

# The review of the Common External Tariff of the East African Community

## Options for strengthening Uganda's negotiating position



### In brief

- The East African Community is a customs union governed by a Common External Tariff (CET). The CET is currently under review, with members considering higher rates of external protection and an increase in the number of tariff bands.
- Uganda proposes to expand the current three band structure of the CET (0, 10 and 25 %) by an additional 5 % rate and a new peak rate of 35%. For the latter, Uganda identified 227 individual products.
- Assessing Uganda's proposal for the review, the researchers conclude that the government should revisit its suggestion to introduce a 35%-band as well as an increase in the number of bands in the CET more generally. Negotiation outcomes may well put Uganda producers, especially its exporters, at serious disadvantage: Other EAC members are likely to employ a new peak rate for protecting products which Uganda needs to import at competitive prices.
- Uganda should also advocate for phasing out of the List of Sensitive Items, with eventual reclassification at the maximum rate. As for forms of unilateral deviation, countrywide Stays of Application should be permitted, but firm-specific Duty Remission Schemes should be re-evaluated in light of likely discriminatory access.

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## Introduction: Uganda's submission to the EAC Secretariat

The Common External Tariff (CET) of the East African Community (EAC) customs union is currently undergoing a comprehensive review. At the end of September 2018, each EAC member state made a submission to the EAC secretariat detailing the principles supported for the review of the CET to lay the groundwork for negotiations scheduled to commence by end of October or early November of 2018. Uganda's position was developed through a national consultative process including the Ministry of Finance, Planning and Economic Development, Ministry of Trade and Industry, Uganda Revenue Authority, Uganda Manufacturers Association and others. Uganda is still able to alter its position on the various issues at stake. This paper aims to inform Uganda's renegotiation of the CET in light of the analytical work of trade experts from the International Growth Centre (IGC).

The submission made by Uganda to the EAC-Secretariat in Arusha on the 27th of September 2018, describes the principles that Uganda supports for the review of the CET. The following are major points from the position.

- Uganda proposes the introduction of a five-band structure for the revised CET. Currently, the CET consists of three tariff bands: 0% (for raw materials); 10% (for semi-processed goods that are to be used as input goods for further processing) and; 25% (for finished products) as well as a List of Sensitive Items offering extreme rates of protection of 35% or above for selected products. The position advocates for the introduction of an additional 5%-band, for products which have been subject to minimal levels of transformation and value addition and, crucially, for the introduction of an additional 35%-band for finished products which are not only produced in the region, but also in adequate quantities;
- Uganda's National Task Force for the Review of the CET identified a total of 227 products (at the 8-Digit level of the Harmonized System) for allocation in the additional 35%-band;
- Uganda proposes for the CET to contain provisions for Duty Remission Schemes, retain a provision for List of Sensitive Items attracting tariffs above the maximum rate of the regular bands and to keep the current institution of Stays of Application, enabling countries to unilaterally deviate from the CET for specific products and time periods;
- Uganda endeavours to review the previous and rampant misclassification of goods into the different bands in the current CET. The misclassification has resulted in many of the imported intermediate inputs used by Ugandan firms being subject to tariffs of 25%.

## Economic analysis

The following sections provide commentary on the issues at stake for Uganda in the renegotiations of the CET, based on research conducted by trade experts from the network of the IGC.

### The 35%-tariff and a 5-band structure in the CET

The rationale for Uganda to agree to the introduction of an additional band imposing a tariff of 35% on selected finished goods is to encourage local consumption of targeted products that are produced in sufficient quality and quantity in the country. The central risk associated with the possibility of such a high rate of protection lies in the opportunity for other EAC members employing the new 35%-band to increase protection for their own strategic industries, many of which are consumed by Ugandans or used as inputs for Ugandan industries.

As argued by Frazer (2018), for every good for which it is strategic for Uganda to raise the rate from 25% to 35%, Uganda can expect that there is a similarly strategic product for each of its EAC partners. Therefore, it is reasonable to assume that for every product for which Uganda wishes to strategically raise tariffs, it will need to suffer increased tariffs on three or four other products for which it is not the primary producer within the EAC.<sup>1</sup>

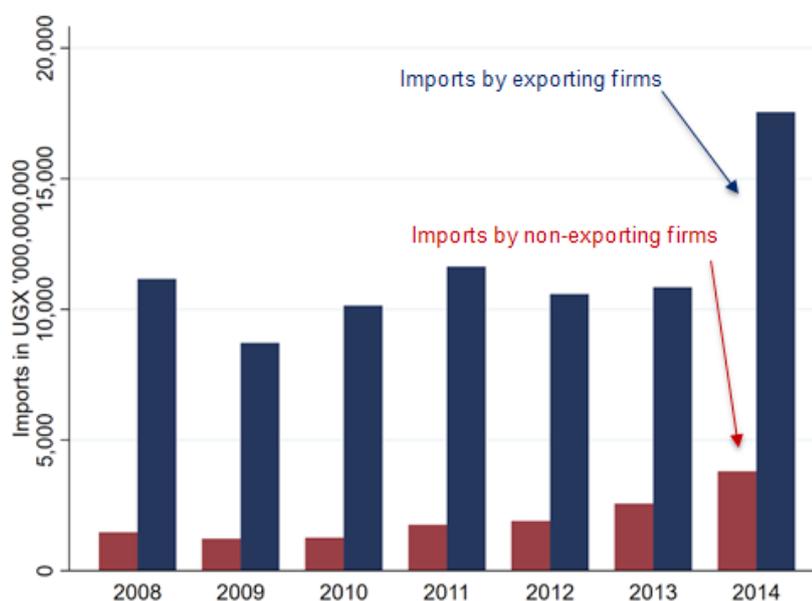
These tariff increases on other products will not only raise prices for consumers. In addition, products identified by other countries as strategic for increased protection pose the likelihood of being inputs into Uganda's manufacturing or service sectors. Many of the firms in these sectors are exporters and form the basis of growth in the country. Spray (2017: 13-15) employs tax admin data from Uganda and demonstrates that exporters have higher productivity, employ more workers and are more profitable than non-exporting firms.

Data from 2008 to 2014 (Figure 1) shows that Ugandan exporters heavily rely on imported inputs and import more than four times the amount of non-exporting Ugandan firms. A price increase of these inputs due to higher tariffs could therefore seriously undermine the country's growth perspective.

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1. In fact, depending on the negotiations and the interests of other member states, the fraction could be even higher (5 or 6 disadvantageous tariff increases, say, for every "advantageous" tariff increase).

**Figure 1: Ugandan exporters rely on imports**



Notes: Author's illustration from transaction level customs data by the Uganda Revenue Authority. Imports are deflated to 2010 values. Exporters are defined as firms that have exported at least once over the whole period under consideration.

The biggest risk associated with Uganda agreeing to the introduction of a 35%-band in the CET is the influence of the Kenyan Manufacturers Association on the negotiating position of Kenya as well as business lobbies in other countries. With industry and government being linked closely to each other, Uganda can expect that the Kenyan negotiation position regarding which products to include in the new 35%-band will largely reflect the interests of the country's manufacturing industry for increased protection against competitors from China and India. Specifically, the Kenyan proposal for the 35%-band is likely to include products from sectors such as steel and iron, plastics and rubbers, footwear, paper products and textiles, all products which Uganda currently sources from China, India and Kenya. If the large EAC countries manage to include products from these sectors in the reviewed CET under the proposed 35%-band, this will lead to a decrease in the competitiveness of products from third states and will likely result in inflated prices as well as a stagnation of quality of these products in the EAC. It will force consumers as well as firms using goods from these sectors as intermediate inputs (e.g. construction) to largely source from those countries. To agree to the introduction of a 35%-band in the CET provides business lobbies in other EAC countries with a powerful tool that will likely make Ugandan consumers and Ugandan firms pay for jobs and profits generated elsewhere in the EAC.

An additional risk emerging from the possibility of an additional 35%-band comes in the form of its uncertain effects on revenue collected from import duties, which in 2016 accounted for about 11.7% of all tax revenue in Uganda (World Bank, 2018). Again, the revenue effects do not only depend on what Uganda selects for the 35% rate, but also which products other countries manage to put up for increased protection. Referring again to the case of competition between China, India, and Kenya as an example, if the latter manages to put a tariff of 35% on the above mentioned products, this is likely to reduce the volume of taxable imports from India and China to Uganda, at least in part replacing these imports with Kenyan products. Unlike imports from China and India, these would be imported duty free under the Customs Union. This argument aside, while the exact implications of a 35%-band for revenue depend on the price elasticities of demand in Uganda, increasing tariffs from 25% to 35% could make certain affected products prohibitively expensive from the perspective of the Ugandan consumer, thereby leading to reduced imports and less duty collected despite an increase of the rate.

Finally, a multiband system is highly susceptible to corruption and administrative difficulties. The proposal to increase the number of CET-bands from three to five (with rates of 0%, 5%, 10%, 25%, 35% plus a Sensitive Items List) increases the complexity of tariff administration, and is often open to administrative discretion. As argued Edwards and Lawrence (2008) in their evaluation of the Southern African Customs Union (SACU) Common External Tariff, variations of tariffs amongst similar products strongly encourage traders to misclassify their imports or bribe customs officials to do it for them so as to exploit a lower tariff on a good similar to the one they are importing (e.g., milk with a fat content of less than X% may be subject to a lower tariff than milk with a fat content of more than X%). A simple three-band tariff structure is less prone to corruption, makes smuggling through misclassification much more difficult and is therefore also better suited for raising revenues through duty collection. Tariff administration is already complex because of the Common Market for Eastern and Southern Africa (COMESA) exemptions that require rules of origin certification and would be further complicated if an Economic Partnership Agreement with the European Union (EU) was finally agreed. A same good would have multiple possible duties depending on classification in the multi-band system and its country of origin.

### **Uganda's choice of specific products for the 35%-band: Economic consequences**

The Ugandan proposal identifies a total of 227 products to be allocated in the proposed 35%-band, most of which are currently taxed under the existing 25%-band as finished consumption goods. An analysis by Garth Frazer (2018) shows that of the 227 product lines proposed for inclusion under the 35%-band, the Ugandan position assigned a rationale to only 147. Of these 147 rationales, in 90 cases, the rationale for the 35% tariff rate is that the “selected products are produced in Uganda and in adequate

quantities and quality (...).” The problem with the “local production capacity” argument is that it reduces competition and provides rents to existing producers. By reducing competition, it removes a driver that could help shift the Ugandan economy from low quality products to high-quality and globally competitive products. Increasing productivity is a paramount objective to ensuring that the country achieves high growth rates over the next decades.

To illustrate, products currently produced in Uganda are evidently competitive enough to be in production while being protected under a 25% tariff. If the 25% tariff protection was raised to 35% for a given product, firms could afford to be less competitive and still survive since they were already profitable at the 25% tariff. Since the value-added embedded in a product is typically a fraction of the final value of the product, as a result the increase in the effective rate of protection can be considerably higher than the 10 percentage point increase from 25% to 35%. Being subject to a 25% tariff rate has already afforded companies “infant industry” protection. Increasing protection to 35% is unlikely to achieve the goal of increased productivity in these industries.

Out of the 147 products for which the Ugandan proposal developed rationales for their inclusion under the 35%-band, for a total of 41 products it is possible that protecting these sectors is consistent with the goal of building growth enhancing industries in the country.<sup>2</sup> However, even if tariff protection is the best available policy tool to foster expansion and productivity growth in these specific products, government has to provide an incentive to ensure that these industries will eventually become competitive. Specifically, without an end date to increased protection, the shift of the highest tariff rate from 25% to 35% will signal firms in these sectors that instead of having to become globally competitive, they will be protected from global competition in the long run.<sup>3</sup>

Even for these 41 products for which a high tariff rate of 35% could be justified there are significant risks associated with such a policy. Specifically, for only 18 of these products the primary import sector is “wholesale and retail trade”. Therefore, many of these products are being directly imported by sectors such as manufacturing, professional services and tourism. This does not yet take into account that manufacturing firms may import these products indirectly through the “wholesale and retail trade” sector. For 39 out of the 41 products the data shows that the primary import sector is “construction” (7 products), “manufacturing” (6 products), “other services” (4 products), “professional services” (2 products), the public sector (1

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2. These are sectors for which the rationales provided relate directly to facilitating the creation of growth enhancing sectors which are currently unviable (13 products) or products which can be linked to such sectors (28 products).

3. To illustrate, many countries in Latin America gave producers infinite protection during three decades of failed imports substitution. Argentina, for example, gave auto manufacturers 30 years of high protection. As a result, this industry never became competitive – until the tariff reforms of the 1990s.

product) and tourism (1 product). Hence, while a justification for strategic defence of these industries could be offered, increasing tariffs beyond 25% is likely to adversely affect key sectors for growth through increased input prices.<sup>4</sup>

For those industries that require further government intervention for the purpose of increasing quality and productivity to become globally competitive, policy options other than increased tariffs are more suitable. Targeted research and development subsidies, capital or technology subsidies, or export subsidies might be more effective in assisting firms in moving up the technology/quality ladder. While these are policies that increase government expenditure, if they are likely to propel the country to middle income status over the next 20 years, they are well worth the cost. Finally, it should be noted that there may be a case that for certain products, none of the subsidies delineated above are the preferred policy, and that high tariff protection is a necessity. For these products, this protection should be classified as “temporary protection for infant industries”, with a clear timeline for dropping the tariff rate back to normal levels once the “infant industry” has grown up. In summary, following a detailed analysis of the 227 products proposed by Uganda for the 35%-band, there are only justifications for 147 products.

- For 90 of these “justified” lines, the argument for increased protection is to encourage exploitation of domestic local capacity, the implications of which stand in stark contrast to the objective of building industries that can compete in the global economy.
- For another 41 goods the National Task Force offers rationales that are aligned with the goal of facilitating the creation of competitive products in these sectors over the next 20 years. However, many of these products are imported as inputs into other key sectors, hence a tariff increase is likely to yield adverse effects on growth. A better policy would be to provide support that would enable these firms to grow and become globally competitive, such as research and development subsidies or temporary export subsidies.
- For a small number of 10 products out of the 227 products proposed for inclusion in the 35%-band a justification can be offered on grounds such as public health.

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4. It should be noted that for another ten product lines alternative rationalisations for raising tariffs can be provided. For example, seven of these product lines are alcoholic beverages (while out of the remaining three, two have other negative health impacts and one is a luxury good). While the ideal tax to reduce consumption of these socially-disadvantageous products would be an excise tax, a high import tariff on these goods is not unreasonable.

## The List of Sensitive Items

The List of Sensitive Items of the CET contains products for which EAC member states agree to issue extreme levels of protection through tariffs ranging from 35% to 100%. Notably, many of the 62 products on the list are food staples such as maize, rice, and flour. Other sensitive items include sugar, dairy products, tobacco, a number of apparel products, as well as used clothing.

Excessive protection of products can have severe adverse consequences for growth. Consider, for example, the impact of excessive and indefinite protection for one product, sugar. In East Africa, sugar has benefited from enormously high protection and there is no evidence that the industry will bring down costs to compete with international prices. In the meantime, the present high tariffs tax domestic consumers and reduce the competitiveness of downstream Ugandan food and beverages producers that use sugar as input. In addition, the tariff arrangements result in land that could otherwise be used to grow other high value crops to be tied up in inefficient sugar production. The following are key insights from IGC research on the List of Sensitive Items conducted by Frazer (2017):

- Since many of the products on the List of Sensitive Items in the CET are food staples (maize, rice, flour) high prices resulting from excessive tariffs on these products disproportionately tax poor households which spend a large share of their income on these goods.
- The high tariff rates for Sensitive Items disincentivise the underlying industries (including agriculture) from becoming more productive and being able to compete on world markets.
- The only items for which high rates of protection can be justified come from the category of used clothing. Here, local textile industries compete with a product that has zero production cost while local production does have a cost

## Stays of Application and Duty Remission Schemes

EAC countries have repeatedly sought relief from the high tariff rates on products on the List of Sensitive Items (and others) by applying for Stays of Application. The provision of Stays of Applications in the CET allows countries to apply for an exemption of a tariff agreed at the CET-level for any given product including those that are Sensitive Items. If granted by the secretariat, the country applies a different (higher or lower) tariff on the product for a pre-specified time period.

A different form of duty exemption in the CET is the Duty Remission Scheme. Unlike the Stays of Application, which constitute country wide exemptions, the Duty Remission Scheme allows individual companies to apply for an exemption on a tariff if the imported good is used for production. The CET Duty Remission Scheme is flawed for the following

reasons. Firstly, access to duty remissions is highly dependent on political influence and firm size. As such it is discriminatory against smaller and less connected firms and effectively serves as a market entry barrier through higher input prices for entering firms and undermines competition. Secondly, the scheme is prone for corruption. For instance, anecdotal evidence suggest that it is possible for a well-connected firm to import its actual final good cheaply and duty free from a technologically advanced economy under the scheme and sell it off to the EAC as a domestically produced product.

## The misclassification of goods in the CET

The frequent use of Stays of Applications in the EAC, as well as the high uptake of the Duty Remission Scheme by Ugandan firms point to a fundamental flaw in the design of the CET. In theory, the three-band structure of the current CET (0% for raw materials; 10% for intermediate inputs; and 25% for products ready for final consumption) should mean that firms applying for a remission from duty payments form an exception.

The reason for the frequent use of the Duty Remission Scheme can be found in the misclassification of different products into the three bands of the CET. Frazer (2017) employs data from Uganda and shows that a number of about 400 products which are subject to the 25%-rate in the CET are primarily imported by the Ugandan manufacturing sector. This is a worrisome finding: while one may expect that the manufacturing sector sometimes imports products that belong to the final goods category, we should obviously not expect these firms to be the dominant importers of consumption goods in the country. The fact that manufacturing firms frequently import products with a 25% CET tariff rate is a strong indicator for a misclassification of goods in the CET.

The Ugandan proposal seems to have acknowledged this issue and postulates that the 10%-band “will also contain some products previously under 25 but where products are being used as intermediate products for further processing.” This intention is commendable.

## The way forward: Towards a stronger CET proposal for Uganda

The upcoming review is an important opportunity to create a CET that fosters economic growth in Uganda. The apparent intention of the Ugandan proposal to resolve issues on misclassification inherent in the current version of the CET is commendable: the misclassification of goods constitutes a serious flaw that puts Ugandan firms at a disadvantage, and the current negotiations form an important opportunity for its review. However, the analysis at hand suggests that Uganda might give additional consideration to positions up for review. Specifically, such a consideration might point to:

- Revisiting Uganda’s proposal to introduce a 35%-band as well as its proposal to increase the number of bands in the CET more generally.

Negotiation outcomes may well put Uganda producers, especially its exporters, at serious disadvantage and undermine the development of a strong and growth enhancing industrial base in the country for years to come. At the same time increased protection at 35% reduces competition that would otherwise drive productivity improvements in affected sectors;

- Advocating the phasing out of the Sensitive Items list, with eventual reclassification at the maximum rate. A possible exception is a high tariff (or an import ban) on used clothing;
- Proposing that only Stays of Application be permitted and advocating for a CET without the Duty Remission Scheme – large firms have privileged access to the scheme, undermining the competitive position of SMEs.

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