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➢ An examination of regional trade agreements:

a case study of the EC and the East African community

by

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➢ Abstract

In following a growing trend, the East African Community (EAC) was recently re-created in order to achieve rigorous developmental objectives it has set for itself. Regional trade agreements are becoming increasingly popular but their benefits are hotly debated. There is neither a great deal of clarity nor universal agreement as to what the over-riding conditions must be for a successful agreement. This, despite strong indications that a North-South agreement would be a necessary additional ingredient in order to improve the prospects for this Treaty. This paper examines those arguments and compares them to the alternative arguments made in favor of MFN trade and even free trade. Even if the economic theory were to be clear, a strong measure of domestic political support for the treaty will be an essential ingredient; several other potential requirements will be outlined.

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1 Introduction

In 1999, the Heads of State of Tanzania, Kenya, and Uganda resolved to create a treaty re-establishing the EAC in order to achieve ambitious economic development objectives and to promote trade within their region. This paper will examine various economic and political factors of this agreement and sets out to assess the feasibility of these goals. However, the path towards these goals may prove complex. As it weighs the economic and political ties to the EC, the EAC is essentially choosing between regional and multilateral trade. This paper will identify and examine the economic costs and benefits of each strategy.

To reap the lessons from the failure of the first EAC, this paper must include a background history of the region which sheds light on the past nature of regionalism in East Africa. What follows is a theoretical examination of regional trade agreements (RTAs) from an economic, legal as well as political point of view. This will explain the various theoretical costs and benefits that confronted the creators of the EAC while providing a direct examination of the EAC treaty.

In any event, it must be pointed out that data and empirical information from the region are frequently either unreliable or unavailable. Where this fact threatens to render some of the analysis inaccurate, the paper deliberately uses broad strokes to address critical but general issues in East African trade.

For convenience, there is a table of all the acronyms used in this paper in Appendix 1.

2 Regionalism in East Africa

2.1 History

By giving a brief history of the region and its previous attempts at regional integration, this section considers what lessons might have been considered while the current treaty was being planned. An examination of the region's history offers a glimpse at some of the economic and political difficulties and stumbling blocks to be anticipated for the new treaty.

In 1961, as the countries of East Africa were gaining their independence from the British, the East African Common Service Organization replaced the British High Commission to run the region. The East African Community was established six years later with the intention of forming the East African Common Market (McKay 1998:16) and

> to strengthen and regulate industrial, commercial and other relationships of the partner states to the end that there shall be accelerated, harmonious and balanced development and sustained expansion of economic activities (Eastern 1967).

For the most part, these objectives were never achieved (Hazelwood 1979) and the community was soon disbanded. Ultimately, political discord amongst the members, coupled with an increasing trade imbalance (McKay 1998: 16) was responsible for the demise of the EAC in 1977, a mere decade after its inception. However, the original Treaty may also have been doomed from the outset, as it was strictly an agreement between governments without much involvement from the private sector or civil society (McKay 1998: 22). Nevertheless, these ambitious goals have mostly been resurrected in the new EAC.

By 1984, new work towards a second EAC had commenced and by 1998, Tanzania, Kenya, and Uganda there was an agreement to work towards a political federation with zero internal tariffs on the majority of trade and with a single common external tariff (McKay 1998: 5). Many economists argue that internal integration is essential for an RTA and so this will be examined in detail.

2.2 Objectives of the EAC and its hurdles

The failure of the first EAC confirmed the importance of maintaining an equitable distribution of economic benefits amongst the three EAC members. The achievement of ambitious development objectives will require an examination of avoidable welfare losses that arise from interrupted trade flows. Keeping both of these considerations in mind, the Members have agreed to promote economic and political cooperation through a regional policy framework with common macroeconomic policies as well as a basic regional infrastructure.

The region has a reputation for long border delays and rampant corruption (Trade blocs 2000:81) and the ports are no exception (Goldstein & Ndung'u 2001: 25). In addition, road transport faces persistent shortages in trucks, fuel and spare parts; the railway system is in disrepair and civil strife has led to frequent border closings (Ndung'u 2000: 37). It is hoped that increased regional cooperation will reduce many of these internal transportation costs as investors are expected to increase their investment in various transport systems (Ndung'u 2000: 36).

For the moment, however, transportation costs remain high. This imposes a significant additional cost on the EAC as the member countries can afford fewer imports and therefore have less domestic supply of those imported goods. In addition, exporters must pay the equivalent of a "tariff" that does not equate to any government revenue. For example, delaying a fleet of trucks for a week does not incur income for anyone, but merely imposes a cost-burden on consumers until these so-called "frictional barriers" can be eliminated.

2.3 The current state of regionalism in the EAC : degrees of regionalism

An economic analysis of the Egypt-EU trade agreement has shown that deep economic integration within RTAs can contribute to significant welfare savings (Hoekman & Konan 1999: 22-23). These findings could help to stimulate extensive regional integration in East Africa as well as focus efforts on a North-South agreement. However, the EAC is unlikely to liberalize its trade completely, as domestic political and economic interests will encourage sheltering some "sensitive" sectors. Therefore, the EAC may require external incentives to usher in these painful but beneficial policies (McKay 1998:67).

Despite encouragement from the EC to form a deeply integrated RTA, the final EAC Treaty was not nearly as far-reaching as was originally intended. Imbalances of trade between the three nations, a lack of a clear and equitable way to fairly redistribute benefits from the RTA, the difficulty of recovering lost tariff revenue, as well as difficulties in developing approaches to ameliorate the damage to unprotected infant industries continue to pose major political stumbling blocks almost three decades after the collapse of the first EAC. The next section will examine how the treaty can expect to achieve economic and political success by overcoming these challenges. It will then examine why East Africa might consider the above-mentioned EPA with the EC.

3 A Political Analysis of RTAs

The EAC was created largely to attain a certain political objective, based, to some degree, on the foundations of economic theory. The structure of any nation's international trading system should be designed to protect it from both the internal political system of lobbyists as well as from other nations (Krugman 1999: 381). In this regard, governments carefully consider the political consequences of their policies and as a result most RTAs are predominantly politically motivated (Demaret 1997: 807).

3.1 Weighing the Political Decision

Generally, RTAs are motivated by foreign policy and national security concerns which are weighed more heavily than the economic considerations of an agreement. Countries that trade together are arguably more likely to get along well politically with each other and this must have been a strong consideration in politically turbulent East Africa. There are also political pressures at home as lobbies have an incentive to increase the market size of their firms without subjecting themselves to too much competition in return. As the economics of an RTA amongst developing countries can be only summarized vaguely, at best, it seems that these economic considerations are often marginalized by local politicians who prioritize political objectives and respond to local political influences when making decisions about forming trade agreements.

Because the economics are not self-evident (Frankel 1997: 107) the costs of an RTA could be quite high. It has been argued that low levels of trade in Sub-Saharan Africa will prevent the fostering of comparative advantages through RTAs and, as a result, there should be little economic incentive for African countries to join together in RTAs. Alexander Yeats, a World Bank economist, maintains that the multilateral trading system based on MFN trade should be their superior economic option (Yeats 1998: i). Furthermore, lowering their trade barriers, he adds, would allow African exporters to develop and improve their international competitiveness (Yeats 1998: ii). If Mr. Yeats' argument were right, this would confirm that the governments of the EAC have put a priority on their political concerns and must be very cautious about what economic benefits they expect.

Domestic firms might seem to contradict his argument but it is not strange that many of them do not favor full multilateral free trade. They would face intense competition from the world market as a result of multilateral liberalization whereas regional trade would limit this competition while offering political benefits in return. Firms generally face less opposition to their price-increasing policies from consumer groups on the regional level than they would on the multilateral level and will therefore favor RTAs over multilateral trade. The consumer, on the other hand, would gain most from free multilateral trade as that would offer lower prices and a greater selection of goods.

Political negotiations on the regional level can also offer benefits through formal income transfers to reimburse those members who lose from an agreement. This would not normally work in multilateral trade negotiations as it would be very complicated to organize amongst a large group of trading partners (Hoekman & Kostecki 1995: 214). In addition, relatively small countries increase their political weight when they unite and can command more attention in international negotiations. These two factors were likely also instrumental in encouraging Kenya, Uganda, and Tanzania to seek a stronger international voice through an RTA.

3.2 Observations

With the growing number of RTAs being negotiated and created, it would seem likely that their benefits were obvious. However, this is not necessarily the case, especially for a region that does not have precise trade data with which to evaluate and weigh the economic costs and benefits. In addition, it is not easy to evaluate the rather vague concept of future political benefits so EAC negotiators were taking a substantial risk in forming this RTA. They were undoubtedly encouraged in their efforts by domestic firms but they must also have considered, at least in broad terms, what the economic benefits could be and then determine how to reap the greatest benefits while limiting the costs.

4 The East African Community

This section (Baldwin & Wyplosz 2001) will examine the economic theory behind joining an RTA in order to help clarify the decision made by the three East African countries. This analysis will explain the effects on tariff revenue, prices and output levels before drawing broad conclusions on the overall effects upon welfare.

4.1 Regionalism and Multilateralism

Simply put, RTAs create and divert trade: trade creation arises as more efficient firms outperform less efficient firms within the territory of the RTA and trade diversion arises as less-efficient producers within the RTA displace producers from outside the RTA due to the tariff protection gained from being a member of the agreement. This diversion hurts those outside of the agreement; therefore RTAs that are generally more trade creating are usually considered beneficial, and those that are generally more trade diverting are considered harmful (Panagariya 2001: 482-483). This essay will evaluate the EAC on these criteria. As mentioned earlier, EPAs in which a large country joins in bilateral trade with a smaller country can "lock-in" necessary but unpopular reforms, and this also will be considered from an economic view.

4.1.1 Economics of MFN Tariffs and RTAs[1]

With MFN trade, tariff revenue in small countries decreases, the price of imports from the rest of the world entering the home country decreases and both supply from the rest of the world and welfare in the home country will decrease as tariffs raise prices at home. This loss is only somewhat offset by the gain in tariff revenue from the MFN tariff—so that a multilateral trading system in which small countries use tariffs on a multilateral level is a welfare-reducing scenario, with respect to free trade.

In an RTA, the partner country no longer pays the tariff in home, therefore it increases its exports to home, but the rest of the world still pays the tariff so the home price remains constant at the world price. The price does not change because small countries are "price takers" and can therefore not affect the world price for goods by increasing or decreasing their consumption or output. The partner country increases its share of imports and the terms of trade for the home country worsen. In addition, the welfare decreases at home due to the RTA as a result of a loss in tariff revenue; therefore, as was suggested above, RTAs between small countries lower welfare in the home country.[2] Therefore, economically speaking, free trade would offer the greatest welfare gains to the EAC, followed by MFN tariffs. An RTA would offer the fewest welfare benefits but bilateral relations, such as with the EPA, might be able to garner additional benefits to offset the costs.

The amount of economic welfare lost in small countries is independent of the amount of their trade with their partners or even of the amount of internal trade of an RTA but instead depends on the elasticity of the partner's supply curve as well as the level of home's external tariff. The more elastic the supply curve and the higher the tariff, the greater will be the resulting welfare loss from an RTA. It follows that the higher the initial tariff the more, proportionally, the home country will trade with its partner due to the relative increase in tariffs on the rest of the world. Furthermore, the economic loss from an RTA increases proportionally with the increase share of trade with its partner country (Schiff 1996: 10) because of the foregone tariff revenue. This would suggest that, economically, small countries like those in East Africa, once committed to an RTA, should not liberalize "substantially all the trade" internally, as that will only result in lost tariff revenue from the their trade with the rest of the world without experiencing additional economic welfare gains.

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[1] This section will refer to "home", "partner", and "the rest of the world". Respectively, these refer to the country that is creating an RTA, the country it proposes to join with, and all other countries that are not in the RTA.

[2] "Note that the welfare loss to the home country would occur in the absence of trade diversion as well (e.g. the loss would be area cejk if S_p were vertical at level Q_2)." (Schiff 1996: 8-9).

Furthermore, a lower MFN tariff on the rest of the world will improve welfare for the home country. This is due to a lower proportion of tariff-free imports from the partner as well as a consumer surplus gain from the increased total imports (Schiff 1996: 10). This contradicts the popular argument that RTA members should trade proportionately more with each other (Schiff 1996: 11).

If the home country relies solely on multilateral trade, it regains the deadweight economic losses incurred by an RTA, as well as additional tariff revenue. Imports from the former partner decrease, imports from the rest of the world increase and overall welfare at home increases (Schiff 1996: 11). Therefore, although small countries lose from an RTA with other small countries, they are better off with an RTA with the rest of the world and perhaps even with a very large trading partner (Schiff 1996: 11).

4.2 Observations

Kenya is larger than Uganda and Tanzania but all three of these countries are smaller than the EC. As explained, if Kenya forms an RTA with smaller partners, it will increase imports from those partners but decrease imports from the rest of the world. Because of the RTA, Kenya loses its tariff revenue from the other EAC members and this loss will increase with the increase of trade volume. Tanzania and Uganda will gain from an increase in producer surplus, which increases with an increase in trade volume. There is an overall negative effect as Kenya loses more than the others gain. This is on account of the trade diversion from imports that used to come from a lower cost source, the EC, but now comes from higher cost East African producers. There is no trade creation as the marginal unit of imports from the EC is at the same cost as before because the EAC is a price taker. Therefore, the EAC, as a standalone trade agreement, will be economically welfare reducing (Schiff 1999: 8).

However, aside from lost tariff revenue, small countries tend to be more protectionist so there is a greater potential for exploiting economies of scale and breaking up monopolies through RTAs as this opens markets to competition (Trade blocs 2000: 32). Therefore, there are internal economic benefits to the business environment from a larger marketplace in East Africa. These benefits are increased when internal liberalization is increased, which suggests that "substantially all the trade" *should* be liberalized and these gains could potentially be far greater than any tariff revenue gains from low levels of trade liberalization.

4.3 Market Access and Tariffs in the EAC

These three countries currently depend heavily on tariff revenue and none of them has committed to removing its agricultural export subsidies, tariff quotas, non-tariff concessions, or exceptional bindings for preferential tariffs (McKay 1998: 35) under the WTO. However, it is important to reiterate that the EAC members are also Members of the WTO and are thus committed to liberalizing their external trade (McKay 1998: 35). In addition, the EAC relies heavily on exporting its agricultural products, so it must hope for the best possible market access for its goods, something best achieved through free multilateral trade (Ndung'u 2000: 15).

Most imports in the region are of machinery, transport materials and equipment from industrial countries. None of the countries in the EAC has a comparative advantage to supply any of those products (Ndung'u 2000: 18). Much of the trade creation and diversion of the EAC would be felt in the manufacturing sectors which are quite small in Uganda and Tanzania but are likely to see growth as the RTA encourages them to become export oriented (McKay 1998: 90).

5 The Economic Partnership Agreement (EPA)

5.1 Lock-In of EPA v. Lock-In of WTO

Kenya, Tanzania, and Uganda have committed to regionalism while trying to retain some of the benefits of the multilateral trading system. However, for the economic and political reasons explained above, they must consider trade relations beyond the walls of their RTA and this section will consider the EPA as it is currently the most likely option.

Formerly, the EC granted unilateral preferential access through waivers under the GATT but it has become increasingly difficult to continue to waive the MFN clause in an exclusionary manner. Therefore, the EC has turned to Article XXIV of the GATT and the Enabling Clause as a legal justification for an EPA as these articles allow exceptions to the MFN clause through the creation of RTAs.

However, African countries have learned from experience that preferential market access is not enough to stimulate growth. Countries in East Asia and Latin America that did not have preferential access to the European market have experienced significantly better growth rates than their African counterparts over the last few decades (Fajana 1998: 216). Politically, close ties can have benefits for African countries as the EAC needs an external guarantor to prevent the failures of the first EAC. The EC would encourage the EAC through guaranteed market access conditional on keeping policy reforms on track (Ndung'u 2000: 27).

There may be gains extending beyond static effects for small countries joining in RTAs with large countries. For example, a small country may be guaranteed access to the market of a large country, even if the large country were to become protectionist in the future. In the small country, future governments with protectionist inclinations would find it difficult to reverse liberalization commitments (Panagariya 2001: 489-490). These gains are two of the important benefits that the EAC might expect from an EPA with the EC.

5.1.1 Trade and Welfare Effects of an EPA with the EU

An economic analysis of North-South RTAs is quite different from one of South-South RTAs (McKay 2000: 2). If the home country has a tariff-free EPA with the EC while maintaining tariffs on imports from the rest of the world, prices at home will fall while imports increase, but these new imports will largely come from the EC. However, the EC is often a higher cost producer with respect to the rest of the world and therefore the EPA will lead to trade diversionary effects, as the EAC will favor less efficient EC products over imports from the rest of the world. Ultimately, there are three effects from this EPA, a consumption expansion effect, a trade diversion effect, and a trade creation effect.

The concept of trade diversion within an EPA is very similar to that of trade diversion within an RTA in that it consists of a shift of trade from more-efficient suppliers outside the EPA to less-efficient suppliers within the EPA. In this case, it means that trade shifts from the rest of the world to the EC, which entails both a resource loss and a tariff loss for the EAC.

Trade creation usually replaces the less-efficient production in the home country with the more efficient production of the rest of the world. In the case of the EPA, this is somewhat similar to an RTA, except that instead of replacing the home production with the significantly more efficient production from the rest of the world, it is now replaced by the only *somewhat* more efficient production from the EC. There is a loss of producer surplus for exporters from the partner countries within the EAC and a consumer surplus gain for home, due to the trade creation effect. The consumer gain would be greater with free trade, as the rest of the world could presumably supply many goods more cheaply than could the EC.

Determining the overall welfare of the EPA depends largely on the overall efficiency of the EC. The more efficient the EC, the lower the cost of trade diversion to the EAC and thus the greater the welfare gain from the EPA. If, for example, the EC can produce and export as efficiently as the rest of the world then the economic effects of the EPA are the same as free trade, to the EAC. In addition, one cannot predict how the East African producers will compete with the EC in the long term (McKay 2000: 7).

5.1.2 Market Access and Internal Effects

The EAC is considering this EPA because the EC is an important trading partner (McKay 1998: 25). However, the EAC must determine whether it can realistically become a chain in the production network of EC firms, perhaps through filling labor-intensive stages of their supply chain. Although there are signs of success in this regard, as RTAs tend to lower most trade obstacles, high transportation costs may reduce the EACs comparative advantage in the EC (Trade blocs 2000: 70). Put simply, the benefits of trade with the EC will be more immediate then the investment flows, which will require a secure and consistent environment.

In short, the EPA could lead to a significantly higher level of liberalized trade in the member countries, and Kenya, as the major trading power in the group, will stand to gain the most from this. Kenya will also increase exports, especially manufactures, to Uganda and Tanzania. Except for foodstuffs, Tanzania and Uganda do not stand to gain much in increased exports to Kenya. As the preferential treatment of GSP under the Lomé Convention will be reduced by 2005, this agreement with the EC will perpetuate those expiring benefits for Kenya. There will also be an increase in tariff-free exports from the EC and consumers in the EAC could gain significantly while the EAC producers could lose. There will also be lost tariff revenue which the EAC may try to make up through other areas of the agreement (McKay 1998: 10).

5.2 Analysis and Observations

The EAC sees an EPA as a means to assure secure and predictable market access to the EC. Furthermore, an EPA will allow EAC goods to remain competitive on the EC market as the EC continues to sign free trade agreements granting preferential access to other countries. However, the EC is largely a saturated market and the EAC must seek other markets for its exports, in order to experience its goal of increased economic growth.

6 Conclusion

The EAC has been revived with similar expectations and objectives to those of its first attempt. As the second EAC is still in its infancy, it is difficult to assess whether its creators have solved those differences, but some observers perhaps do not feel that much progress has been made. However, there have been several developments since the collapse of the first treaty. Much economic and political literature has addressed the subject of small countries entering into RTAs. Some of the conclusions are encouraging, others are not. Strictly from an economic point of view, the EAC may experience a welfare loss, due to lost tariff revenue. This loss may be regained, to some extent, by increased consumer welfare, and thus an increased consumer tax base.

Perhaps more importantly, the most significant gains would derive from the increased levels of investment resulting from the increased size of the internal market and heightened political stability through stronger ties with the EC. The EAC would be forced to gradually open up its borders to EC goods, which would hopefully lead to increasingly competitive and efficient domestically produced goods. However, domestic producers would experience tremendous losses until they could effectively compete with the high-quality, low priced European imports.

The varying levels of economic development and macroeconomic strength in the three member nations may pose a problem in the second EAC just as it did in the first EAC. Furthermore, the members have not given up their national sovereignty and are opposed to initiatives that may conflict with their national interests. This will slow integration and make compromise difficult to reach (Ndung'u 2000: 31).

It is rarely helpful to identify problems unless feasible solutions can also be offered. The problems have been identified, and this essay has explained why these problems can be so injurious to the full development of the region. The resources may not always be available and the legal structure may not always be able to lock in the reforms effectively but internal and external political support will be the imperative ingredient to ensure that, even during the slow periods, the EAC continues along its ambitious path of development.

Conditions for integration in the region may not have improved since the first EAC, but there has been a wealth of new research into the subject of regionalism. This, coupled with analyses of the mistakes made in the first agreement may be enough to prevent history repeating itself. If so, the new EAC could be an effective and efficient building block within the structure of the WTO. But more importantly, the EAC must remain wholely committed to developing this impoverished region.

7 Appendix: Table of Acronyms

ACP	African, Caribbean and Pacific Island countries.
AEC	African Economic Community
COMESA	Common Market for Eastern and Southern Africa
DWL	Deadweight Loss
EAC	East African Community
EADB	East African Development Bank
EC	European Community
EEC	European Economic Community
EPA	Economic Partnership Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences
LDC	Least-Developed Countries
MFN	Most-Favored Nation
MRA	Mutual Recognition Agreement
MTN	Multilateral Trade Negotiations
MTS	Multilateral Trading System
NAFTA	North American Free Trade Agreement
OAU	Organization of African Unity
RTA	Regional Trade Agreement
SADC	Southern African Development Community
UNECA	United Nations Economic Commission for Africa
WTO	World Trade Organization

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