER

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ABSTRACT

The paper evaluates the economic necessity and political incentives of a transitional fund for the East African Community (EAC). The fund has been proposed to encounter trade imbalances which may arise due to the intended customs union in East Africa. Using a disaggregated approach at the two-digit level of the Standard International Trade Classification, the paper assesses the overall impact of the EAC on trade flows. Moreover, the commodities that will be particularly affected by the customs union are identified. The results show that considerable trade effects cannot be expected, except for a very narrow range of products. The need for a transitional fund becomes less urgent from this perspective.

JEL classification: F15, F17

Key words: Customs Union, EAC, Kenya, Tanzania, Uganda

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1. Introduction

There has been a relatively long tradition of attempts to integrate the economies in East Africa. Starting in 1948 with the East African High Commission, several attempts have been made to foster deeper integration of Kenya, Tanzania and Uganda. With different reasons playing a confounding role, most of these efforts finally failed. The most recent attempt, the new East African Community (EAC), however, reaches far beyond the failed ones in the past. The new EAC treaty, agreed on in 1999, envisages first the establishment of a customs union, then a common market, a monetary union and ultimately a political federation. The first step is the establishment of the EAC customs union, planned for November 2003, which aims to eliminate all remaining intra-regional tariffs, to remove non-tariff barriers and to introduce a common external tariff.

There have been fears that the application of the provisions for the establishment of a customs union and a common market would lead to severe trade imbalances. These fears have been stated in all relevant documents of the EAC. For instance, Article 77 of the treaty is titled "Measures to Address Imbalances Arising from the Application of the Provisions for the Establishment of a Customs Union and a Common Market" (EAC Secretariat 2000, p. 52). Similarly, the problem of imbalances was also discussed in the First Development Strategy of the EAC, covering the period ranging from 1997 to 2000. This strategy translated the vision of co-operation among the partner states into a comprehensive action programme including areas like trade and industry, transport and communications, agriculture, environment, tourism, social and cultural activities and fiscal and monetary policies. In the strategy, the problem of imbalances is cast in terms of costs and benefits. There, it is stated that "while there are benefits accruing from regional integration, unequal distribution of the ensuing benefits has been a major shortcoming in many integration schemes, including the well-known case of the collapse of the defunct East African Community" (Secretariat of the Permanent Tripartite Commission for East African Co-operation 1997, p. 17).

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

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

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

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

Against this background, three questions will be addressed in this paper: (1) What are the likely overall trade effects of the EAC customs union, (2) which disaggregated commodities will be affected in particular, and (3) who has a particular interest in a transitional fund? The following sections will begin in Section 2 with a survey of the structure of EAC trade flows and provide an overview of central features of the EAC in the past and at present. Once the historical background has been elucidated, Section 3 presents the model which is used to estimate the trade effects. The results of the trade estimations are then presented in Section 4. Based on these results, Section 5 examines the political economy of the proposed transitional fund. Finally, some concluding remarks as well as a summary of the major results are found in Section 6.

2. Historical Background and Achievements of the EAC

In November 1999, the treaty for the establishment of the new EAC was signed between the three partner states. According to §1, Article 5 of this treaty, the objectives of the Community "shall be to develop policies and programmes aimed at widening and deepening co-operation among the partner states in political, economic, social and cultural fields, research and technology, defence, security and legal and judicial affairs, for their mutual benefit" (EAC Secretariat 2000, p. 12).

As already mentioned in the previous section, the new EAC is only partly a new organisation. The first attempt to integrate the East African economies was the East

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

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

As a combining result of these factors, the old EAC broke down in 1977 and Tanzania closed its border with Kenya. It took 16 years until the first attempts began to revive the EAC and to clear the way for a new foundation. In the Mediation Agreement, signed in 1984 for the division of assets and liabilities of the former EAC, there was a provision to explore areas of future co-operation. On the basis of this provision, the heads of state of the three states agreed during a meeting in 1986 in Nairobi to promote the spirit of co-operation among their respective countries. On 30 November 1993, the three East African partner states signed an agreement establishing the Permanent Tripartite

Commission for East African Co-operation with a mandate to identify areas of co-operation and propose appropriate arrangements for regional co-operation.

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

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

In some areas, the EAC has already made remarkable progress. For instance, intra-regional trade has been liberalised to a large extent. Kenya already applies a preferential tariff reduction of 90 per cent on imports from the other two EAC members. The tariff regimes of Tanzania and Uganda have been liberalised as well (see Table 1). Moreover, non-tariff barriers on cross-border trade have been removed. The establishment of full customs union, implying an elimination of the remaining tariffs on intra-EAC trade, is planned for November 2003.

Table 1: Import Tariffs of EAC Countries, 1999 (in per cent)

Country	Average tariff rate inside EAC	Average tariff rate outside EAC
Kenya	2.0	20.4
Tanzania	5.4	15.7
Uganda	1.3	1.4

Source: National Tariff Statistics and UNCTAD (2003). Note: Figures refer to applied import weighted averages for the three East African Countries.

Bilateral trade flows of the EAC member countries show that Kenya had a significant trade surplus with both Tanzania and Uganda in 1999, the latest year for which trade data for all three East African countries is available (Table 2). All three EAC countries had a large (absolute) trade deficit with the rest of the world. On the other hand, the share of the current account deficit to GDP is particularly large in Tanzania and Uganda. Seen from this perspective, fears in Tanzania and Uganda about a further decline in their trade balance due to EAC tariff removal seemed to be comprehensible to a certain extent.

Table 2: Trade Balance of EAC Countries, 1999 (US $ Mill.)

Reporting country	Bilateral trade surplus (+) / deficit (-) with				Total current account deficit in % of GDP
	Kenya	Tanzania	Uganda	World	
Kenya		+156.2	+260.7	-1,134.7	-0.9
Tanzania			+7.5	-945.9	-7.6
Uganda				-509.9	-11.6

Source: ITC (2003). Note: Bilateral trade figures refer to trade in goods only, whereas the current account data also include imports and exports of services.

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

3. Model Structure

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

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

Since the required data are not available for all three East African countries, we have to rely on an appropriate partial equilibrium model to analyse the trade effects of the EAC. More specifically, the model of Verdoorn (1960) will be used to estimate the impact of the EAC on trade flows. Despite its age, it is the best suited partial equilibrium model for the analysis of trade flows in the proposed EAC.[1] In the spirit of the "Armington assumption" (Armington, 1969), this model assumes product differentiation between supplying countries. More specifically, imported goods from different countries are considered to be imperfect substitutes in use. This assumption seems reasonable, since the majority of EAC trade consists of manufactured goods (Table 3).

[1] It can be shown that the model of Verdoorn is a simplified version of the more general partial equilibrium model of Clague (1971, 1972). See Busse (1996) and Busse and Koopmann (2002) for details.

Table 3: Import Structure of EAC Countries, 1999

Products (SITC No.)	Total imports of Kenya		Total imports of Tanzania		Total imports of Uganda		Total intra-EAC-imports	
	Mill. US$	%	Mill. US$	%	Mill. US$	%	Mill. US$	%
Food, live animals, beverages and tobacco (0-1)	201	7.2	202	12.7	92	9.1	41	11.1
Raw materials (2-4)	652	23.4	222	14.0	212	20.9	138	37.1
Manufactures (5-9)	1,933	69.4	1,163	73.3	710	70.0	194	52.8
Total	2,786	100.0	1,587	100.0	1,014	100.0	373	100.0

Source: ITC (2003).

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

Table 4: Exports and GDP of EAC Countries, 1999

Country	Total exports in mill. US$	Total intra-EAC exports in mill. US$	Total intra-EAC exports in % of GDP
Kenya	1,650	428	4.1
Tanzania	642	47	0.5
Uganda	506	38	0.6

Source: ITC (2003) and World Bank (2003).

To analyse the different trade effects the customs union may have, let us consider a particular commodity category (Q), such as shoes. The consumer wishes to maximise his utility

(1) $$U = f\left[f_1(Q_1, Q_2), Q_3\right],$$

where the branch of the utility function f_1 is homogeneous. Q_1 and Q_2 denote imports of shoes from preferred and non-preferred countries, and Q_3 represents domestically produced shoes. The assumption of homogeneity of the utility function implies that total imports (Q_1+Q_2) are substituted equally for domestic production. By using import demand elasticities (ξ), we can thus employ import data, without having to rely on domestic production data. This particular assumption is not only convenient, but rather necessary in the case of Kenya, Tanzania and Uganda, since detailed domestic production data are not available.

Against this background, we can focus on different sorts of imported shoes only. The consumer allocates expenditure to preferred and non-preferred imports subject to his budget constraint

$$\text{(2)} \qquad Y_s = P_1 Q_1 + P_2 Q_2,$$

where Y_s refers to the share of total income spent on imported shoes and P_i stands for the prices of different imports.

Consider now the impact of a tariff (t) elimination only on preferred imports Q_1. If the supply elasticities are infinite, then the price of the beneficiaries' imports P_1 changes by

$$\text{(3)} \qquad \frac{dp_1}{p_1} = \frac{\Delta t}{1+t}.$$

To measure the degree of substitution of Q_1 and Q_2, we use the Allen partial elasticity of substitution (σ).[2] We can thus express the total expansion of imports from the preferred country's viewpoint as follows:[3]

$$\text{(4)} \qquad \frac{\delta Q_1}{Q_1} = \left(\alpha_1 \xi + (1-\alpha_1)\,\sigma\right)\left(\frac{\Delta t}{1+t}\right),$$

[2] See Allen (1962).

[3] See Verdoorn (1960) for details. Income effects are neglected, since these would be extremely small.

where α_1 refers to the share of Q_1 in the total consumption of imported shoes ($\alpha_1 = Q_1/(Q_1+Q_2)$). Accordingly, α_2 measures the share of Q_2 in total imports and the sum of α_1 and α_2 equals 1. The chain reaction comes in two stages: first the tariff is eliminated only on Q_1 and P_1 falls, and then the consumer substitutes Q_1 for Q_2 and Q_1 for Q_3. Thus, both Q_2 and Q_3 decline.

Equation (4) can be rearranged by substituting α_2 for α_1:

$$(5) \qquad \frac{\delta Q_1}{Q_1} = \left(\xi + \alpha_2(\sigma - \xi)\right)\left(\frac{\Delta t}{1+t}\right).$$

Finally, the total trade effect can be separated into trade creation (TC) and trade diversion (TD). Trade creation is defined as the change in imports from preferred countries (Q_1) which displaces domestic production due to the preferential tariff elimination. This effect can be determined from the recipient country's viewpoint as follows:

$$(6) \qquad TC = Q_1 \, \xi \left(\frac{\Delta t}{1+t}\right).$$

Likewise, trade diversion is defined as the replacement of non-preferred with preferred imports:

$$(7) \qquad TD = Q_1 \, \alpha_2 \, (\sigma - \xi) \left(\frac{\Delta t}{1+t}\right).$$

As can be seen from (6) and (7), estimation of TC and TD in the differentiated product model requires estimates of import demand and substitution elasticities. Since reliable estimates for both the import demand elasticity and the elasticity of substitution cannot be estimated reliably for Kenya, Tanzania and Uganda, we are following the standard "Dutch" convention, which is to assume values of 0.5 and 2.0 for the import demand elasticity and the elasticity of substitution, respectively. These values are well within the range of similar elasticities of other countries.[4]

4. Empirical Results

Before we present the estimated trade effects, we will first take a brief look at the data used. All trade data refer to the base year 1999, the most recent year for which a complete data set for all three EAC countries can be obtained (ITC 2003). The tariffs were obtained from the national tariff statistics of the three EAC countries and the UNCTAD Trade Analysis and Information System (TRAINS), which is a comprehensive computerised information system at the tariff-line level using the Harmonised System of product classifications. These tariffs were then transformed into the SITC (Standard International Trade Classification, Revision 3), since all trade data is based on the SITC system.[5] The analysis has been performed at the two-digit SITC level, which allows a detailed specification of different products.

The projections of the impact of the EAC customs union on trade flows can be seen from Table 5. Total trade will increase by roughly US $13 million or 3.6%. Trade creation and trade diversion amount to US $4.5 and US $8.7 million, respectively. In comparison to Kenya and Uganda, trade effects in Tanzania can be expected to be much larger with respect to both absolute and relative size. This outcome was to be expected, since intra-EAC tariff rates in Tanzania are considerably higher in comparison to Kenya and Uganda. Yet for all three East African countries, trade diversion exceeds trade creation. From an economic point of view, trade creation is welfare improving, as consumers substitute lower cost beneficiary imports for goods produced at home. Trade diversion, on the other hand, will decrease welfare, as a more efficient source of imports will be displaced by a higher-cost producer.

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[4] See Sawyer and Sprinkle (1999) for a survey of trade elasticities.

[5] The concordances can be found in United Nations (1986).

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

Country	Trade creation $ '000	% [a)]	Trade diversion $ '000	% [b)]	Total trade effects $ '000	% [a)]
In Kenya	105	0.9 %	305	0.01 %	410	3.7 %
In Tanzania	2,485	2.3 %	5,860	0.4 %	8,345	7.7 %
In Uganda	1,948	0.8 %	2,570	0.3 %	4,518	1.8 %
Total	4,538	1.2 %	8,735	0.2 %	13,273	3.6 %

Notes: [a)] Of preferred imports. [b)] Of non-preferred imports.

To check for the robustness of these results, we could, for instance, double both the assumed values for the elasticity of substitution and import demand elasticity to 4.0 and 1.0, respectively. As can be seen from equations (6) and (7), trade creation and diversion would double as well. Hence, we have to keep in mind that the assumptions regarding both elasticities are crucial for the expected trade effects. Even though the assumed values for both elasticities are well within the range of estimates for other developing countries, they are still crude assumptions and may contain a possible bias of all trade estimates.

To see which of the three EAC countries benefits most from the preferential trade liberalisation, trade creation and diversion effects have been analysed at the country level (Tables 6 and 7). In both cases, Kenya profits most with shares of 95 and 93 per cent of total trade creation and diversion, respectively. This result is clearly due to the relatively high export share of Kenyan exporters within the EAC.

Table 6: Distribution of Trade Creation Effects of the EAC

Country	Kenya $ '000	% [a)]	Tanzania $ '000	% [a)]	Uganda $ '000	% [a)]	Total trade creation $ '000	% [a)]
In Kenya			60	57 %	45	43 %	105	100 %
In Tanzania	2,431	98 %			54	2 %	2,485	100 %
In Uganda	1,862	96 %	86	4 %			1,948	100 %
Total	4,293	95 %	146	3 %	99	2 %	4,538	100 %

Note: [a)] Of total trade creation.

Table 7: Distribution of Trade Diversion Effects of the EAC

Country	Kenya		Tanzania		Uganda		Total trade diversion	
	$ '000	%[a]	$ '000	%[a]	$ '000	%[a]	$ '000	%[a]
In Kenya			175	57 %	130	43 %	305	100 %
In Tanzania	5,711	97 %			149	3 %	5,860	100 %
In Uganda	2,443	95 %	127	5 %			2,570	100 %
Total	8,154	93 %	302	4 %	279	3 %	8,735	100 %

Note: [a] Of total trade diversion.

Apart from the overall trade effects, there are considerable differences at the product level in all three East African countries (Tables 8 to 10). At the two-digit level of the SITC, trade effects of up to 40 per cent can be expected. Again, much higher relative trade effects occur in Tanzania due to higher tariff levels. On the other hand, there is no strong pattern of particular commodity groups that are affected most by the agreement. The commodity groups are rather scattered, as a large variety of different products are affected in all three EAC countries.

Table 8: Products in Kenya Most Affected by the EAC

	Trade creation		Trade diversion		Total trade effects	
Product category (SITC No.)	$ '000	in %[a]	$ '000	in %[b]	$ '000	in %[a]
Dairy products (02)	0.7	2.8	2.1	0.0	2.8	11.3
Paper and articles of paper (64)	0.0	1.7	0.1	0.0	0.1	6.8
Manufactures of metals (69)	0.5	1.7	1.4	0.0	1.8	6.8
Art. of apparel & clothing accessories (84)	0.4	1.7	1.1	0.0	1.5	6.8
Non metallic mineral manufactures (66)	2.4	1.7	7.1	0.0	9.5	6.7
Essential oils, resinoids & perfume mat. (55)	1.9	1.7	5.7	0.0	7.6	6.7
Cork and wood manufactures (63)	0.6	1.7	1.7	0.0	2.3	6.7
Meat and meat preparations (01)	0.3	1.7	1.0	0.1	1.3	6.7
Vegetables and fruit (05)	14.9	1.7	41.5	0.4	56.4	6.4
Tobacco and tobacco manufactures (12)	2.0	1.7	5.3	0.6	7.2	6.1

Notes: [a] Of preferred imports. [b] Of non-preferred imports.

Table 9: Products in Tanzania Most Affected by the EAC

Product category (SITC No.)	Trade creation		Trade diversion		Total trade effects	
	$ '000	in %[a)]	$ '000	in %[b)]	$ '000	in %[a)]
Tobacco and tobacco manufactures (12)	2.0	10.0	5.9	0.3	7.9	40
Rubber manufactures (62)	65.4	10.0	190.0	0.9	255.4	39
Art. of apparel & clothing accessories (84)	73.5	10.0	213.5	1.0	287.0	39
Dairy products (02)	20.9	10.0	59.6	1.5	80.5	39
Essential oils, resinoids & perfume mat. (55)	573.0	10.0	987.7	12.8	1,560.7	27
Paper and articles of paper (64)	241.4	6.5	633.9	2.4	875.3	24
Dyeing, tanning and colouring materials (53)	23.8	5.6	66.0	1.3	89.8	21
Animal or vegetable fats, oils processed (43)	110.6	6.5	219.3	6.6	329.9	19
Travel goods, handbags (83)	0.2	2.4	0.5	0.0	0.7	10
Telecommunications (76)	4.3	2.4	12.9	0.0	17.2	9

Notes [a)] Of preferred imports. [b)] Of non-preferred imports.

Table 10: Products in Uganda Most Affected by the EAC

Product category (SITC No.)	Trade creation		Trade diversion		Total trade effects	
	$ '000	in %[a)]	$ '000	in %[b)]	$ '000	in %[a)]
Furniture (82)	8.7	1.2	22.3	0.6	31.1	4.4
Prefabricated buildings (81)	17.0	1.2	34.9	1.2	51.9	3.8
Coal, coke and briquettes (32)	0.1	1.0	0.2	0.3	0.2	3.5
Animal oils and fats (41)	0.0	0.7	0.0	0.0	0.1	2.9
Fixed vegetable fats and oils (42)	0.8	0.7	2.3	0.0	3.1	2.9
Textile fibres (26)	2.2	0.7	6.6	0.0	8.9	2.9
Animal or vegetable fats, oils processed (43)	3.0	0.7	8.8	0.1	11.8	2.9
Telecommunications (76)	2.7	0.7	8.0	0.0	10.7	2.7
Travel goods, handbags (83)	0.4	0.7	1.3	0.0	1.7	2.7
Photogr. apparatus, watches and clocks (88)	0.4	0.7	1.2	0.0	1.6	2.7

Notes: [a)] Of preferred imports. [b)] Of non-preferred imports.

In a further analysis, the trade effects of the new external tariff of the proposed customs union have been computed. The new external EAC tariff would apply to all three EAC countries, regardless of individual national tariff rates at the moment. So far, two different proposals have been made. The first assumes a tariff rate of 0 per cent for primary raw materials, essential drugs, medical equipment, plant and agricultural inputs, 10 per cent for intermediate goods/inputs and 20 per cent for finished goods for imports. These tariff rates would apply for all imports from outside the EAC. The second proposal is identical to the first one, except that a tariff of 25 per cent is assumed for finished goods.

As can be seen from Table 11, the first proposal will lead to a decline in total extra-EAC imports by US $6.8 million or 0.1 per cent. While Kenya and Tanzania will see increasing imports, Uganda's imports will decrease significantly (-6.5 per cent). This outcome is clearly due to the fact that Uganda would have to raise its overall tariff level vis-à-vis the rest of the world considerably. If the external tariff rate for finished goods were to be set at 25 per cent, extra-EAC imports by Uganda would decline even more (-8.0 per cent). Yet Tanzania would also face declining imports.

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

Country	Total trade effects (20)[a)]		Total trade effects (25)[b)]	
	$ '000	%[c)]	$ '000	%[c)]
In Kenya	34,309	1.4	4,138	0.2
In Tanzania	8,074	0.5	-12,181	-0.8
In Uganda	-49,236	-6.5	-61,058	-8.0
Total	-6,853	-0.1	-69,101	-1.5

Notes: [a)] Assumes a tariff rate of 20% for finished goods for imports from outside the EAC. [b)] Assumes a tariff rate of 25% for finished goods for imports from outside the EAC. In both cases, a tariff rate of 0 % is assumed for primary raw materials, essential drugs, medical equipment, plant, agricultural inputs and 10 % for intermediate goods/inputs. [c)] Of non-preferred imports.

Finally, both trade projections, trade creation and diversion on the one hand and the introduction of a new external EAC tariff on the other, have been put together to see their combined impact on total exports, imports and the respective trade balance of all three EAC countries (Table 12). If the external tariff for finished goods is set at 20 per cent, Kenya and Tanzania are likely to see a decline in their trade balance by roughly US $22 million and US $10 million, respectively. Due to sharply declining imports, the trade balance of Uganda, on the other hand, will improve by some US $48 million. A different picture emerges in the case of the second proposal (25 per cent tariff for finished goods). Now the trade balances of all three East African Countries are likely to improve, again due to lower imports, or (in the case of Kenya) improved exports to Tanzania and Uganda.

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

Country	Tariff rate of 20 % for finished goods for imports outside EAC[c)]			Tariff rate of 25 % for finished goods for imports outside EAC[c)]		
	Exports[a)]	Imports[b)]	Trade Balance	Exports[a)]	Imports[b)]	Trade Balance
In Kenya	12,447	34,414	-21,967	12,447	4,243	8,204
In Tanzania	448	10,559	-10,111	448	-9,696	10,144
In Uganda	378	-47,288	47,666	378	-59,110	59,488
Total	13,273	-2,315	15,588	13,273	-64,563	77,836

Notes: [a)] Total trade creation + total trade diversion for each country. [b)] Total trade effect due to new external EAC tariff + trade creation for each country. [c)] In addition, a tariff rate of 0 % is assumed for primary raw materials, essential drugs, medical equipment, plant, agricultural inputs and 10 % for intermediate goods/inputs.

To sum up, Kenya will profit most from the internal liberalisation of intra-EAC trade and is, thus, likely to see a significant increase in its exports to Tanzania and Uganda. The other two East African countries will gain less from the EAC, but their trade balance will not deteriorate significantly. Rather the opposite seems to be the case, as external imports will be reduced as a consequence of the new external tariff of the EAC. Based on these projections, fears in Tanzania and Uganda about significant trade effects due to the completion of the EAC seem to be misguided.

5. Stakeholders and the Proposal for a Transitional Fund

Given the results of our calculations, it is not easy to explain the persistence of fears of severe trade imbalances due to the establishment of the EAC customs union or, therefore, to justify the case for a transitional fund. All in all, potential losses due to the establishment of the customs union would be small and could be easily absorbed by proper adjustment mechanisms. Apart from historical experience, one reason why a case has been made for a transitional fund may be the influence of stakeholders on the regional integration policy in East Africa.[6] According to Maasdorp (1999), who compiled a report on that issue for the EAC Secretariat, there is a strong perception in

[6] Examples of such stakeholders are the Confederation of Tanzania Industries, the Kenya Association of Manufacturers, Uganda Manufacturers Association and Chambers of Commerce and Industries.

both Tanzania and Uganda that their manufacturing sectors would not be able to compete with Kenyan producers in a customs union.

In Annex IV of his report, Maasdorp cites a local consultant's perspective on Tanzania, assessing the perception of Tanzanian business on EAC free trade. Major trade imbalances between the partner states, particularly between Kenya and Tanzania are seen as the main problem and challenge facing the EAC. The Tanzanian industrialists share the view that "the imposition of zero internal tariffs would generate trade creation and trade diversion effects in Kenya's favour which would further widen the trade imbalance in Kenya's favour" (Maasdorp 1999, p. 143). From the Tanzanian industrialists' point of view, a real danger exists that the EAC would collapse if the issue of trade imbalances between Kenya and Tanzania is not properly addressed. The report by Maasdorp does not contradict these views and it is recommended to establish a regional fund.

Four years later, stakeholders' views were again discussed in a study on a possible transitional fund made by Gitu et al. (2003). In Tanzania, there has been a change in style but not in substance. Sectors like manufacturing, agriculture, trade and transport are pointed out by stakeholders as areas for potential gains. But as far as manufacturing is concerned, it is expected that this sector would be hit most by the trade liberalisation, at least in the short run. Apart from the transitional fund, other considered remedies for the expected losses may be, for instance, a gradual elimination of internal tariffs (instead of a complete liberalisation in one stage) and a progressive taxation of those who benefit more from integration. In Uganda, in contrast, a transitional fund is seen as a vital necessity, given the distinct possibility that there will be "losers" after integration.

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

6. Concluding Remarks

The main results of this paper can be summarised as follows: First, the relative size of the estimated trade effects shows that fears in both Tanzania and Uganda about negative trade balance effects following the completion of the EAC customs union seems to be misguided. Second, Kenya is likely to profit most from the liberalisation of intra-EAC trade. Tanzania and Uganda, on the other hand, will gain less from completing the customs union. Yet their trade balance will not deteriorate significantly, if at all, due to the higher level of the new external EAC tariff. Third, at the product level, there are considerable differences in all three East African countries. There is no strong pattern of particular commodity groups that are affected most by the customs union. The commodity groups are rather scattered, as a large variety of different products are affected in all three EAC countries.

Finally, the persistence of fears due to the establishment of the customs union can be traced to the influence of stakeholders on the regional integration policy in East Africa. There has been a strong perception among Tanzanian and Ugandan industrialists and businessmen that the manufacturing sectors of the two countries would not be able to compete with the longer-established and larger Kenyan producers in a customs union. This perception has slowly become a hindrance to the establishment of the customs union and an argument to substantiate the case for a transitional fund in the EAC. Based on the results presented in this paper, a fund is not only unnecessary in the case of the EAC, but if established could become a source for rent seeking and corruption. The planned customs union for November 2003 can be put into action without any fears as far as the expected trade effects are concerned.

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