

Examining the impact of the Common External Tariff of the East African Community in Uganda



In brief

- The primary goal of the Common External Tariff (CET) of the East African Community (EAC) is to allow for free trade within a larger market than that of the individual countries that comprise it.
- The CET has, from inception, held a 0-10-25 tariff structure: 0% for raw materials, 10% for semi-finished products and 25% on finished products. Although this structure has an economic logic, there have been a number of challenges to its implementation.
- This brief discusses the four key challenges of implementing the EAC's tariff structure: Sensitive items, landlocked countries, non-tariff barriers, and agreeing appropriate classifications for certain goods.
- The author concludes that these challenges can be easily addressed by EAC country governments. However, the greatest challenge of the challenges will be removing non-tariff barriers.

*This project was funded
by IGC Uganda*

Background

Since 2017, preferential trade agreements appear to be under attack. Britain has voted to exit the European Union. U.S. President Donald Trump has withdrawn the U.S. from the Trans-Pacific Partnership, placing its future in doubt, and has also strongly attacked the North American Free Trade Agreement (NAFTA), which appears set for renegotiation.

In contrast, Africa appears to be moving towards freer trade. Several (overlapping) free trade agreements exist on the continent, including the Common Market of Eastern and Southern Africa (COMESA), the East African Community (EAC), and the Southern Africa Development Community (SADC). In fact, these regional trade agreements have jointly agreed to form the Tripartite Free Trade Area. The agreement was signed in 2015 and is awaiting ratification by member governments. Discussions are underway towards a Continental Free Trade Area that would encompass much of Africa.

The most recent of these three free trade areas is the EAC, which might also be the most dynamic. It was formed in 2005, initially by the countries of Kenya, Tanzania, and Uganda. In 2007, Rwanda, along with Burundi, joined the East African Community (EAC). On July 1, 2009, Rwanda and Burundi formally adopted the Common External Tariff (CET) of the EAC. While there were some minor modifications of this joint tariff later in 2012, the CET has remained largely unchanged since its inception. This paper serves the purpose of evaluating the CET from the perspective of Uganda in the context of 2017.

Goals of the CET

The goals of the CET are similar to all other preferential trade agreements. The mission of the EAC is “to widen and deepen economic, political, social and cultural integration in order to improve the quality of life of the people of East Africa through increased competitiveness, value added production, trade and investments.”¹ Like other preferential trade agreements, the primary goal is to allow for free trade within a larger market than that of the individual countries. This allows for firms to take advantage of economies of scale in production by selling to a wider market, in this case throughout the EAC. It also encourages foreign direct investment (FDI) in the region by allowing international firms free access to a larger market than that of the individual countries. At the same time, the common external tariff allows for some medium-term protection to remain in place to encourage production within the EAC.

The exact levels of this tariff were originally set by the founding members of the EAC, namely Kenya, Tanzania, and Uganda for the purpose of

1. As expressed on the EAC’s website at <http://www.eac.int/about/key-documents>.

protecting industries of significance to these countries. When Rwanda and Burundi joined the EAC in 2007, they accepted the CET structure as it was given, but were set to be full and equal participants in all future renegotiations of the CET.

The CET has, from inception, held a 0-10-25 tariff structure: 0% for raw materials, 10% for semi-finished products and 25% on finished products. Setting differential tariff rates for raw materials (0%), intermediate inputs or semi-finished goods (10%) and finished products (25%) is not unusual. The overall rationale for the 0-10-25 structure is to provide protection, particularly to manufacturing firms that are producing, or could in the near future produce, goods that are classified as finished products (25%). Its secondary goal is to provide more limited protection to goods that have already undergone some processing but may also be used as inputs into manufacturing (10%). However, previous work (TMEA, 2015), in fact found that a number of goods that are subject to the 25% tariff line are in fact classified as raw materials or intermediate inputs according to the U.N. Broad Economic Categories (BEC) classification. Therefore, as the TMEA (2015) paper noted, these tariff lines were likely to in fact harm, rather than help, Ugandan manufacturing, by placing high 25% tariffs on their inputs, rather than high tariffs on the products being produced by Ugandan manufacturers.

While the 0-10-25 tariff structure has an economic logic that undergirds it, there have been a number of challenges in implementing this tariff structure, and these challenges of implementation will form the rest of this paper.

Implementation of the CET

Sensitive items

The first challenge of implementing the CET occurred from its outset, namely the creation of a Sensitive Items (SI) List of items that have, under the rules of the CET, had tariff rates in excess of 25%. Many of these items are food staples, and therefore the increased prices as a result of the high tariffs on these items disproportionately affect poor households in all EAC countries (Frazer, 2012).

The goal of the SI List is to provide extreme protection to specific industries. However, this protection has been sufficiently punishing that individual countries have repeatedly applied for exemptions to the SI tariff rates by requesting Stays of Application (SOAs). SOAs are exemptions that individual EAC countries can request from the EAC Council of Ministers, which, if agreed to, allow for a country to apply a tariff rate for a period of one year that differs from the rate of the CET, including the SI List. Countries have repeatedly sought relief from the extreme tariff rates of the SI List through SOAs.

While it is reasonable for countries that are middle-income countries (Kenya) or low-income countries (Burundi, Rwanda, Tanzania, Uganda) to seek protection for their industries in the short to medium-term, in the long run, industries (including agriculture) will be most successful and productive if they are not only able to produce for the protected domestic market, in this case the EAC market, but if they can also produce for the world market. This will only occur if these firms can withstand international competition. Finding the exact rate of protection in the medium-term can be difficult, but the danger in the long run with firms facing protected markets with external tariffs of 30% or more, is that these companies can fail to become sufficiently productive to succeed on the international market. The Sensitive Items (SI) List has the danger of preventing exactly the type of productive improvements in firms that are essential if the EAC countries are going to develop and join the ranks of middle-income and high-income countries in the medium run and long run.

Moreover, even if a reasonable case could have been made for the protection of some industries at the outset of the EAC CET in 2005 to ensure that these industries could grow until they could compete internationally, now, in 2017, twelve years later, it is time for these industries to be allowed to become productive on an international scale.

Therefore, at a minimum all of the items on the SI List, with one exception, should have the current exceptional tariff rate reduced. Ideally, the tariff rate should be reduced to 25%, but reducing these tariff rates to 30% would also provide significant benefits. While ideally this should happen immediately, if tariff rates are gradually reduced from their current SI levels over the next two or three years to achieve the rate of 30%, that would not be unreasonable.

The one product that could be reasonably be considered for the continued extreme rates of protection of the SI List is the product category of used clothing. This is not a typical product, in that the cost of production of used clothing is zero. Its total cost is simply the transportation cost of shipping the goods from industrialised countries to Africa. However, used clothing competes in markets with apparel products that do have a production cost. At the same time, the apparel sector has proven to be important in the industrialisation of virtually all high-income countries (Frazer, 2007). It should be noted that there is a plan that has yet to be implemented (scheduled for 2018) to ban used clothing imports into East Africa. Whether used clothing is banned outright, or whether an extremely high (SI) tariff rate on these items is maintained is a policy issue for the EAC governments to jointly decide. However, used clothing is the exception that highlights the rule. None of the other products on the SI List share these unique characteristics of used clothing that justify this level of protection.

Landlocked countries and the CET

A second challenge of the CET is the challenge that the CET presents to the landlocked EAC countries: Burundi, Rwanda, and Uganda. When a good has a tariff rate of 25%, the cost of obtaining this good from the world market increases by 25% as a result of the tariff (for small countries without world market power, which is the case for EAC countries). For the countries of Kenya and Tanzania, and in particular, the coastal cities of Mombasa and Dar Es Salaam, the cost of a good obtained from the world market reflects the cost of this good at the port, plus the 25% tariff. However, for the inland, landlocked countries, there is already an implicit rate of protection that is equivalent to an “extra tariff” that results from the considerable costs of inland transport. For example, given that the cost of shipping a 40-foot container from the port of Mombasa to Kampala can be near 3000 USD, this added shipping cost can be substantial.

As a result, while the CET raises the prices of goods, including the prices of inputs, by at most 25% compared to the world price for Kenya and Tanzania, the prices of goods under the CET for the inland countries are often considerably higher than 25% above the world price. As such, it would be reasonable for the landlocked countries to impose CET tariff rates that are lower than the posted CET tariff rates to reflect the higher cost of inland transport. The exact implicit tariff from the higher transport costs could be calculated using ASYCUDA data and could be adjusted annually.

Tariffs and non-tariff barriers

A third challenge in CET implementation relates to barriers to trade other than tariffs. Countries have been working over a span of centuries to reduce barriers to trade between them. Since the Second World War, these efforts have taken the form of regional and preferential trade agreements, as well as the multilateral agreements of the General Agreement on Tariffs and Trade (GATT), followed by the World Trade Organisation (WTO). Initially, the major restrictions on trade were tariffs, and as a result, these economic co-operation efforts involved reducing the tariff rates between countries. However, in the postwar era, a major challenge has arisen in maintaining not just the “letter of the law” reflected in the reduced tariff rates, but also the “spirit of the law” of reduced barriers to trade. The problem has arisen from the fact that countries have been able to find other ways of restricting trade, other than import tariffs. These have varied from quotas, to “voluntary” export restraints, to the misuse of legitimate health and safety regulations, as well as labelling laws, for the purpose of restricting trade.²

2. For just one example, after the U.S. extended MFN status to Vietnam, it found that imports of catfish from Vietnam dramatically increased. As a result, U.S. lawmakers made an effort to restrict imports of Vietnamese catfish by regulating that only catfish caught in the U.S. could be labelled as “catfish”. See the New York Times article at <http://www.nytimes.com/2002/11/05/world/americans-and-vietnamese-fighting-over-catfish.html>.

In the context of the EAC, the non-tariff barriers (NTBs) to trade are not typically directly calculated or overt restrictions, but the impact of these NTBs is still sizeable. The largest non-tariff barriers to trade in the EAC have been related to transport, and largely impact the landlocked countries as a result of their inland location. To reach Tanzania or Kenya, goods can be shipped via sea from anywhere in the world, provided that a shipping vessel can travel via the ocean to the ocean ports of either Mombasa or Dar Es Salaam. In contrast, to reach the inland markets of Uganda, Rwanda or Burundi, the only realistic routes of non-air shipping go through Kenya and Tanzania.

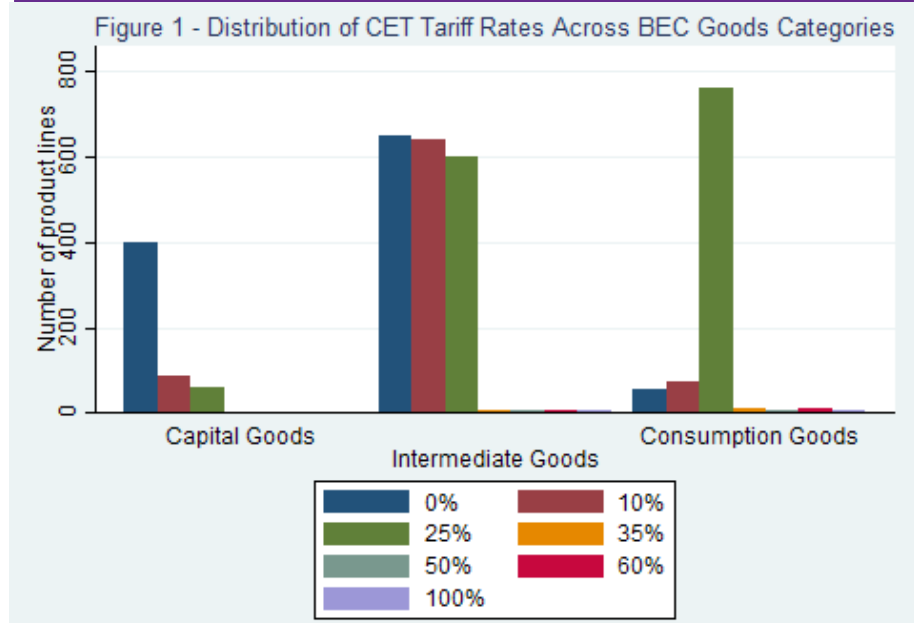
For this reason, any general shipping and transport challenges involved in shipping goods across Kenya or across Tanzania will, of course affect, at least in some measure, Kenyan and Tanzanian businesses and consumers. However, these challenges will also affect, to a disproportionately greater degree, businesses and consumers in Uganda, Rwanda and Burundi because ALL of their imported goods (not shipped by air) must travel the full distance of these land routes, not just in part. In addition, if any rules, or application of rules, or any other actions, disproportionately affect trucks that are carrying goods to the landlocked countries, these will also be non-tariff barrier (NTB) restrictions to trade. Such restrictions can be formal, such as restrictions on the licensing of trucks that move through Kenya or Tanzania. These restrictions can also be informal, related to differential treatment of Ugandan trucks at weigh stations or police checkpoints along the shipping routes.

Fortunately, the EAC has been working at reducing these NTBs (EAC, 2015), but continued monitoring and vigilance is necessary in order to ensure that these NTBs are eliminated and do not re-emerge.

Appropriate classification of goods

A third challenge in the implementation of the CET is the appropriate classification of goods as either raw material (subject to 0% tariff), intermediate inputs (subject to 10% tariff) or finished products (subject to 25% tariff). The U.N. has made an effort to perform this classification through its Broad Economic Categories (BEC) taxonomy of goods. The BEC categorises goods across a number of different dimensions. The first categorisation that is relevant from the perspective of setting tariffs is the BEC categorisation across different goods categories—specifically whether goods are i) capital goods (e.g. machines) used for the production of other goods, ii) intermediate goods, which are used to produce final consumption goods, or iii) consumption goods, which are purchased by the final consumer. Figure 1 shows the distribution of product lines across these categories of goods for Uganda.

Figure 1: Distribution of CET tariff rates across BEC goods categories

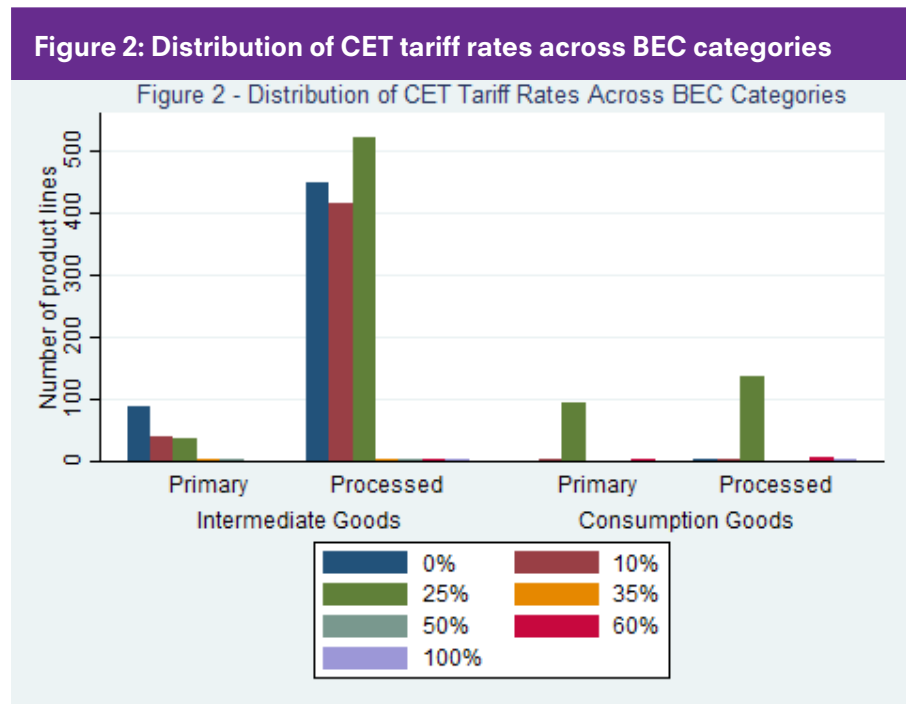


Source: Author calculations using ASYCUDA data.

The vertical bars represent the number of Harmonized System (HS) 8-digit products that are imported into Uganda that fall within each category: capital goods, intermediate goods, or consumption goods. Within each of these categories in Figure 1, products are further differentiated by the CET tariff rate associated with the product: the 0-10-25 normal product categories, as well as the higher tariff levels (35% to 100%) for Sensitive Items. We can see that, at least along this dimension, both the capital goods and the consumption goods are relatively effectively categorised within the CET, with the bulk of capital goods having a 0% tariff rate under the CET, and the bulk of consumption goods having the higher 25% tariff rate. Still, as we can see there are some capital goods that have higher tariff rates (10% or 25%). The greater variance comes when we examine intermediate goods, with these goods roughly split between the 0%, 10% and 25% tariff rates. These could reflect the level of processing that has been embedded in these intermediate goods. Some of these intermediate goods could essentially be raw materials, while other intermediate goods could have undergone a significant amount of processing.

Fortunately, the second dimension of the BEC categorisation that is relevant for our purposes reflects the level of processing that is embedded in the goods. This is, in fact, a better measure for the purpose of setting appropriate tariff rates. The greater the level of processing, the higher the level of value-added embedded in the good. If that value-added has occurred within Uganda, then it has contributed to the economy of Uganda. If it has occurred elsewhere, it has not directly contributed to Uganda's economy until it arrives in Uganda. Since capital goods are by definition,

highly processed goods, the BEC does not differentiate these goods along these measures. However, while capital goods are highly processed, they are also different, in that they are durable goods used to produce other goods, rather than inputs. Therefore, we can examine the breakdown of both intermediate goods and consumption goods by their level of processing. This is done in Figure 2.



Source: Author calculations using ASYCUDA data.

First, examining the consumption goods, we see that they are fairly evenly split between primary and processed goods, with the 25% tariff rate applying to virtually all consumption goods whether primary or not. Primary consumption goods include, for example, fish, as well as agricultural items that do not undergo processing before sale to the consumer. Naturally, to encourage processing of primary commodities, it would make sense to have a higher tariff rate for processed consumption goods than for primary consumption goods.

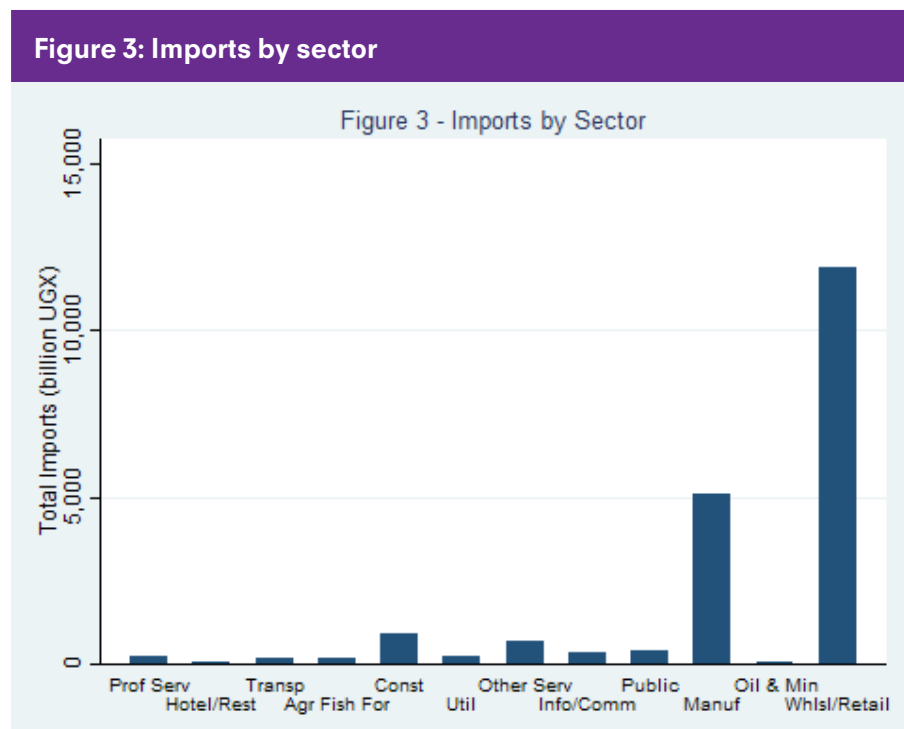
For the intermediate goods, many more of these products are processed. Of the primary intermediate goods, the majority have a 0% tariff rate, but there are 75 product lines that, despite having no processing associated with them, have tariff rates of 10% or 25%. These product lines deserve investigation to ensure that there is some justifiable independent reason for setting higher tariffs for these goods. For the processed intermediate goods, these goods are roughly evenly split between the three tariff categories: 0%, 10%, and 25%. Since intermediate goods are not final consumption goods, in principle, there should be very few products in this category that warrant the 25% tariff rate, and therefore these more than 500 product lines are worthy of investigation for re-categorisation under the CET.

Naturally, the BEC categories have been developed based on the worldwide standards adopted by the U.N. It may be that goods that are final goods in a different context could in fact be used as intermediate goods in Uganda, with further processing applied to these goods before resale in the Ugandan context. While most of the BEC categories apply universally (cotton is a universal raw material, while yarn is an intermediate input, and clothing is a consumption good), it is not impossible that there may be exceptions for some categories for the Ugandan case.

Therefore, to obtain a better sense of how these products are USED in Uganda, we can examine to which sectors they are being imported. Goods that are being imported into the retail sector, for example, are much more likely to be final consumption goods than goods that are being imported by the manufacturing sector, which would be using them as inputs into production.

Distribution of imports and tariffs across sectors in Uganda

The first step in exploring the distribution of imports across sectors in Uganda is to simply examine which sectors are the major importers. This information, as an average across the years 2013 through 2015 (data for 2016 is not yet available) is given in Figure 3.

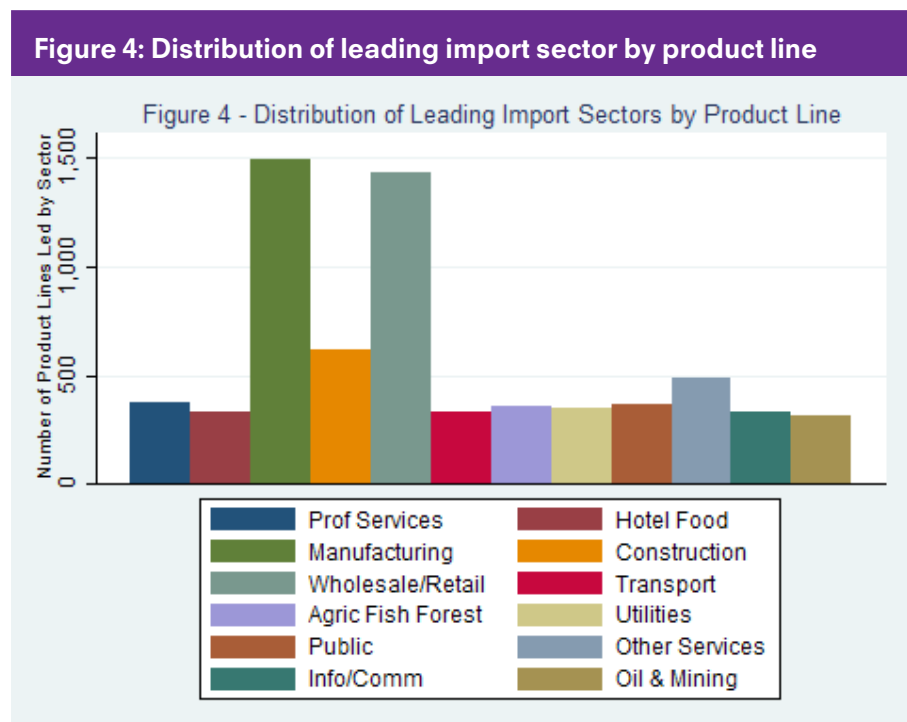


Source: Author calculations using ASYCUDA data.

We see that the dominant sectors for importing are the wholesale and retail sectors (which are not differentiated in the data). These sectors import more than 10 trillion UGX annually. The other sector that is a significant

importer is the manufacturing sector.³

Figure 3 examines the distribution of imports by value. However, since we are interested in getting the tariff rates correct for all sectors, both large and small importers, and since we are interested in setting appropriate tariff levels for all CET tariff lines, the more appropriate distribution for the current examination is Figure 4. Each HS product line can, of course, be imported by multiple sectors. However, if we assign a label to each product line according to the sector that imports the largest fraction of that product, the distribution of these labels is given in Figure 4. Here, we can see that there are many product lines that are very important for manufacturing. In fact, manufacturing has more product lines for which it is the leading importer than the retail and wholesale sectors combined. For nearly 1500 product lines, manufacturing is the leading importer.

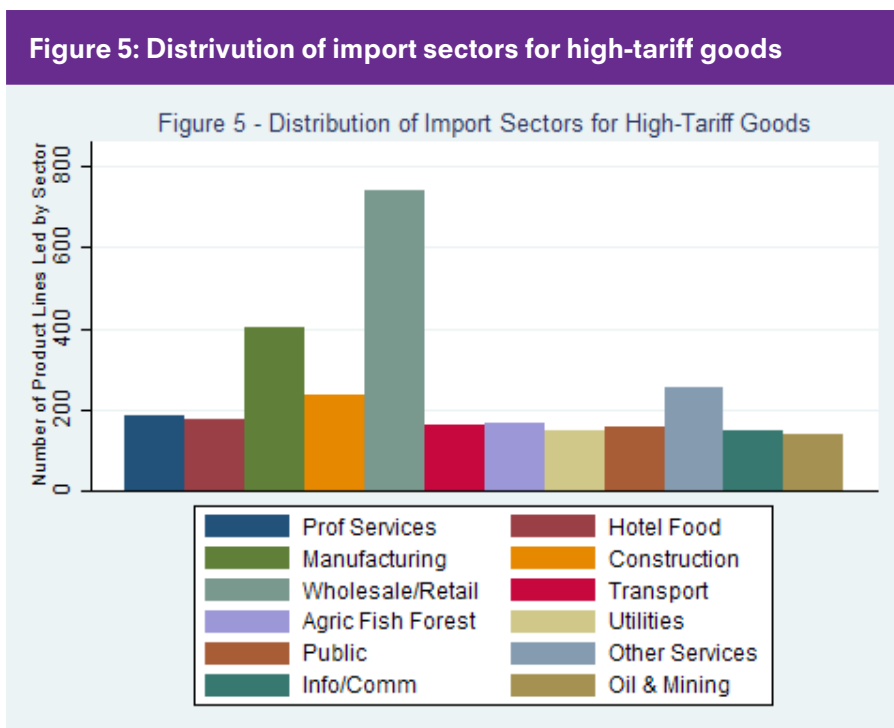


Source: Author calculations using ASYCUDA data.

One way of examining whether the CET tariff categorisation is appropriate for the East African context is to examine to which sectors the goods in the high-tariff category are being imported. If the CET is optimally set, high-tariff goods should predominantly be going to the retail and wholesale sectors. In particular, we would be concerned about high-tariff goods that are being used as inputs into the manufacturing sector. While, of course, it is possible for manufacturing firms to import products that could be final consumer goods (e.g. a firm imports an office desk for its factory, rather than

3. It should be noted that the imports within each sector are lower bounds on the actual imports to that sector, since some imports could not be attached to firms within a specific sector.

purchasing it locally), it is unlikely that the manufacturing sector is likely to be the leading import sector for a product line unless it is using this product line as an input into manufacturing. Figure 5 therefore examines the same distribution as Figure 4, but ONLY for goods that have tariff rates of 25% or higher.



Source: Author calculations using ASYCUDA data.

Fortunately, we see the leading sectors that are subject to high tariffs are the wholesale and retail sectors, with more than 700 product lines subject to the high 25% tariff rate. However, we also see that there are other product lines of concern. Specifically, nearly 400 product lines are primarily imported by the manufacturing sector, and yet have tariff rates of 25% or higher. These are product lines that are very likely used as inputs into manufacturing, and yet have the highest tariff rates (25% or higher).

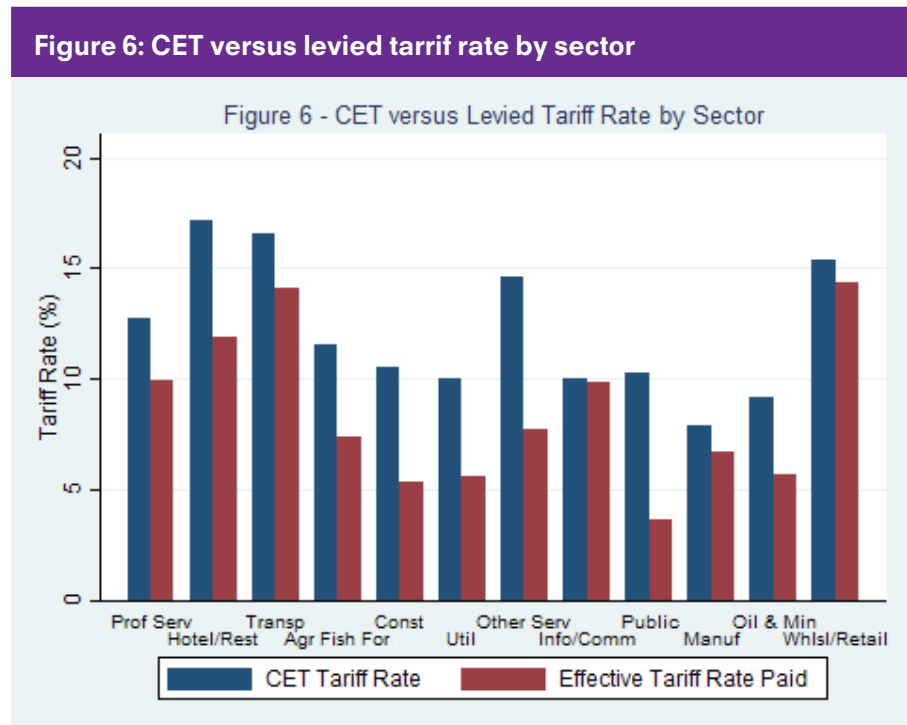
Duty Remission Schemes (DRS) and tariff exemptions

These tariff rates are the CET tariff rates for these product lines. While, in principle, these product lines should not have the high 25% CET tariff rate since they are inputs into manufacturing, this point could be moot if manufacturing firms are able to obtain exemptions for their inputs. In fact, as part of the EAC Protocol, under the duty remission scheme (DRS), manufacturing firms are allowed to import inputs duty-free that are used in the production of goods either for domestic consumption or for export.⁴ Therefore, it is entirely possible that although these inputs should not have a

4. See Article 3 of the Duty Remission Regulations of 2008.

25% tariff rate under the goals of the CET, manufacturing firms are paying a 0% tariff rate on them regardless, under duty remission schemes.

Other sectors other than the manufacturing sector are also able to obtain duty remission under other regulations. Figure 6 compares the average of the CET tariff rate across the product lines imported within each sector with the average tariff rate paid across products coming into that sector.



Source: Author calculations using ASYCUDA data.

Surprisingly, we notice that the exemptions for the manufacturing sector (the gap between the CET tariff rate and the effective rate paid) are in fact larger for virtually all sectors other than the manufacturing sector. This is not in line with the overall structural goals of the CET. There may be reasons for the exemptions in other sectors, but it is surprising that these exemptions are in fact larger than they are for manufacturing. In addition, obviously, we notice that the tariff rate being paid by the manufacturing sector is not zero. Therefore, manufacturing firms are not able to largely offset their duties paid through duty remission schemes.

Conclusion

After a dozen years of implementation among the original EAC members and eight years of implementation with the full membership including Burundi and Rwanda, the CET is ripe for re-evaluation to ensure that it is achieving the developmental goals of the EAC member countries.

The CET of the EAC, with its 0-10-25 tariff structure, has been designed to achieve certain developmental goals by encouraging production within higher value-added industries. However, while the design of the CET is clear, there have been a number of challenges in its implementation.

The first challenge relates to the Sensitive Items (SI) List of goods that are not subject to the 0-10-25 tariff structure but are in fact subject to much higher tariff rates of between 35 and 100 percent. These extremely high tariff rates are keeping the firms within the protected sectors from achieving the type of productivity increases that would allow them to compete on world markets. Moreover, the high tariff rates on the SI goods have a disproportionate impact on poor households, as many of the items on the SI list are food staples that are disproportionately consumed by poor households. At the same time, one item that could be considered for special treatment, either under the SI List, or under the planned import ban, is used clothing. These goods have a zero cost of production, and yet are competing in apparel markets with goods that do have a production cost. Still, used clothing is the exception that proves the rule, and all other items should be removed from the SI List.

The second challenge relates to the special situation of the landlocked countries within the EAC. In addition to the direct tariffs of the CET, importing firms in these countries face implicit “extra tariffs” related to the high costs of inland transport. A case could be made for reducing the CET rates for the landlocked countries as a result of these higher transport costs, and in fact these reductions could be directly calculated from transport costs at the product level.

The third challenge of the CET is now well known, and being monitored by the EAC, specifically non-tariff barriers (NTBs). These NTBs should continue to be monitored and removed whenever they are found.

A fourth challenge of the CET is more fundamental and relates to the appropriate classification of goods into one of the three tariff categories: 0%, 10%, or 25%. In principle, high value-added goods, ideally for final consumption should be classified in the 25% category. Goods that have had some processing already but are going to undergo further processing should be in the 10% category. Goods with little processing, particularly those used as raw materials by manufacturing firms, should have a 0% tariff. Unfortunately, there are hundreds of product categories that appear to be deviating from this goal. These product lines should be re-evaluated with the intention, in particular, of lowering the tariffs on goods that are used as inputs into the manufacturing sector.

Fortunately, these challenges can be easily addressed by EAC country governments. In fact, the greatest challenge of these four is the challenge of removing NTBs in the EAC. This challenge is also the one to which EAC governments have made the most progress in addressing. If the same level of energy is applied to the other three challenges, the CET will better serve the developmental goals of the EAC, and its member nations.

References

EAC Secretariat, 2015. "Status of Elimination of Non Tariff Barriers in the East African Community as of September 2015," Arusha, Tanzania.

Frazer, Garth, 2012. "The EAC Common External Tariff (CET) and Rwanda," IGC Policy Paper.

Frazer, Garth, 2008. "Used-Clothing Donations and Apparel Production in Africa," *Economic Journal* 118(532), pp. 1764-1784.

Trade Mark East Africa, 2014. "Review of EAC Common External Tariff," 10 December 2014.