The Free Trade Area *of the* Common Market *for* Eastern *and* Southern Africa

Edited by
Victor Murinde

ROUTLEDGE

THE FREE TRADE AREA OF THE COMMON MARKET FOR EASTERN AND SOUTHERN AFRICA

To Feddy B. Mwerinde, for timely igniting the spark.

The Free Trade Area of the Common Market for Eastern and Southern Africa

Edited by
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About the editor

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Preface and acknowledgements

Since the early 1980s, while GATT and (later) WTO have been actively advocating the doctrine of free trade, the world has witnessed unprecedented formation of regional trading blocks, mainly involving developing countries on their own but also featuring developed countries either on their own or in partnership with their developing counterparts. In 1992, the US signed a free trading agreement with Canada and Mexico to form the North American Free Trade Area (NAFTA), pointing to a possibility of an American free trade zone spanning North and South America. In 1991, the South American nations of Brazil, Uruguay and Argentina formed a customs union, generally known as Mercosur. The Australia-New Zealand Free Trade Accord has been cemented, with arrangements set in motion for a Western Pacific trading block. In Asia, the formation of the Association of South East Asian Nations (ASEAN) has been an important step towards regional integration known as ASEAN Free Trade Area (AFTA). There are also discussions by some developed country members of the Asia Pacific Economic Co-operation (APEC) to form some partial trade preferences. The Single European Market was implemented in January 1993, paving the way for the European Union to move towards adopting a single currency, the Euro. In the meantime in Africa, a major initiative has been invoked by almost half of the countries in the continent forming themselves into the Common Market for Eastern and Southern Africa.

The formation of COMESA is a very important step forward because African countries have, since the 1970s, continued to face economic downturn; most of the countries are poorer now than they were at the time of political independence. Singular among the widely held explanations of Africa's economic problems is that, in the post-independence era, the countries placed emphasis on counterproductive trade policy and development strategy. Most African countries adopted import substitution strategies and tried to build their industrial base just as Europe had done historically, and ignored advice from the Bretton Woods institutions (mainly the World Bank and International Monetary Fund), GATT and WTO to pursue export promotion and free trade strategies.

Clearly, therefore, this book is timely given, on the one hand, the current wave of preferential trading arrangements in the world today and, on the other hand, the determination of the countries in Eastern and Southern Africa to organise themselves under COMESA and claim a stake in the world trading system.

The book is the first of its kind to address the prospects and challenges of the free trade area of the Common Market for Eastern and Southern Africa. In a broad context, therefore, the book focuses on one of the most important challenges to world trade in the twenty first century, especially for Africa and the developing world, namely the question of regional trade integration. The most extant theoretical and empirical aspects of the question are integrated smoothly with institutional and policy issues. The analysis is illustrated through examples from a sample of African economies. The book concludes by proposing the vision and appropriate strategies for advancing the regional trading arrangements by COMESA. It is hoped that this book will make a timely contribution not only to our understanding of the prospects and challenges of regional trading arrangements in Africa but also to the paradigm of regional trade integration in developing countries. The book is comprehensive in coverage and attempts to strike a balance between the theory, evidence and policy issues.

It is expected that the book will have its widest appeal to advisers and policy makers working for African governments, central banks and NGOs. The business community, including local as well as transnational firms, will find this book invaluable in explaining the challenges and opportunities posed by COMESA. Practitioners in international organisations (WTO, UN, World Bank), who are involved in trade and development issues, as well as other practitioners in Africa and other developing countries should find the book relevant and worthwhile. Faculty members, researchers and students on undergraduate as well as postgraduate programmes in International Trade, International Economics, Development Finance, Development Economics, International Relations in universities in Europe and the US as well as universities in Africa, Asia, Latin America and the Middle East should benefit greatly from reading this book.

The book is intentionally written in a non-mathematical spirit and emphasizes an institutional dimension in order to make it widely accessible to a wide readership, including readers who are not trained economists. It is structured to unfold in a systematic manner. A brief introduction offers the motivation of the study and an outline of the contents of the book. The rest of the work is structured into eight neatly divided, but thematically linked, chapters. The book ends with a bibliography of useful literature, including text references, and an author-cum-subject index.

The idea of writing this book was initiated by the COMESA Secretariat. I am greatly indebted to the COMESA Secretariat for unconditionally supporting this project. I owe another special debt to Heather Rowlands for competently accomplishing the painstaking exercise of giving this book a perfect finish, as usual. The staff at Ashgate Publishing Limited, especially Carolyn Court, Adam Hickford, Anne Keirby, Sarah Markham, Ruth Peters, Tamsin Seymour and Adrian Shanks, deserve a lot of thanks for their patience and support during the gestation period for this final product; the desk editor, Maureen Mansell-Ward, was particularly competent in guiding the project through the final phases.

Finally but importantly, I am greatly indebted to the contributing authors for availing me their original and previously unpublished papers rather than opting for sending the papers to top-rated journals. The editorial work was made particularly easy by the co-operation of the authors in revising their drafts as well as proof-reading the galleys.

In the usual tradition I accept responsibility for any surviving errors and omissions in the book.

Victor Murinde
Birmingham

September 2000

1 Introductory overview

Victor Murinde

1.1 Background

Following the seminal work of Raul Prebisch (1950) and Hans Singer (1950), many developing countries started to voice their concern that world trade favours developed countries. The contribution of the Singer-Prebisch thesis was to provide empirical support to the argument that developing countries are faced with a secular tendency towards declining terms of trade.[1] But it was not until the establishment of the United Nations Conference on Trade and Development (UNCTAD) in 1964 that a forum was in place for developing countries to call for a change in the world trading system. Almost ten years thereafter, in 1973, these countries engineered the creation of a New International Economic Order (NIEO), under which they hoped to increase their role in world trade in order to achieve higher economic growth. Under the NIEO, developed countries were urged to give preferential treatment to imports of manufactured and processed products from developing countries, in order to move towards a more balanced world trade than was the *status quo*. However, the NIEO seems to have failed very badly in the sense that, as Chanthunya and Murinde (1998) show, there has been increased protectionism by developed countries against imports from developing countries, and in general the pattern of trade has remained imbalanced against developing countries.

Against this background, many developing countries have sought to encourage trade among themselves. The idea is that since developing countries are on a similar level of development, economic co-operation among themselves encourages competition which in turn increases efficiency in production and trade at the regional level. Some countries in Africa formed the Economic Community of West African States (ECOWAS), the Southern African Customs Union (SACU), the Customs and Economic Union of Central Africa (UDEAC), the East African Community (EAC), and the Preferential Trade Area (PTA) and its successor, the Common Market for Eastern and Southern Africa (COMESA). In this context, the formation of these regional trading arrangements is expected to ameliorate the economic fortunes of the participating African countries by increasing trade among the member countries and by fostering economic growth of the sub-region through economic co-operation.

In general, the world has witnessed unprecedented formation of regional preferential trading blocks, mainly involving developing countries on their own but also featuring developed countries either on their own or in partnership with their developing counterparts. In 1992, the US signed a free trading agreement with Canada and Mexico to form the North American Free Trade Area (NAFTA), pointing to a possibility of an American free trade zone spanning North and South America. In 1991, the South American nations of Brazil, Uruguay and Argentina formed a customs union, generally known as Mercosur. The Australia-New Zealand Free Trade Accord has been cemented, with arrangements set in motion for a Western Pacific trading block. In Asia, the formation of the Association of South East Asian Nations (ASEAN) has been an important step towards regional integration known as ASEAN Free Trade Area (AFTA). There are also discussions by some developed country members of the Asia Pacific Economic Co-operation (APEC) to form some partial trade preferences. The Single European Market was implemented in January 1993, paving the way for the European Union to move towards adopting a single currency, the Euro. Given that more than a third of world trade takes place within the European free trade area, preferential trading arrangements are an important real-world issue (see Krugman and Obstfeld, 1996; Panagariya, 2000).

In the context of the above, many countries in Africa and elsewhere in the developing world are looking to these preferential trading arrangements as a promising route to participating beneficiary in world trade. Many economists agree with this version of preferential trade liberalization. However, the current thrust of research in this direction seems to suggest that some economists are asking the question of whether, in Bhagwati's (1991) words, these preferential trading blocs are working as "building blocks" or as "stumbling blocks" for a free world trading system. Panagariya (2000) seems to indicate that these trading blocs may be stumbling blocks in transition but are building blocks in the long run.

It is useful to emphasize that the current regional integration efforts in Africa offer a broad strategy for reversing the economic plight currently experienced by most African economies, and do not necessarily conflict with the international trading system under the World Trade Organisation (WTO).[2]

Membership in the WTO is conditional on countries having schedules of concessions and commitments on market access in industrial and agricultural products. Market access also covers the services sector, as reflected in the establishment of the General Agreement on Trade in Services (GATS). For African economies, it would appear that the new WTO will lead to an expansion in trade, mainly due to the reductions in tariff and non-tariff barriers. African countries would thus stand to benefit from liberalization in agriculture and services as well as open market access to industrial countries. However, the impact of the WTO on African countries has been a subject of much controversy. While some analysts have raised concerns about the high costs for African countries of complying with the new obligations and the extent these may impede some development strategies, some analysts have pointed out the potential market losses for Africa arising from the possible erosion in the value of its preferences in its export markets following overall cuts in tariffs, and the possible terms-of-trade losses if net importers of food face higher food prices; see Sorsa (1996) and Chanthunya and Murinde (1998). Given that the most recent trade investigations that are bound to influence the behaviour of African countries in the new WTO are contained in the Uruguay Round 1994, it is important to point out that the commitments by African countries in WTO mainly relate to three sectors, namely agriculture, industry and services; see Chanthunya and Murinde (1998, p. 226-228) for a summary of the initial commitments in the three countries for all the member African countries. Clearly, some of the liberalization commitments in the Uruguay Round in the three sectors were not directly relevant to most African countries; for example, the Uruguay Round schedules discourage subsidies in agriculture, African countries actually tax (and not subsidise) the agriculture sector. In addition, given that the commitments will hold for the foreseeable future, some African countries have preferred not to lock themselves into non-negotiable commitments. As the economies develop, it will become very important to compete in the export market for light industrial goods and agriculture-based manufactured products. In the meantime, the life-boat for these economies lies in preferential trading liberalization under arrangements such as COMESA.

This chapter serves two purposes. First, it presents the motivation of the book. Second, it provides an accessible and brief survey of the theory of economic integration. The broad theory of preferential trading arrangements has been competently surveyed by Baldwin and Venables (1995), Bhagwati and Panagariya (1996a, 1996b), Winters (1996), Bhagwati, Greenaway and Panagariya (1998), Fernandez and Portes (1998) and Panagariya (2000). Thus, this chapter does not reproduce these surveys; rather, emphasis is placed on presenting an accessible version of the theories that relate to the main issues addressed in this book. We exclude the theory relating to some aspects of preferential trading arrangements; for example, direct foreign investment issues (which are considered by Bende-Nabende in Chapter 5), trade in services (which is considered by Murinde and Ryan in Chapter 7) as well as globalisation (which is addressed by Mahdi in Chapter 8).

1.2 The theory of economic integration

1.2.1 Six forms of economic integration

Economic integration may be defined as an attempt to link together the economies of two or more countries, typically with some geographical proximity, through the removal of economic barriers such as tariffs and immigration controls, aimed at raising the living standards as well as achieving peaceful relations among the participating countries.

The theory of economic integration can take several forms, which are ultimate objectives in their own right and thus represent varying degrees of integration. Precisely, the seminal Balassa (1961) classification identifies six distinct forms of economic integration. The first of these forms is sectoral integration, which occurs when there is a removal of barriers to trade in one economic sector. A good historical example is the European Coal and Steel industry. The second is the free trade area, whereby member countries abolish all trade impediments among themselves but retain their individual trade policies and trade barriers with the outside world. For example, each member country retains the power to fix its own separate tariff rates on imports from non-member countries. In addition, member countries are equipped with "rules of origin" to ensure that preferential treatment is confined to commodities originating within the free trade area, in order to limit trade deflection *i.e.* a reduction of imports through the country with the largest tariff for the purpose of exploiting the tariff differential. A historical example is the European Free Trade Association. The third form is a customs union, which eliminates substantially all tariffs and other forms of trade restrictions among the participating countries and establishes union tariffs and other regulations on foreign trade with non-participating economies. Hence, there is substitution of a single customs territory for two or more customs territories. The first customs union in Europe was the Zollverein, 1830-1870, on which basis the German empire was founded in 1870, after which several attempts were made to integrate the economies of various European countries. The fourth is the common market. Common markets are also customs unions, but they have free factor mobility across national member boundaries so that capital, labour and enterprise move without hindrance among the member countries. The fifth form of economic integration is economic and monetary union, which essentially is a common market with a central authority which controls the economic policies of member countries; there is also a common currency. The European Union is moving towards this direction, with the adoption of the Euro as a common currency in some member countries at present, possibly extending to all member countries in future. Finally, the ultimate form of economic integration involves complete political integration in which there is a central authority whose sovereignty is that of a national government. Historically, the USSR was such an arrangements.

However, apart from the above six standard types of preferential trade arrangements, some international trade agreements involve a "non-discriminatory" reduction in tariff rates. For example, if South Africa agrees with the UK to lower its tariff on imported machinery, the new tariff rate applies to imported machinery from any country in the world. Thus, all countries pay the same rates, especially under a status formally known as that of "most favoured nation" (MFN) - a guarantee that exporters from those countries pay tariffs no higher than that of the nation that pays the lowest. As Krugman and Obstfeld (1996) point out, tariff reductions under GATT and WTO are always made on an MFN basis. In general, the main articles of GATT and WTO that relate to preferential trading arrangements under the multilateral trade policy framework, especially Article I and Article XXIV, are reviewed in Bhagwati and Panagariya (1996a, 1996b), Bhagwati, Greenaway and Panagariya (1998) and Panagariya (2000).

1.2.2 The theory of trade creation and trade diversion

The seminal work relating to preferential trading arrangements is Jacob Viner's (1950) theory of trade creation and trade diversion. The theory represents some static welfare analysis. Suppose that two countries, Kenya and Uganda, form a customs union such that there are no quantitative restrictions on trade between them. The removal of tariffs makes it possible for a member country to replace high cost domestic production with lower cost production from another member. Thus, after the customs union, each country specialises in the production of commodities in which it has a comparative advantage, thus increasing productivity and welfare gains of the countries in the union. This is trade creation. A welfare gain is associated with trade creation.

Let us take a hypothetical example, shown in Table 1.1. The formation of the customs union implies that the rest of the world (ROW) will be discriminated against *vis-a-vis* the countries in the customs union. Suppose, as in Table 1.1, the ROW is a low-cost producer (US$16), Uganda is a medium-cost producer (US$20) and Kenya a high-cost producer (US$25), for a unit of a hypothetical product. Before the formation of the customs union, producers in the ROW face the same tariff barrier in Kenya as do producers in Uganda. Initially, therefore, Kenya's tariff is high enough to exclude imports from

Uganda and the ROW; imports from Uganda cost US$40 per unit and those from ROW cost US$32 per unit, so Kenyan consumers buy domestically produced goods at US$25 per unit. After economic integration, producers in ROW have to meet the common external tariff of the union while producers in Uganda now pay no duty. Thus, because the tariff on Ugandan products is abolished, imports from Uganda would replace Kenyan goods. This is a gain from Kenya's point of view because it costs US$25 to produce a unit of the good domestically while Kenya now needs to produce only US$20 of exports goods to buy Ugandan goods. Trade creation has occurred which benefits Kenya and Uganda, as member countries of the economic integration. This example can be expanded for a whole range of commodities such that the comparative advantage of the member country is shown to differ from commodity to commodity.

Table 1.1
Trade creation arising from economic integration

Country	Production cost per unit (US$)	Non-discriminatory tariff of 100 per cent (US$)	Price in Kenya with Kenya-Uganda customs union (US$)
Kenya	25	25	25
Uganda	20	40	20
ROW	16	32	32

However, if the tariff was 50 percent as in Table 1.2, Kenya would be importing from the ROW at US$24 per unit before economic integration, rather than producing domestically at US$25 or importing from Uganda at US$30 per unit. After the formation of the customs union, Kenyan consumers buy Ugandan goods at US$20 per unit rather than US$24 from the ROW. Specifically, imports from the ROW now cease. This is notwithstanding the fact that imports from the ROW are really cheaper at US$16 before the tax; even at US$24 after tax, the amount of the tax is received by the Kenyan treasury as import tax revenue and thus used in the Kenyan economy. Kenya loses in the sense that trade within the customs union simply supplants trade with countries outside the union. Thus, assuming constant costs, if the ROW supplied Kenya with a particular commodity prior to integration but the sum of its production costs and the common tariff of the union exceeds the cost of production in the member country Uganda, the latter will supplant the ROW as suppliers of the commodity in question in Kenya. This is a standard case of trade diversion. A welfare loss is associated with trade diversion. In this context, it is possible for a country to make itself worse off by joining a customs union.

Table 1.2
Trade diversion arising from economic integration

	Production cost per unit (US$)	Non-discriminatory tariff of 50 per cent (US$)	Price in Kenya with Kenya-Uganda customs union (US$)
Kenya	25	25	25
Uganda	20	30	20
ROW	16	24	24

The bottom-line is that whether a customs union is desirable or undesirable depends on whether it largely leads to trade creation or trade diversion. However, the amount of trade creation and trade diversion does not adequately represent the full gains or losses from a custom's union. The analysis does not take into account the size of the differences in production costs of different commodities in different countries. A more appropriate assessment is whether on balance the production effects of integration are positive or negative. Moreover, the above trade diversion and trade creation results depend on a very special assumption that there is no substitution in consumption.

1.2.3 The revenue transfer effect

In the above example, it is assumed that imports to Kenya come from Uganda or the ROW but not both. The realistic case, however, is that imports may come from both Uganda and the ROW. Panagariya (1996) and Bhagwati and Panagariya (1996) allow for this by introducing an assumption that there is finite elasticity of supply in at least one of the union partners and the ROW. Assuming that Kenya is the potential importer of the good, then we subtract her supply from her demand and obtain her import-demand curve. Assuming that Uganda is the exporter of the good, we subtract her demand from her supply and obtain her export-supply curve. After imposing a per unit tariff, Kenya gains from trade, relative to autarky, in terms of tariff revenue. After the formation of the customs union, two things may happen. First, if Uganda has an elastic supply curve, then all Kenya's imports will be supplied by Uganda and none by the ROW. In this case, Kenya loses the tariff revenue, while Uganda gains by increasing her exports to Kenya but the custom union and world trade lose in terms of the higher per unit price paid by Kenya and the loss of exports from the ROW. Second, if Uganda has an inelastic supply curve, the imports to Kenya might come from both Uganda and the ROW. In this case, Kenya gains some amount of tariff revenue, while Uganda and the ROW gain by increasing their exports to Kenya. The revenue effect is gained by Kenya.