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Recommendation for South Sudan to join the East African Community

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1. Introduction

In November 2014, South Sudan began negotiating its accession to the East African Community (EAC). The talks have accelerated, indicating the positive commitment from all sides for South Sudan joining the EAC. To date, the technical negotiations have been concluded. On October 8, 2015 the final report of the technical negotiations was presented to the ministerial negotiation team, which upon review of the report, observed that South Sudan meets the threshold for admission to the EAC. However, the ministerial team further observed a need for capacity building and institutional strengthening for South Sudan to attain the required capacity to implement EAC projects and programmes.

The ultimate decision lies with EAC Heads of States, and current indicators point towards a possible admission of South Sudan to the regional bloc at the next EAC Summit of Heads of State.[1] In the meantime, a draft Treaty of Accession is already in place and more so H.E. Gen. Salva Kiir Mayardit, President of the Republic of South Sudan, has a standing invitation to attend the Summit.

[1] The Summit was initially scheduled to take place on November 30, 2015. However, due to other circumstances, including the visit of the Pope to the region, the event was postponed; and a new date of March 02, 2016 has been set.

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Whilst South Sudan's accession to the EAC seems imminent, there are still South Sudanese citizens, including legislators and civil servants, who question the benefits of South Sudan joining the EAC at this point in time. They are correct in assuming that joining a regional trade agreement could involve some costs in the short run even though in the medium to long run the benefits will surely outweigh these potential costs. This policy note outlines the benefits to be derived for South Sudan from deeper integration within the region and discusses these potential costs. Drawing on the Rwandan experience that integrated successfully the EAC in a similar setting, this note argues that these costs would be manageable and well worth taking in view of the much greater benefits in the longer run. The main benefits for South Sudan of joining the EAC include:

- Hard infrastructure: Regional public goods to reduce trade costs
- Soft infrastructure to support growth: Policies favouring openness
- Factor mobility
- Diversification

Reaping these benefits will require that South Sudan undertake a series of policy reforms that would be in the country's interests under any circumstance. Potential short-run costs of integration are harder to identify and could include dealing with:

- Increases in cost of some imported products
- Effects on government revenue
- Foreign Direct Investment

The discussion of these benefits and costs is difficult because South Sudan is a new country with very little available data. The best that can be done is to illustrate potential benefits and costs drawing on other experiences and to point out the domestic reforms that South Sudan should undertake to maximise net benefits of EAC membership. These reforms and policy decisions are largely decisions that would, under normal circumstances, be in the country's long-term interests.

This brief draws on comparisons with Rwanda, which faced similar trade-offs when negotiating its accession to the EAC in 2007. Like South Sudan, Rwanda is a landlocked country that has emerged from a devastating war in its recent past. Although there were some costs associated with joining the EAC, Rwanda went ahead and became an EAC member in 2007. Less than a decade later after joining the EAC, indicators suggest strong net benefits of EAC membership for the Rwandan economy.[2]

2. Potential benefits

Hard infrastructure: Regional public goods to reduce trade costs

As a landlocked country with low infrastructure development, South Sudan faces very high transport costs. These costs render the country uncompetitive and limit its participation in international trade. In spite of low tariffs, the costs of imports are high for South Sudanese consumers and producers and exports are uncompetitive also because of high transport costs. A case in point is the high cost of transporting South Sudan's oil through Sudan's pipeline and Port Sudan, which has presently rendered oil unprofitable for South Sudan. For a landlocked country, hard infrastructure (except perhaps communication by satellite) is a regional public good that requires collective action by the governments of the countries involved to insure their adequate provision. Participation in the EAC would speed up the provision of needed hard infrastructure

Under these circumstances, the biggest benefits for the country's development will come from access to the EAC's regional infrastructure projects, including road and rail network, the construction of the port in Lamu, Kenya, and the development of regional communication networks, such as the EASSy internet cable. Accession to the EAC, will accelerate the development of this backbone infrastructure most strongly needed for any landlocked country that has to rely on the infrastructure of its

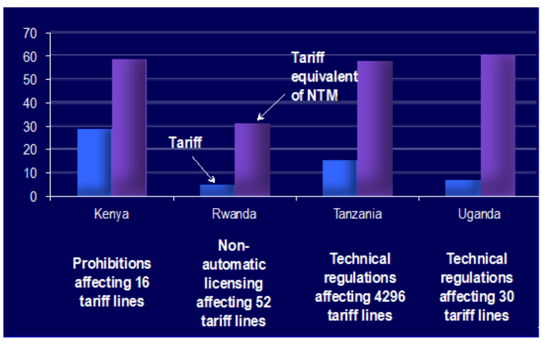
[2] See the benefits of increased labor mobility and reduced trade costs for Rwanda here http://www.focus.rw/wp/2014/11/28/rwanda-reaps-benefits-from-eac-integration/ and the benefits in terms of FDI here http://www.newtimes.co.rw/section/article/2015-04-13/187793/

neighbours to access world markets. Membership will also help ensure that South Sudan's infrastructure needs are represented in the EAC agenda and programming. These projects will significantly improve South Sudan's connectivity and lower its trade costs thus improving its export competitiveness, a critical factor for South Sudan's long-term development.

As a member of the EAC, by participating, South Sudan will learn and contribute to the decision-making process for regional policies. Furthermore, membership will also mean that South Sudan can directly benefit from existing and future regional institutions and networks, such as the East African Development Bank (EADB). This will contribute to increasing South Sudan's access to development financing. Likewise, as an EAC member, South Sudan will participate in the Inter-University Council for East Africa (IUCEA), which focuses on establishing academic standards and cross-region academic exchanges.

Soft Infrastructure to support growth: Policies favouring openness

Joining the EAC will help South Sudan to learn more rapidly about the domestic laws, regulations and policies supportive of integration and openness to the world. As an EAC member, South Sudan will be required to converge to regional standards, regulations and best practices, though, as was the case when Rwanda joined the EAC, South Sudan will be allowed to do so at a measured pace during a transition period. The adoption of these needed laws and regulations will take place more rapidly under membership than in isolation, if only because of the external pressure to meet an agreed-upon deadline and provide the complementary (to hard) soft infrastructure necessary for growth.



Source: de Melo, J. (2011)

EAC membership will introduce transparency into South Sudan's trade policy (e.g. tariff levels and other policy instruments like Non-tariff Measures (NTMs)) that are more difficult to detect, but weigh heavily in the overall barriers to trade. As the preceding figure shows, the estimated contribution of NTMs to the cost of doing business exceeds the cost of tariff measures in four of the EAC members.

Joining the EAC will allow South Sudan to harmonise its standards and regulations and help reduce or eliminate other non-tariff barriers, including improvements in border administration. These improvements in its domestic regulatory environment will be pivotal in reducing uncertainty, which is necessary to reassure and encourage the private sector to develop and expand investments in South Sudan. Thus becoming a Member State in the EAC will send a strong signal, even in the short run, of the Government's commitment to these growth-enhancing reforms.

Factor mobility

Probably the most politically sensitive area associated with South Sudan's EAC accession is the provision for the free movement of labour, as envisaged by the EAC’s Common Market Protocol. Currently foreign workers fill critical gaps in the labour market but there are fears that they will take jobs away from nationals in the future. Rwanda faced the same threat but it embraced this part of the Common Market Protocol by being the first member country to abolish work permit fees for other EAC citizens. This meant that it was able to tap into the regional labour force to help upgrade their technologies and skills. Additionally, it was another way for some Rwandan firms to lower their costs of production.[3] For example, Rwanda has some of the lowest barriers to entry for foreign accounting professionals in all of Africa, meaning that the market can both benefit from foreign accountants and competition between these professionals (Brenton and Isik 2012).

To fully reap the benefits from factor mobility, the Government of South

[3] When Great Britain decided to join the European Common Market in 1973 while it was a member of the European Free Trade Area, discussion centered about the «cold shower effect» that would result from joining a larger market where its firms would both face stiffer competition while also having access to a broader market at lower costs as border-related costs beyond tariffs –that were already zero—would be lowered.

Sudan should consider carrying out a labour market survey to identify sectors that require foreign labour and sequentially open these up to foreign workers first. Over time it would then move towards a model where it gradually opens up other sectors to foreign labour. As with the case of Rwanda, joining the EAC should also help fast-track South Sudan's ability to build their domestic labour supply through spill over effects and learning from a foreign labour force.

Diversification

The EAC Treaty provides for the sharing of knowledge and technology across the region. Therefore, as an EAC member, South Sudan will be able to build on the experience of its neighbours as it looks to diversify its economy and further develop its agricultural, manufacturing and industrial sectors. Currently, its exports are dominated by oil. However, as the known oil reserves in South Sudan are finite in the near future, it is imperative to reduce the Government's dependency on this sector and look to diversify, particularly its tradable sector.

The first major step that will be critical for the private sector to develop and become competitive in the regional market was taken in December 2015 with South Sudan's move to a floating exchange rate regime. Prior to this, the exchange rate was overvalued which meant that imports were relatively cheap when compared to locally produced goods and potential exports were also uncompetitive. This meant that local producers found it difficult to compete in tradable activities and the hoped-for diversification of the economy was compromised.

Notwithstanding the current wide efficiency gap between South Sudan and its partners in the region in the agricultural sector, South Sudan could still enjoy a comparative advantage in farming certain crops such as rice, thanks to its extensive flood plains that cover most of its Greater Bahr el Ghazal and Greater Upper Nile regions. The country could improve its efficiency and compete in this sector by focusing on large-scale mechanised farming. South Sudan's low population density and abundant fertile land makes this avenue for diversification is promising. Moreover, the savannah grassland vegetation has a flat topography which further increases South Sudan's comparative advantage in mechanised farming. A study of South Sudan's agricultural potential by Diao X et al. (2012) shows that 70 percent of land is suitable for agriculture. Yet, less than 4 percent of total land (about 2.7 million ha) is currently cultivated while more than 80 percent is still under natural vegetation (e.g. trees, shrubs, grass). The study goes on to show:

> "… that the current total value of agriculture production (i.e. 'realized potential') only amounts to about US$800 million (US$ 600 million from crops) or less than US$300 per hectare, which is much lower than that of its neighbouring countries …. Doubling the current average cereal yield of 0.95 ton/ha, along with moderate cropland expansion, will shoot up the value of agricultural production to US$3.7 billion, a level that can overtake the current agricultural value in Uganda." (p. 151)

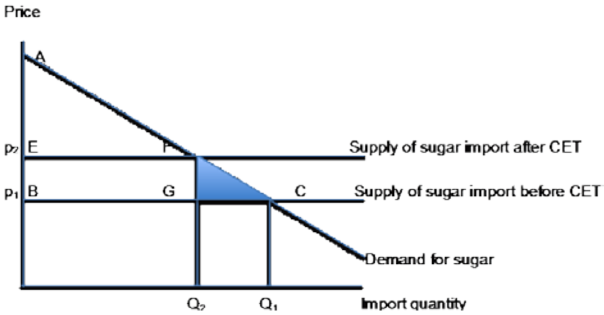
Adopting the Common External Tariff (CET) structure together with the Sensitive Items (SI) list would provide protection to the domestic industry in the short run as the CET structure and level is generally higher than South Sudan's current tariff schedule. Since the domestic industry is not yet developed, short-run benefits (and costs) will be negligible while there is the potential for setting up of largely efficient activities. In the longer run, South Sudan should view deeper regional integration as a learning opportunity. As domestic firms become exposed to the regional market, it is expected that they will get access to growth-enhancing skills as well as to business development services. Evidence from Kenya, Rwanda, Tanzania and Uganda has showed that firms that use accounting, legal and engineering services, whether externally outsourced or provided in-house, have higher average labor productivity than firms without such professional services linkages (De Melo, 2011).

3. Potential costs

Increases in cost of living for consumers

The effect of joining the EAC on the cost of living for consumers is controversial. On the one hand, opening up the South Sudanese market, currently dominated by imports would lead to welfare gains for the consumer if the price of imports to the consumer falls. This would happen through three channels: (i) lower tariffs; (ii) lower trade costs as customs procedures are simplified; (iii) lower transport costs resulting from economies of scale related to an increased volume of trade. On the other side of the ledger, for some goods moving to the CET would imply higher tariffs. If these cost increases more than compensate for the three channels contributing to a fall in trade costs-- as might be the case for some agricultural products (see below)--the purchasing power of consumers will fall and the cost of imported intermediate goods for producers will rise.

Currently South Sudan's customs tariff rates are much lower than those in the three-band Common External Tariff (CET) structure which stipulates 10% for intermediate products and 25% for finished products along with a Sensitive Items (SI) list that includes basic food items (e.g. sugar, maize flour, wheat flour) with tariffs that range from 50 to 100 percent. A genuine concern for South Sudan is that the cost of some key consumer products (and also some intermediate products) may increase, particularly in the short term, under the EAC's Common External Tariff (CET).



The case of sugar (entirely imported) is illustrated in the figure here.

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Even though government revenue would increase (by area EFBG in the figure) as the tariff is raised to the CET level, through higher prices and reduced choice, consumers would lose more (the area EFBC).

With 1000 metric tons of sugar selling at 20 SSP(≈$3.27) per kilogram, moving from the current 5% tariff to a CET tariff rate of 25% per ton would more than double government revenue from SSP 100,000 to SSP 280,000 but the loss to consumers from less sugar consumed at a higher price would exceed the increase in government revenue by SSP 66,400.[4] .

Rwanda was also in a similar position as it imported its sugar at world prices prior to joining the EAC. Estimates suggest that the move to the CET resulted in a 3.8% decline in real income for the bottom decile but no decline for the top decile(Frazer (2012).[5]

Rwanda managed to mitigate these effects by negotiating exemptions and delays in enacting the CET through a transition period. Additionally, the Rwandan Government has employed a Duty Remissions Scheme, which, allows for inputs to be imported duty free for manufacturing for consumption either in the home or export market. Additionally, they have made extensive use of Stays of Application (SoA) for products pertaining to consumer welfare as well as for larger imports. These are differential tariff rates to the CET rate that are granted to particular EAC Member States for one year at

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[4]. Take 100 metric tons of Brazilian sugar that sell at SSP 20 (≈$3.27) per kilogram at the 5% tariff inclusive price. Moving to a CET rate of 25% would imply a 20 percentage point increase for the consumer. Assuming that traders sell at a margin of 10%, the net price charged to consumers will increase by 22 percent. Assuming a price elasticity of demand of 2 (the price elasticity of demand =(percentage change in quantity demanded)/(percentage change in price), the quantity of Brazilian Sugar consumed will fall by 44 percent to 56 tonnes. At the new tariff rate, government revenue will be SSP 280,000 (=25% of (56 tonnes x 1,000 kg in a metric tonne x SSP 20 per kg), more than twice the amount the government currently collects (SSP 100,000) on the 100 metric tonnes at 5 percent. However, for the consumer, the 56 metric tonnes, which currently costs SSP 1,120,000, will eventually cost SSP 1,366,400 after the CET goes into effect. The additional cost of SSP 246,400 to the consumer is greater than the additional revenue to the government (SSP 180,000) causing a net welfare loss of SSP 66,400 to society.

[5] For producers, some intermediate goods like tractors and construction materials entered duty-free but were placed in the 25% tariff band in the CET. Rwanda obtained an exemption allowing for a temporary exemption from the CET which allowed Rwandan firms to transition gradually before the CET came into full effect.

a time. Where necessary, South Sudan should make use of the Duty Remission Scheme; but sparingly so that it does not lend itself to being captured by inefficient domestic producers as a way for (re-)instituting protectionism

Effect on government revenue

As importers switch to goods produced within the EAC, due to the more favourable tariff structures, tax revenue to the Government of South Sudan will be reduced as these imports will enter duty-free. In the Rwandan experience, the first few years of implementing the CET were associated with nearly 50 percent decrease in customs tax revenue. In the case of South Sudan, the situation could be different given that the current rates of customs duty are generally low in South Sudan and implementing the CET could lead to a higher revenue for imports from outside the EAC. However, given that South Sudan already imports a great deal from Uganda and Kenya, whose goods will no longer be taxed, the substitution effect towards products originating from the EAC could outweigh the rate effect charged on goods from outside the EAC. The Government of South Sudan could also alter its tax instruments on products expected to experience large revenue losses.[6] More information should be collected to structure these taxes appropriately so as to minimise revenue losses as was achieved by the Government of Rwanda.

Foreign Direct Investment

Attracting Foreign Direct Investment (FDI) is an objective for all countries. For low-income countries, a stable and predictable macroeconomic environment with reasonably functioning institutions is the most important determinant of FDI for footloose manufacturing activities that can relocate relatively easily. Membership in the EAC should be helpful in this regard. On the other hand, with guaranteed open access to the entire EAC market, investors do not have to establish their firms in South Sudan to sell their products there. Then availability of skilled labour and adequate hard and

[6] Rwanda was expected to lose tariff revenue on petroleum products. However, this loss was dampened by replacing the previous petroleum tariff with an excise tax, thereby preserving government revenues.

soft infrastructure will become a deciding factor in the choice of location for firms. Given the limited supply of skilled labour in South Sudan, firms may prefer to locate in say Uganda where labour costs are generally lower. Likewise, being landlocked and having poor state of infrastructure currently make South Sudan an inferior choice for firms specialising in manufacturing and other forms of value addition that is reliant on imported inputs from outside the EAC. Rather than transporting inputs from the Kenyan or Tanzanian ports to South Sudan and then re-exporting finished products to the rest of EAC, firms can cut down their production cost by setting up their production bases in Kenya or Tanzania and only export their products to landlocked countries such as South Sudan.

In short, for FDI, until the market size grows sufficiently in South Sudan as the economy develops, agglomeration effects (locating in Kenya or Tanzania) will likely dominate dispersion effects (locating in South Sudan). At the same time, since there are very few firms in South Sudan, the relocation of firms to other member states as South Sudan develops can be expected to be minimal.

Currently, the cost of labour is South Sudan is probably the highest in the region. Additionally, the labour supply, especially for skilled labour, is limited due to the many years of conflict that prevented most South Sudanese from getting an education. At the same time, there is a temporary surge in demand for labour in South Sudan driven by the presence of numerous humanitarian and international development organisations, pushing wages up further. As South Sudan stabilises, not only should the supply of labour increase, but also the demand for labour may go down, as some international organisations leave South Sudan. Ultimately, helped by a fall in oil revenue, labour costs in South Sudan should fall making it more attractive for labour-intensive industries to locate there.

4. Conclusions

Experience around the world, and more concretely from Rwanda, strongly suggests that joining the EAC would have multiple growth-enhancing (and hence poverty-reducing) benefits for South Sudan in the medium to long run. Potential short-run costs, especially for low-income consumers from moving to the CET could be largely dampened from exemptions during the period when the long-run benefits are materialising. More data will be needed to estimate these effects. Thus like the Rwandan Government when it decided to join the EAC, it will be difficult for the Government of South Sudan to make fully-informed choices, on how they can mitigate against possible negative effects to the economy and consumer welfare.

Beyond data collection and analysis, it is imperative that South Sudan carry out domestic reforms and capacity building to alleviate its low institutional capacity to be a in a better position for EAC membership. It is comforting that the negotiation team acknowledges this need for capacity building and institutional strengthening of South Sudan's institutions. The South Sudan government should take heed of Rwanda's successful experience while it builds domestic support for accession to the EAC.

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