PART III

INTEGRATING SERVICES MARKETS

12. Africa's Trade in Services and the Opportunities and Risks of Economic Partnership Agreements

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Introduction

Services matter for economic growth and development. In most non-oil producing sub-Saharan African countries the services sector is now the largest part of the economy, and as countries develop the importance of the services sector tends to rise further. The provision of clean water, effective sewerage, a stable supply of energy, and access to education and health services is critical to increasing welfare and alleviating poverty. Services, such as telecommunications, energy, transport, and business services are important inputs into the production of goods and other services and hence influence productivity and competitiveness. Increasing the availability, affordability and quality of these services is crucial for economic growth and poverty reduction in all developing countries.

In this context, international trade can play a key role in the development of services sectors in Africa. Opening up to services imports and foreign direct investment can be an effective mechanism to increase competition and efficiency in the provision of services in the domestic economy. In addition, services offer dynamic new opportunities for exports, but too often services are overlooked as a source of export diversification, with trade policies focusing solely on goods. Exports of services are of particular importance for land-locked countries for which opportunities to diversify into the export of manufactures are more limited by the high costs of transporting goods.[49]

However, trade opening may need to be coordinated with regulatory reforms to ensure efficient outcomes, while additional policies may be necessary to ensure that public policy objectives regarding equity are achieved. This emphasizes the importance of developing the capacity to define and implement sound regulatory policies for services sectors, capacity that is limited in many African countries.

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[49] Indeed, over the past 10 years exports of services from non-oil exporting land-locked countries in Africa have increased at a rate more than three times faster than their exports of goods.

This chapter examines the role that international trade agreements, particularly the Economic Partnership Agreements (EPAs) that are currently being negotiated with the European Union (EU), can play in supporting coordinated trade and regulatory reforms. Such reforms will enable African countries to exploit the considerable opportunities for the expansion of trade in services both within Africa as well as with the global market. The note discusses the key issues that EPAs will have to address if they are to support the development of service sectors in Africa, while recognizing that EPAs might not necessarily be the most effective way to pursue service sector reform for all African countries. The note proceeds by first reviewing the role that trade liberalization can play in the reform of services sectors.

Trade Liberalization and Regulation of Services Sectors

Trade policy plays an important role in determining the nature of competition in domestic services sectors. Countries that place restrictions on foreign service providers may limit access to the most efficient suppliers and the best technologies, and deny producers and consumers throughout the economy access to low-cost services. Empirical studies have shown that openness to trade in services is associated with greater efficiency and faster economic growth.[50] In addition, liberalization of services trade has positive impacts on trade in goods and allows developing countries to better exploit their comparative advantages in labor-intensive manufactures. The gains from services liberalization are likely to be larger than those from goods liberalization and the adjustment costs that arise from service sector reforms are likely to be lower than those arising from reducing protection of goods. This is because the dominant mode of cross-border supply in many services sectors is through commercial presence (mode 3), which means that services will likely continue to be produced locally, albeit following investment and the transfer of expertise and assistance by foreign firms.

However, liberalizing services trade can be more complex than the liberalization of goods trade and requires considerable technical capacity, which is often lacking in Africa. The complexity arises from the necessity for many services sectors to be regulated in order to ensure that they operate efficiently in the face of market failures. Opening up to services trade in the absence of appropriate regulations may not necessarily increase trade and generate greater efficiency in the provision of services.

It may also be necessary to put in place mechanisms to ensure that social objectives regarding access to key services are not compromised by trade reform. The challenge is to achieve an appropriate balance between greater competition by improving market access for foreign providers and achieving public policy objectives. A particular concern is that increasing competition and liberalizing services will lead to a deterioration in the provision of services to the poorest or less populated areas because these are the least profitable to serve. This could arise if new competitors in formerly monopolized sectors compete away monopoly profits that were previously used to cross-subsidize unprofitable provision of services to poorer regions. In response, governments can use a range of market-based mechanisms to ensure the provision of key services to poorer or under-populated areas in a competitive environment.

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[50] Hoekman and Mattoo (2008) provide a full review of the empirical evidence regarding trade in services, trade liberalization, and growth.

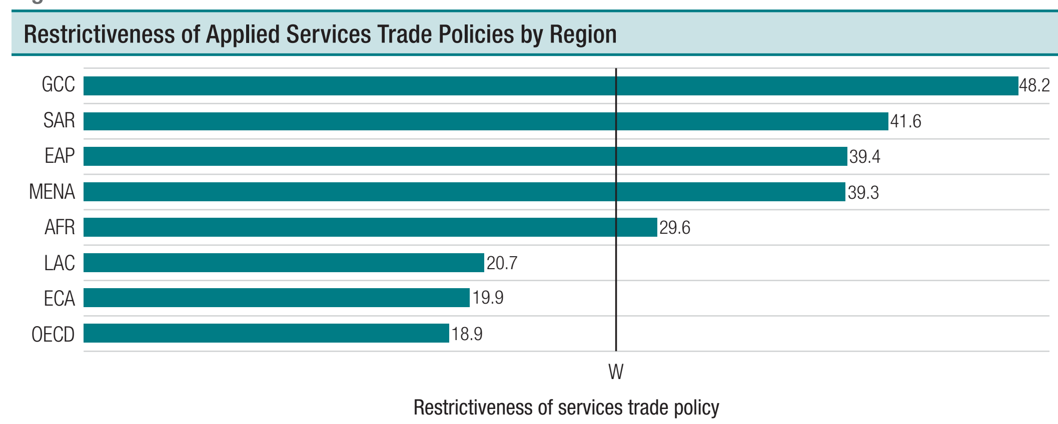
Coordinating services trade liberalization with regulatory reform is therefore important. Although there is no strict sequencing necessary such that regulatory reform should precede trade liberalization or vice versa, in general efforts should be made to ensure competition in the market. In some cases, trade liberalization can be a driver of regulatory reform, such as when incumbent producers have captured regulatory agencies and trade liberalization leads to greater participation of consumers and new suppliers of services in the regulatory process. In other cases, regulatory reform or an improvement in the business climate may be necessary to allow investment or cross-border trade to take place.

To be able to effectively plan trade liberalization and negotiate agreements on trade in services bilaterally, regionally, or at the multilateral level it is essential for policy makers and negotiators to have extensive information on the nature of regulation and trade restrictions in all of the sectors that are subject to discussion. In many African countries as well as other developing countries, though, comprehensive data on services sectors are not available, and developing countries typically face difficulties in effectively participating in trade negotiations on services.

To address the shortage of data on applied policies governing trade in services in developing countries, the World Bank has recently carried out a survey to assess applied (actual) trade policies in five services sectors—financial services, telecommunications, retail distribution, maritime transport, and professional services—in 78 developing and transition countries and 24 developed countries in 2007 and 2008. Twenty-two African countries are considered in the analysis. The results show that, on average, African countries have relatively liberal services trade policies (Figure 12.1). For these African countries, the overall restrictiveness index of applied services polices is just above the world average and lower than the restrictiveness index in all other developing country regions except for Eastern Europe and Latin America. There is, however, considerable variation across countries in Africa. Madagascar and Mauritius have very open policies towards trade in services with a value of the restrictiveness considerably below the world average and also below the average for OECD countries. On the other hand, the value of the index

Figure 12.1 >

Restrictiveness of Applied Services Trade Policies by Region



Source: Gootiiz and Mattoo (2009).
Note: Regional abbreviations: GCC – Gulf Cooperation Council, SAR – South Asia, EAP – East Asia and Pacific, MENA – Middle East and North Africa, AFR – Sub-Saharan Africa, LAC – Latin America and Caribbean, ECA – Europe and Central Asia, OECD – Organization for Economic Co-operation and Development.
W is average STRI of total 102 countries.

for Ethiopia is the highest score of any country in the sample. Only seven of the 22 African countries have an overall services restrictiveness index that exceeds the world average.

The Role of International Trade Agreements in Services Reform

International trade agreements can support governments that wish to implement services reforms but which are opposed by powerful vested interests. Such agreements can help break domestic deadlocks by improving market access for the country's exporters and mobilizing export groups to support the reform effort. Trade agreements can also provide a mechanism for overcoming domestic resistance to desirable reforms by locking in the commitment to reform and enhancing the credibility of the reform process. However, most African countries have been reluctant to make commitments on services at the WTO under the General Agreement on Trade in Services (GATS). Almost all of the liberalization of trade in services reflected in Figure 12.1 has been implemented unilaterally.

This caution reflects that negotiation of reciprocal commitments under the GATS has given insufficient attention and resources to enable developing countries to assess the impact of making market access concessions on domestic regulations and market outcomes. A lack of attention to concerns over regulation and the ability to regulate have constrained effective participation in negotiations. Regulators will respond to substantive arguments for reform, while GATS-style mercantilist bargaining over market access alone will be of little importance to them. This supports the need for careful analysis of the economic benefits as well as wider consequences of reform and the involvement of key stakeholders in discussions of regulatory reform.

There are several additional challenges to services trade liberalization negotiations. Developing countries often have concerns that negotiated global liberalization of services trade and negotiations over an EPA will be largely one sided, with developed country service providers likely to gain improved access to developing country service markets but with little improved access for developing-country service providers in developed country markets. The standard mercantilist bargaining over liberalization of trade in services may, therefore, not deliver improved outcomes in many of the poorest countries. In addition, many African countries face serious technical and administrative capacity constraints in designing, negotiating, and implementing liberalization of their trade in services and complementary regulatory reforms. The unwillingness of many African countries to bind existing services trade policies at the WTO/GATS level may also reflect their inability to prepare negotiating positions, and to participate meaningfully in the negotiations in a way that will positively affect the negotiation's outcome.

In general, the greatest gains from liberalizing trade in services will arise when access is provided to all suppliers on an MFN basis. By so doing a country gives its consumers and produces access to the best service-providers in the world. Sequencing preferential liberalization of trade in services before broader MFN liberalization can have adverse long-run consequences by handing a first-mover advantage to a less efficient supplier that a subsequent increase in openness cannot dislodge or force to become more efficient. Liberalization at the regional level first may be justified if there are important learning effects that local firms have not been able to exploit due to the small size of national markets or restrictive national regulatory regimes that have inhibited opportunities for growth. Preferential regional liberalization may then allow regional service providers

to emerge in Africa that are then able to compete effectively when MFN liberalization is implemented.

Liberalizing first on a regional basis may allow regulators to gain experience before full opening is implemented. Regional agreements may also make it possible to reap scale economies in regulation and supervision, particularly where national regulatory agencies face skill constraints; they could also reduce scope for the capture of national regulation by private sector interests and reduce regulatory heterogeneity. However, regional policy makers also need to avoid creating protected regional service sectors that will be difficult to liberalize and giving first mover advantages to inefficient regional suppliers against which more efficient international suppliers will not subsequently be able to compete. For this reason, it is important to carefully assess the potential costs and benefits of proceeding with preferential regional liberalization. Countries should also look for ways to make binding commitments to ensure that there is subsequent MFN liberalization.

Reform of Services in Africa and Economic Partnership Agreements

The provisions on services in the CARIFORUM EPA between a group of Caribbean countries and the EU suggest that a similar EPA with African countries could be a mechanism for locking in existing levels of openness, enhancing the credibility of reform, and providing a signal to investors of the stability of the current policy stance on services. The CARIFORUM EPA also defines frameworks for the regulation of a number of services sectors, which could provide a basis for increasing the quality and credibility of regulations in Africa. In other sectors in which Africa has export interests, such as tourism and IT related services, commitments that go beyond the GATS could provide important precedents for future regional and multilateral trade agreements. Provisions in the CARIFORUM EPA for cooperation between competition authorities, especially the specific commitments in tourism, could be useful in disciplining anti-competitive behavior by EU firms in African markets and in allowing African firms to effectively compete in vertically integrated production chains. Regional regulatory cooperation and a regional preference clause could be useful for advancing regional integration in services in Africa. Putting in place structures for dialogue on mutual recognition at the EPA level may facilitate progress at the regional level.

However, an EPA is unlikely to offer much in terms of improved access for African countries to the EU market. Although the CARIFORUM EPA contains provisions for expanding the temporary employment of skilled professionals, it does not address the issue of temporary movement of unskilled workers. Greater temporary access to the EU for unskilled workers, for example, through carefully crafted and managed sub-contracting schemes would have a significant economic impact in Africa. Without significant opening to temporary movement of unskilled workers by the EU, services reform will have to be driven by African countries seeking to reform their domestic services sectors. Further, the current GATS-style negotiation of reciprocal commitments between the EU and African countries under the EPA has given insufficient attention and resources to improving regulatory policies and strengthening regulatory institutions.

For countries with limited capacity to negotiate and regulate services a focus on priority services sectors from a development perspective (in most countries these are likely to include transportation, telecommunications, electricity, finance, and business services)

is likely to be more effective than a broad but shallow preferential trade agreement that involves negotiations across all sectors and modes of supply.

Recommendations

Regulatory and trade reforms in Africa will need to be supported with technical and financial assistance. Such assistance should be targeted at those factors with the greatest impact on performance in the market and not solely at market access and national treatment considerations and the preparation of GATS-type schedules of commitments. However, this assistance should not be directly linked to the signing of an EPA. Assistance should be available to all African countries that wish to reform their services sectors, whether they sign an EPA or not.

One way to organize and coordinate such support could be through a dedicated forum, independent of specific trade negotiations, that supports the application of economic and regulatory impact analysis, discussion of good practices and effective institutional structures. The forum, which would need to be organized around the priority sectors for Africa, would allow for meaningful dialogue between regulators and trade negotiators to address concerns about the impact of trade reform on the capacity to effectively regulate. Such a forum would have to encapsulate that for services reform one size does often not fit all and that reforms and appropriate regulatory structures will often tend to be country specific. A key issue would be where to host such a forum and how to ensure access to its resources for all countries in Africa.

Countries in Africa, should draw upon available sources of financial support and technical assistance to:

- Define a strategy for trade in services that is integrated into the national development plan through the following activities: (1) improving the collection and dissemination of more and better data on service sectors and trade in services; (2) creating awareness and facilitating a dialogue among various stakeholders about the potential impact of services trade liberalization and reform; (3) identification of priority sectors where greater competition, foreign investment, and new technology can drive efficiency and growth; and (4) establishing a committee for services trade and regulatory reform to champion open and transparent approaches to regulation and trade opening and oversee the use of regulatory impact analysis.
- In the priority domestic services sectors, implement a trade and regulatory audit to identify the main constraints to competition and investment. Do they lie in insufficient openness to trade and investment, lack of credibility of existing openness, inappropriate regulations, insufficient capacity to implement a sound regulatory framework, a hostile investment climate, or some other area?
- In priority export sectors assess the need for improvements in the regulatory regime to support competitiveness and mobilize an export supporting approach in relevant line ministries and institutions such as the export promotion agency.
- Identify if, and how, unilateral reforms and trade agreements at the regional, EPA, and multilateral level can be used to alleviate the constraints that are identified for the priority sectors and support the process of trade and regulatory reform. Explore

opportunities for cooperation with the EU outside of a formal broad services agreement, for example, with regard to cooperation between competition authorities.

- Pursue more actively opportunities for regional cooperation and deeper integration of services in priority sectors of mutual interest with regional partners.

With regard to the EPAs:

- The EU and African countries consider a more flexible approach to the EPAs that reflects the diversity of capacities and priorities across African countries. The EPAs become a process in which the focus is not on a bilateral deal between the EU and regional blocks in Africa for the preferential opening of services sectors based upon a GATS type schedule but rather a country-based cooperative approach to remove the constraints that block development of the sectors identified as priorities by African countries. For example, if requested by an African country or group of countries, the EU could work with these countries to facilitate cooperation between competition authorities. This could be provided even in the absence of a formal comprehensive EPA agreement. Similarly the EU could look at opportunities for mutual recognition of qualifications that are not predicated on signing a formal EPA agreement.
- African countries and the EU adopt a sector-by-sector approach to coordinated trade and regulatory reform rather than a broad but shallow GATS type negotiation in which priority sectors for reform are defined by each country consistent with national development plans.
- The EU supports African countries in pursuing openness to trade in services primarily through MFN liberalization especially in infrastructure sectors where preferential opening may have long-term adverse implications.
- The EU works with other donors and international institutions to make adequate technical assistance available to all reforming countries in Africa from a fund that is independently managed and delink the provision of such funding from negotiations and agreement on an EPA. Such a fund could organize financial resources and expertise around key services sectors for Africa. Suggestions would include telecommunications, tourism, transport, finance, and business services.

References

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13. Developing Professional Services in Africa

How Regional Integration Can Help?

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Introduction

Professional services play an important role in the functioning of modern economies and are among the fastest growing services sectors[49] in many developed and developing economies. Professional services contribute directly and indirectly to economic growth, including by lowering transactions costs and by creating spillovers of knowledge to other industries.

Accountancy is critical for accountability, sound financial management, and good corporate governance (Trolliet and Hegarty 2003). Effective legal and justice systems and access to legal services improve the predictability of the business environment, facilitate engagement in contracts, and mitigate investment risks (Cattaneo and Walkenhorst 2010). Engineering is a knowledge-intensive sector essential to the productivity and sustainability of other economic activities. For example, civil engineering is critical for the development and maintenance of a country's physical infrastructure, while electrical engineering is important to the operation of public networks such as utilities or commercial facilities and communication systems (Cattaneo et al. 2010).

Greater usage of professional services is associated with higher labor productivity for firms—particularly small firms—across countries in Eastern and Southern Africa. For example, the average labor productivity of East African users of professional services is 10 to 45 percent higher than that of non-users of professional services. In addition, increasing trade in professional services can become an important source of export diversification in Africa and contribute to reducing reliance on the export of a small number of mineral products or cash crops. Finally, in common with services generally, professional services show greater resilience to economic downturns than do manufactures, in part because of their lower demand cyclicality (Borchert and Mattoo 2009).

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[52] The available data for Eastern and Southern Africa indicates that the average annual growth rates of business services outputs (of which professional services constitute an important part) were of 21 percent in Zambia, 18 percent in Uganda, 14 percent in Tanzania, 8 percent in Kenya and 7 percent in South Africa over 2000 to 2009.

But there is a large gap between the potential contribution these services could make and the meager contribution they make today to growth and economic development in Africa. Policy makers in East and Southern Africa have recognized the critical importance of developing professional services. Along with reform of backbone services like telecommunications, banking, and transport, governments are adding professional services to their list of priorities. Improving and expanding these services will require both national reform and international cooperation, including creating a more integrated regional market.

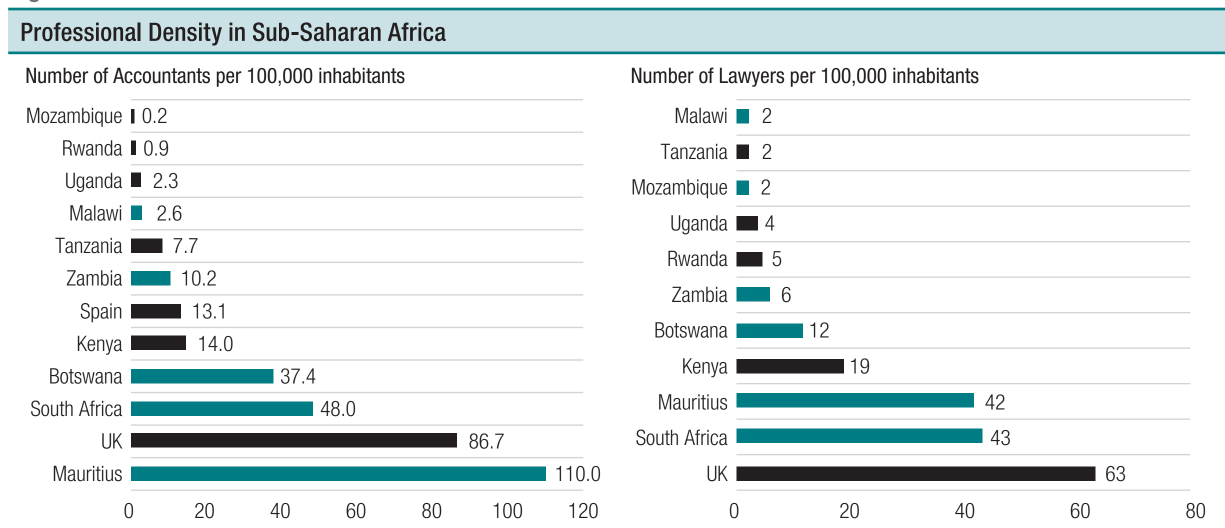
This note presents the results of extensive information gathering and analysis of these largely unexplored segments in Eastern and Southern Africa. It shows why national markets for professionals and professional services in Eastern and Southern Africa remain underdeveloped, while regional markets are fragmented by restrictive policies and regulations. To turn this sector around, the note calls for policy action in four areas: education, regulation of professional services, trade policy, and labor mobility at both the national and international levels.

Striking Differences in the Level of Development of Professional Services in Eastern and Southern Africa

Countries in Eastern and Southern Africa exhibit striking differences in the level of development of their professional services sectors, with relative abundance of professionals in Mauritius, South Africa and Kenya and relative scarcity in Rwanda, Zambia, Malawi, Uganda and Tanzania. But per capita availability of accountants and lawyers in most Eastern and Southern African countries is only a fraction of that in the more advanced economies of Mauritius and South Africa (Figure 13.1).

Figure 13.1 >

Professional Density in Sub-Saharan Africa



Source: World Bank Regulatory Surveys in Eastern Africa, 2009; World Bank Regulatory Surveys in Southern Africa, 2010; Paterson et al. 2003; and CEPEJ 2008).

Although professionals in Eastern and Southern Africa receive low nominal wages relative to their counterparts in developed and other developing countries, once their wages are adjusted for purchasing power, professionals in South Africa, Botswana, Uganda, Mozambique, Kenya, and Malawi are comparatively well paid—reflecting their scarcity relative to the demand for their services. However, in legal services, the very high wages earned by professionals are not necessarily indicative of their scarcity but rather of the power of professional bodies which impose strict entry and conduct regulations that enable incumbents to capture high rents and thus limit the potential contribution of the sector to growth in the region.

A Middle-level Skills Vacuum and Significant Skills Mismatches

Middle-level professionals such as accounting and engineering technicians, or paralegals who can provide services to under-served client segments and produce large economic gains are sometimes underappreciated category of professionals. For example, accounting technicians can provide basic recordkeeping services needed by SMEs. Paralegals engage with clients on a variety of complex law-related tasks, including working with lawyers on criminal justice cases, advising clients on law-related issues, and mediating commercial disputes between parties. Indeed, there is a growing role for paralegals in the criminal justice space in Africa. The existing data suggest that—with the exception of accounting technicians in Kenya—East Africa is facing a middle-level skills vacuum. Southern Africa is somewhat better endowed with middle-level professionals but they generally account for only half the total number of professionals in a given sector.

Skills mismatches at all levels are a serious issue across professions in all African countries. For example, accounting associations in Kenya, Malawi, and Tanzania reported that there are jobless accountants despite high demand for qualified accountants. Potential explanations include the absence of links between the education system, labor market, and professional associations. Consultations with accounting sector stakeholders in Mozambique revealed that multinational auditing and accounting firms face shortages of entry-level accounting and auditing professionals as most applicants do not have the requisite training quality, and of senior-level local professionals who could monitor the quality of financial reporting. In South Africa, mismatches in accounting result from private sector firms hiring chartered accountants (CA) registered with the South African Institute of Chartered Accountants (SAICA) because of their perceived quality for work that could be performed by less highly qualified accountants.

Professional Services Remain Inaccessible for Many Small and Micro Enterprises

Evidence from recent firm-level surveys in Eastern and Southern Africa suggests that usage of professional services is highest for large firms regardless of their sector in all countries. Anecdotal evidence confirmed by observed patterns of services use by firms of different sizes in sub-Saharan Africa suggests that the prices of professional services are prohibitive for many small firms.

Limited Trade in Professional Services

The heterogeneity of professional endowments and differences in sectoral earnings suggest that there is substantive scope for increased regional trade in professional services in sub-Saharan Africa. Foreign professionals and foreign professional firms could help address the underdevelopment of the sectors and the unmet demands in the region. However, data on the presence of foreign professionals in Eastern and Southern Africa show that in Kenya, Malawi, Tanzania, Uganda, and Zambia foreign accounting professionals represent less than 10 percent of the total. That percentage is higher in Botswana, Mozambique, and Rwanda. In legal services, there are virtually no foreign professionals practicing in any of the African countries.

In terms of commercial presence, statistics from professional associations reveal some foreign participation in accounting and engineering services. In accounting/auditing services, firms with foreign affiliation (i.e., with foreign equity or with foreign partners) dominate the markets. In engineering, 25 percent of registered firms in Mauritius and 35 percent of registered firms in Tanzania have foreign participation. In Zambia however, out of 298 engineering firms only two are foreign-owned. Foreign law firms are virtually absent in most African countries. In South Africa out of 8,200 registered law practices in 2008 only three were foreign-owned. Exceptions are Botswana and Mozambique where foreign-owned law firms are among the five major law firms in each country. In Mauritius, where law firms are a recent development, the majority are actually foreign-owned.

The World Bank surveys of Users of Professional Services in Eastern and Southern Africa show that only a small proportion of firms import accounting, engineering, or legal services in Eastern and Southern African countries which may be a consequence of high trade barriers in place.

Evidence compiled on World Bank-supported civil works procurement contracts between 1994 and 2009 reflects the lack of integration of Eastern and Southern African markets for engineering services. Domestic companies generally win most contracts, except in energy, mining, and transportation, and, in some countries, industry, trade, and water and sanitation, where non-African companies have the lion's share. Surprisingly, there is virtually no intra-East African foreign firm participation in these contracts, with the limited exception of Kenyan firms in some Tanzanian and Ugandan projects and Ugandan firms in some Rwandan projects. Similarly, there is virtually no intra-Southern African foreign firm participation in these contracts with the limited exception of South African firms in several Southern African countries and some Malawian projects in Mozambique.

Explaining Skills Shortages and the Segmentation of Markets for Professional Services in Eastern and Southern Africa – Weaknesses in Education

A number of factors explain the lack of supply of appropriately qualified professionals in Eastern and Southern Africa. First, professional education is very expensive in all Eastern and Southern African countries. While skills premiums for professionals exist, and internal rates of return to education are high in the region, the average cost of acquiring a professional degree across all countries and professions is more than US$22,000.

This makes attaining professional qualification unaffordable for the vast majority of the population in these countries, especially given the underdeveloped nature of the markets for educational loans.

Second, the weaknesses in secondary education witnessed across Eastern and Southern African countries limit the ability of students to acquire professional skills. The general erosion of mathematical skills in all countries explains the declining number of applicants in science, engineering, and technology courses, leading to shortages in the engineering sector.

Third, the capacity and quality of professional education institutions are limited. In several Eastern and Southern African countries, institutions that offer specialized post-graduate courses, as well as institutions that offer academic and professional training courses for middle-level professionals are entirely absent.

Fourth, there is an absence of links between educational systems, employers, and users of services. This dynamic leads to unmet needs and unemployed professionals, explaining the attrition of skills in several professions in Eastern and Southern Africa. Stakeholders from the private sector emphasized the severe lack of coordination between employers, professional associations, and education institutions with regards to the content of educational programs for accountants and engineers.

Fifth, opportunities for spillovers at the regional level are not being exploited due to the high trade barriers and regulatory heterogeneity affecting education services.

Explaining the Segmentation of Markets for Professional Services – Strict Domestic Regulation and Regulatory Heterogeneity

Domestic regulation on the entry and on the operations of professional services firms often undermines competition and constrains the growth of strong professional services sectors in Eastern and Southern Africa. Domestic entry regulation, such as licensing and educational requirements, quantitative restrictions on the number of suppliers of professional services, and exclusive rights granted to suppliers in certain activities, as well as regulations on the operations of firms, such as restrictions on prices and fees, advertising, form of business, and inter-professional cooperation, are particularly heavy when compared to those in emerging economies and in OECD countries.

In Eastern and Southern Africa, entry regulation is significant in all professional services sectors. The three professions (accounting, legal services, and engineering) are subject to qualitative entry requirements related to education and qualifications that do not vary significantly across African countries.

Other qualitative entry requirements are present in most African countries. Membership in the relevant professional association is mandatory in accounting and legal services in all countries. Compulsory licensing is a must in accounting in all countries but in legal services Mauritius and South Africa do not require licensing. In engineering, licensing requirements are also absent in South Africa, Botswana, and Rwanda—in the last two countries because engineering boards have not been established yet. Continuing education is an obligation for accountants in all countries except Mozambique, for lawyers only in Kenya, Tanzania, and Uganda, and for engineers only in South Africa and Zambia.

The regulation of middle-level professionals is much more heterogeneous across African countries. For example, the regulatory spectrum for engineering technicians ranges from

total absence of entry requirements in Botswana and Rwanda to requirements to pass a professional exam, undertake compulsory training, and engage in continuing professional development in South Africa and Tanzania.

Furthermore, restrictive qualitative requirements in the form of restrictions on access to the profession, mainly due to the monopoly of professional associations over training institutions, were identified in legal services in Kenya and Zambia. The higher education institutions that provide the required law degrees are controlled by the professional associations, which restrict the number of students. The Kenya School of Law, through which all legal professionals must pass, had a limited capacity of 600 students per year in 2008. The Zambia Institute of Advanced Legal Education is the only institution providing the post-graduate one-year course necessary for domestic and foreign candidates to become licensed lawyers in Zambia.

Highly skilled professionals in all sectors and countries have exclusive rights to perform certain activities, for example: auditing for accountants; representation of clients before courts and advice on legal matters for lawyers; feasibility studies, design and planning for engineers. The scope of exclusive activities is wider in accounting and legal services.

Regulation affecting the operations of legal and engineering providers in Eastern and Southern Africa is heavier than in most other countries. This evidence is explained by price regulations, advertising prohibitions, and restrictions on firms' business structure and on multidisciplinary activities. In accounting and engineering, fees for professional services tend to be negotiated freely between practitioners and clients across African countries but accountancy fees are regulated in Zambia and engineering fees are regulated in Botswana, South Africa, Tanzania, and Zambia. As opposed to most developed countries, legal services' fees are regulated in all African countries except Mozambique and Rwanda.

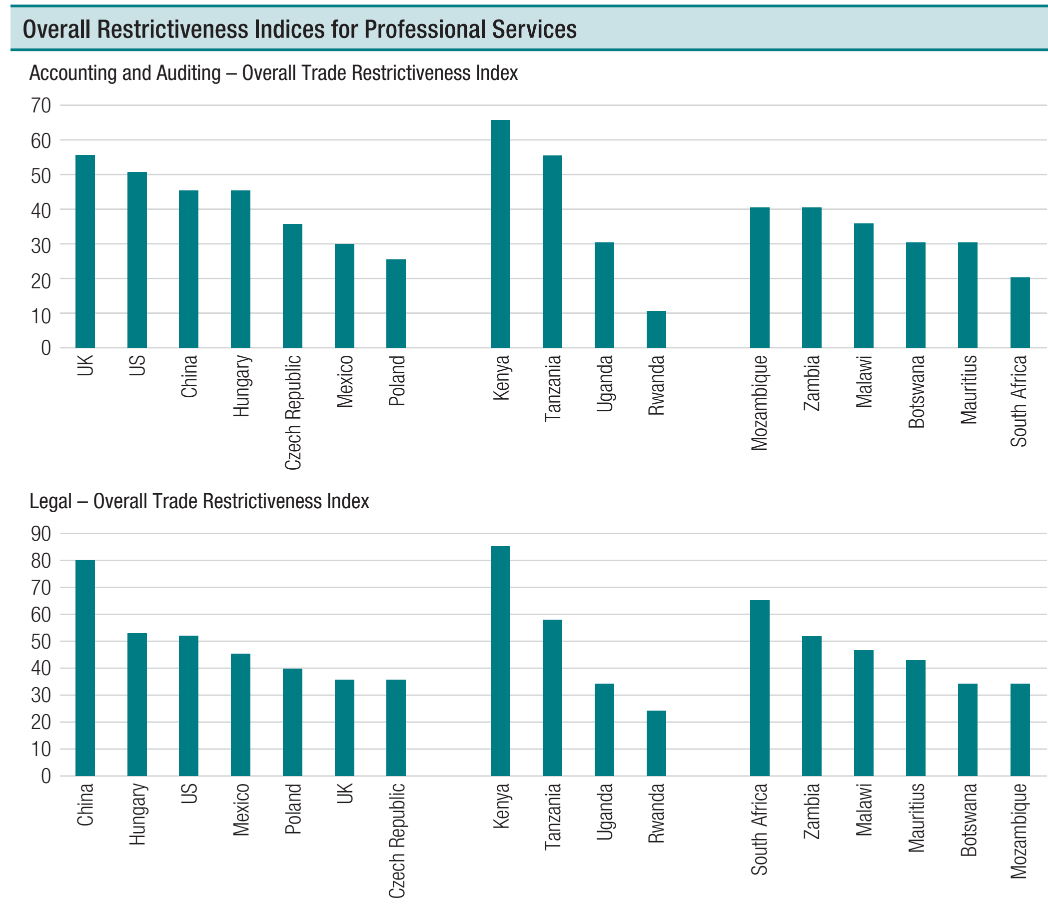
Several professional services in Eastern and Southern Africa are subject to advertising prohibitions: accounting in Botswana, Kenya, Tanzania and Uganda; legal in Botswana, Kenya, Malawi, Mozambique, Rwanda, Tanzania, Uganda, and Zambia; and engineering in Tanzania and Zambia. In general, African countries impose more severe regulations on advertising than most developed and developing countries. Restrictions on business structure are present in all professional services in most African countries. These regulations restrict the ownership structure of professional services companies, the scope for collaboration within the profession and with other professions, and the opening of branches, franchises, or chains. For example, these regulations might prevent lawyers and accountants from providing integrated legal and accountancy advice for tax issues.

Explaining the Segmentation of Markets for Professional Services – Trade Barriers and Restrictive Immigration Policies

Trade barriers limit competition and the efficiency of professional service providers in Eastern and Southern Africa. Trade in legal services tends to be more heavily regulated and restricted than trade in accounting/auditing services in Africa and elsewhere. Kenya, South Africa, Tanzania and Zambia are characterized by more severe restrictions on trade in legal services than most countries in the sample. In contrast, South Africa and Rwanda have some of the least restrictive trade policies in accounting/auditing services (Figure 13.2).

Figure 13.2 >

Overall Restrictiveness Indices for Professional Services



Source: Gootiiz and Mattoo (2009). Note: a larger index value indicates a more restrictive trade policy.

The establishment of foreign law firms (mode 3 of trade in services in GATS) tends to be substantially more difficult than that of foreign accounting/auditing firms in Africa, but also elsewhere in the world. Nevertheless, a few of the examined African countries—Botswana, Mozambique, Rwanda, and Uganda—exhibit the most open markets to the presence of foreign law firms across a large worldwide sample of countries. However, the entry of foreign law firms is prohibited in South Africa while ownership by non-locally-licensed professionals is prohibited in Zambia and limited in Mozambique. In Mauritius entry is allowed only if the foreign law firm sets up a joint venture with a local firm, while in Malawi branches are not allowed. Local members of international networks face restrictions on using the network's brand name or the foreign parent's name in Botswana, Kenya, Tanzania, and Uganda.

In accounting and auditing, the establishment of foreign firms is permitted in all African countries but with restrictions. Malawi, Rwanda, and Uganda have lower restrictions than those in many OECD countries. Kenya, Tanzania, Malawi, Mauritius, Mozambique, and Zambia prohibit ownership or control by non-locally licensed professionals. In Kenya, Uganda, and even the more liberal Rwanda, branches of foreign firms are prohibited. In Tanzania, ownership by foreign nationals is limited to 50 percent. Botswana and Tanzania impose restrictions on the use of the foreign parent firm name.

The movement of natural persons (mode 4 of trade in services in GATS) is substantially more restricted for legal professionals than for accounting/auditing professionals in Kenya, Tanzania, South Africa, Malawi, and Zambia. Those countries impose some of the most restrictive barriers to the practice of foreign lawyers in their jurisdictions, only equaled by the barriers imposed by China. In Kenya, Tanzania, Malawi, Mauritius, Mozambique, and South Africa, de jure or de facto nationality requirements to practice domestic law exclude participation by foreign professionals.

The entry of foreign accountants and auditors is less restricted across African countries. In fact, Mauritius and Rwanda exhibit the most liberal trade policies towards the movement of foreign accountants among all countries. Except for Mauritius, all African countries impose discretionary limits on the presence of foreign accounting professionals. Entry conditions through mode 3 and mode 4 are much more liberal for engineering. The establishment of foreign engineering firms is not prohibited in any African country and the form of entry is not restricted.

In terms of immigration policies, Eastern and Southern African countries apply stringent regulations to the movement of skilled workers into and out from their borders. In South Africa, the difficulties in obtaining work permits lead many international firms to set up partnerships with local firms instead of setting up commercial presence in the country. The immigration law of 2007 in Mozambique is very restrictive and makes hiring foreign workers extremely difficult.

Reforming Markets for Professional Services in Eastern and Southern Africa

Given all of the preceding information, the national markets for professionals and professional services in most Eastern and Southern African countries remain generally underdeveloped with performance indicators below the averages of countries at a similar level of development. Also, the regional markets for professional services and professional education in sub-Saharan Africa are fragmented by restrictive policies, such as nationality requirements and regulatory heterogeneity, relating to licensing, qualification, and educational requirements. Strict domestic regulations combined with a lack of regional coordination among countries further constrain foreign investment and hinder economic growth and development in the region. These outcomes are the result of constraints that suggest policy action in the following areas: education, regulation of professional services, trade policy, and labor mobility. While policy action at the national level will differ from country to country given diverse conditions and outcomes in the examined countries, international and regional cooperation would complement domestic policy reform. Trade liberalization and regional integration are mechanisms that can be used to reduce the scope for private-interest regulation, enhance competition, and deal with labor mobility issues that are crucial in professional services.

Reforms at the National Level

Reforms at the national level need to focus on the development of framework conditions that address skills shortages and skills mismatches and that attempt to facilitate the growth of professional services in the various African countries.

Education reforms need to focus on the following issues:

- Financial constraints prevent individuals from acquiring a professional education, so *developing new and expanded means of financing higher education* (such as student loans schemes) is a priority.
- Weaknesses in African educational systems mean that students are poorly equipped to acquire professional skills, so *enhancing the quality and capacity of schools (especially in mathematics, sciences, and technical studies)* needs to be a key item on all countries' policy agendas.
- Given the capacity constraints and quality limitations of professional education institutions, *improving existing institutions and encouraging the creation of new ones is necessary*.
- Policy action to *encourage closer collaboration and consultation between employers, professional associations, and education institutions* could help professionals acquire job-market relevant skills and crucial practical training.

Reforms need to focus on incremental, qualitative improvements in domestic regulation:

- *Disproportionate cumulative entry requirements need to be relaxed.* The argument in favor of exclusive rights is that they can lead to increased specialization of professionals and guarantee a higher quality of service. But the negative price and allocation effects of exclusive rights, which act as monopolies, can be substantial, especially if they are granted for standardized services that can be provided at a lower cost by less-regulated or non-regulated providers. For example, narrowing the scope of exclusive tasks in certain professions would contribute to this goal. Exclusive rights can lead to increased specialization of professionals and guarantee a higher quality of service, but if they create monopolies they can have adverse price and allocation effects, especially when granted for services for which adequate quality can be provided at a lower cost by less-regulated middle-level professionals.
- Disproportionate restrictions that limit competition need to be eliminated:
  - Price regulations are supported and introduced by professional associations who claim that they are useful tools to prevent adverse selection problems. But such regulatory instruments can seriously harm competition by eliminating or reducing the benefits that competitive markets deliver for consumers. Countries need to adopt less restrictive mechanisms such as better access to information on services and services providers to accomplish the same goals at lower economic cost.
  - Countries impose restrictions on the ownership structure of professional services firms; the scope of collaboration within the profession and with other professions; and, in some cases, the opening of branches, franchises, or chains. To justify these regulations, professional associations argue that professionals are more likely to give independent advice if certain forms of intra-professional partnerships are prohibited, while restrictions on multidisciplinary activities prevent potential conflicts of interests that are detrimental to consumers. But often such regulations are clearly anticompetitive and may harm consumers by preventing providers from developing new services or cost-efficient business models, and need to be eliminated. In general, restrictions on collaboration between members of the same profession seem to be less justifiable

than restrictions on collaboration between members of different professions where there is a strong need to protect the independence and liability of professionals.

- Most examined African countries impose advertising prohibitions on many of their professional services sectors. Professional associations justify advertising restrictions by the need to protect consumers. But there is no justification for prohibiting advertising that is relevant, truthful, and not misleading. Instead, advertising fosters competition by informing consumers about different products and allowing them to make better- informed buying decisions. Countries need to allow advertising of professional services that facilitates competition by informing consumers about different products and that can be used as a competitive tool for new firms entering the market.

Reforms at the International Level

The fragmentation of regional markets for professional services and professional education by restrictive policies and regulatory heterogeneity prevents countries from taking advantage of gains from trade based on comparative advantage, as well as gains from enhanced competition and economies of scale.

The potential benefits from regional integration in Eastern and Southern Africa are considerable:

- The differences in national endowments of professionals and in the capacity for professional training, reflected in differences in professionals' earnings and the costs of training across countries, suggest that there is substantive scope for trade based on comparative advantage and potentially large gains from eliminating trade impediments.
- Deeper regional integration would enhance competition between service providers, allow providers to exploit economies of scale, especially in professional education, produce a wider variety of services, and increase the prospects for attracting domestic and foreign investment.
- Regionalization may make it possible to reap scale economies in regulation and supervision, particularly where national regulatory agencies face skill constraints; it could also reduce scope for capture of national regulation by private sector interests.

Policy action is called for in the following key areas.

Steps need to be taken to relax the explicit trade barriers applied by African countries to the movement of natural persons and the commercial presence of professional services. Despite compelling benefits from liberalization, policy makers often maintain protective measures at a cost to productivity. Regulatory capture and the complexities associated with the coordination of liberalization with regulatory reform are among the main explanatory factors for the high level of protection in professional services. Examples of possible reforms in the trade policy area are: articulating the economic and social motivation for nationality and residency requirements; developing transparent criteria and procedures for applying any quantitative restrictions on the movement of professionals, such as economic needs tests; minimizing restrictions on the forms of establishment allowed; and developing a transparent and consistent framework for accepting professionals with foreign qualifications.

The reduction of explicit trade barriers needs to be complemented with the reform of immigration laws.

Trade liberalization needs to be coordinated with regulatory reform and cooperation at the regional level. Trade barriers ideally would be liberalized on a most-favored-nation or non-preferential basis because that would generate the largest welfare gains. But such liberalization may not be technically feasible or politically acceptable, especially when impediments arise from differences in regulatory requirements. Deeper regional integration through regulatory cooperation with neighboring partners who have similar regulatory preferences can usefully complement non-preferential trade liberalization.

Regulatory cooperation to overcome regulatory heterogeneity under the aegis of the Tripartite arrangement between the East African Community (EAC), the Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) would be particularly useful in the following areas:

Mutual recognition of professional qualifications and licensing: The model adopted by East Africa could be followed by Southern African countries. The five East African countries have taken the first steps towards mutual recognition in professional services in the context of the EAC Common Market negotiations. The Common Market Protocol, adopted by the Multi Sector Council in 2009, includes an annex on a framework agreement on mutual recognition (MRA) of academic and professional qualifications. The implementation of a full-fledged MRA would need to cover areas such as education, examinations, experience, conduct and ethics, professional development and re-certification, scope of practice, and local knowledge. If African countries adopted common criteria for professional qualifications or recognized the qualifications and licenses obtained in other African countries, significant efficiency gains would be obtained.[50] The EAC MRAs could be useful models to be followed by other African subregions.

Developing appropriate standards: Inappropriate standards can stifle demand for services. While uniformity of standards may improve the quality, completeness, and comparability of the reported information, and international standards remain appropriate in specific cases, applying common international standards to large firms and SMEs can prevent smaller firms from using auditing and accounting services. A single standard may be appropriate if there is little demand for service variety and there is no anticompetitive risk from having a single standard. However, if the market requires variety to satisfy different types of users, then a single standard may not be appropriate. The development of an appropriate standard may be desirable at a regional rather than national level in order to exploit economies of scale in regulatory expertise, prevent fragmentation of the market by differences in standards, and limit the scope for regulatory capture.

Removal of restrictions to free movement of labor: Regional cooperation in removing restrictions on the free movement of labor (including visa and immigration laws) is crucial for Africa. The mobility of businesspeople is a key factor in the promotion of free and open trade. While the EAC and the SADC have tried to regulate labor mobility, so far none of the

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53 Kox et al. (2004) estimate that the stock of FDI in the European Union could increase by 20–35 percent if regulatory heterogeneity across countries was reduced as a result of a common services regulation directive.

groupings has adopted a regional labor mobility agreement, mostly due to disagreements among national governments. The experience of the EU or the APEC Business Mobility Group that have made considerable progress in this area could provide practical guidance for the implementation of commitments related to the free movement of labor and harmonization of immigration policies in Africa.

Financing higher education and improving professional education institutions: Regional cooperation in terms of sharing information and experiences to increase the recovery rate of loans while increasing students' access to higher education could improve the impact of student loan schemes in Africa. The recent partnership between the Kenya Higher Education Loan Board, the Tanzania Higher Education Students Loans Board, and the Students Finance Agency for Rwanda under the aegis of the African Higher Education Financing Agencies to tackle students' loan schemes regionally is a useful example from East Africa that could be followed by Southern Africa.

The absence of institutions that offer specialized (post-graduate) courses (e.g., in legal and engineering services) was noted in many African countries, as was the absence of institutions offering academic and professional training courses for middle-level professionals. Where the market of a given country (e.g., Malawi, Mozambique, Rwanda) is too small to justify the creation of these missing institutions or courses, policies to facilitate access to foreign training are needed—including portability of course credits and scholarships. The system of credits in higher education to be implemented within SADC is a right step in this direction.

Also, specialized courses for which a need was expressed in Eastern and Southern Africa (e.g., legal courses focusing on e-commerce, technology transfer, etc.) could be designed and implemented at the regional level. In general, the fragmentation of the regional market for education by differences in regulation can prevent the emergence of regional hubs for higher education; so smoothing these regulatory differences can lead to a greater variety of higher education services becoming available at lower costs for students in sub-Saharan Africa. Regional institutions that are allowed to operate at the regional level and are accredited to deliver courses that are recognized by all countries could exploit economies of scale and recoup the large fixed costs of establishing training programs in order to produce students with the necessary specializations for the EAC and SADC regions. South Africa has the highest potential to become a regional hub for higher and professional education.

While the economic benefits from regional integration are evident, the pace of integration is largely dependent upon the members' political motivation and conviction that such liberalization is beneficial to their domestic constituencies. To improve such prospects, the promotion of more frequent and open dialogue between the key stakeholders involved in professional services—professional bodies, private sector providers and users of services, higher education institutions, trade negotiators—is essential. The Eastern and Southern African countries have committed themselves (at least on paper) to pursue regional integration in the context of the EAC, SADC and COMESA. While recognizing that there is a varying degree of political will and commitment among the Eastern and Southern African countries, the information provided in this chapter serves as a pointer towards more informed choices as countries contemplate reform and regional integration in professional services sectors. Countries wishing to reform and integrate their

professional services markets can be supported through aid for trade and knowledge platform projects.

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14. Scaling up Regional Financial Integration in the EAC

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Introduction

Regional Financial Integration (RFI) in sub-Saharan Africa (SSA) has usually taken two different, though not mutually exclusive, paths. For some regional economic communities (RECs), institutional initiatives including, a common currency, an overarching regulatory authority, and supranational financial markets, are the building blocks of regionalization in financial markets. This applies to West and Central Africa where the two CFA franc zones, regional central banks (BCEAO and BEAC), and a regional stock exchange (the BRVM in the WAEMU) are the cornerstones of regionalization. For other RECs, integration is a more market driven process, following the movement of people, businesses, and goods across fluid borders. South African and Kenyan banks have led this model of integration in the southern and eastern parts of SSA. Of course, this distinction serves only to highlight the more visible drivers of integration rather than suggesting that market forces are at standstill in the WAEMU and CEMAC regions, or that institutional arrangements are irrelevant in the SADC or EAC regions. WAEMU has a growing regional bond market and the recent signing of the Common Market Protocol in the EAC in 2009 is a significant institutional step forward in the regionalization process.

In the East African Community (EAC) commercial banks have generally been ahead of the curve in assessing the potential of the regional financial market. Several banks have to some degree adopted a regional business model motivated by a range of factors including client-demand, their own corporate structures, or by opportunities perceived along the regional trade corridors. These banks display a fair degree of operational integration not just within EAC markets but also all the way along the trade corridors to southern Sudan and the eastern Democratic Republic of Congo (DRC).

Institutional initiatives are perhaps more significant for the development of the non-banking financial sector and capital markets in the EAC. With the exception of motor insurance, insurance products in the region generally have very low penetration rates. Weak regulatory frameworks for the insurance sector and low incomes have hindered the development of markets in all EAC countries, with penetration rates being especially low for life insurance

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products. Capital markets are also widely disparate in size, investor base, infrastructure, and regulatory and supervisory capacity. Highly publicized initial public offerings (IPOs) have, in the recent past, been enthusiastically received by the public and institutions within the EAC, even where the rules on intra-EAC cross-border investment have not been clear. Despite this, cross-listings and cross-border investments are still in their infancy, and several *de facto* hurdles remain for businesses wishing to raise capital on a regional basis.

Extending the EAC to include Burundi and Rwanda in 2007 has greatly added to the diversity of the membership. The three founding members of the EAC have a long history of trade and administrative cooperation (stretching back nearly a century), and as a result of their colonial history have all inherited legal systems based on English common law. Both Rwanda and Burundi are former Belgian colonies and as a result follow the civil law tradition.

This note focuses on two aspects of scaling-up trade in financial services within the EAC:

- Documenting and building on financial integration in the EAC as it is actually taking shape on the ground; and,
- Elaborating on the challenges specific to the further integration of Burundi and Rwanda

The note concludes by discussing a new capacity building initiative that the World Bank is implementing with the EAC Secretariat to support the deepening of financial integration in east Africa.

Cross-Border Financial Linkages in the EAC

Banking Sector

Kenya-based banks are leading regional integration in the EAC banking sector. About 11 multinational and Kenyan owned banks use Kenya as a hub to expand their operations into the EAC region.

There are four indigenous Kenyan banks with branches within the region. These banks include Kenya Commercial Bank (KCB), Equity Bank, Fina Bank, and Commercial Bank of Africa. These banks have a total of 63 branches outside Kenya (16 in Tanzania, 31 in Uganda and 16 in Rwanda). Ugandan and Tanzanian banks do not have a regional presence and operate exclusively in their home markets:

- Since 2006 KCB has been expanding extensively in the EAC region. It has 164 branches in Kenya, and 36 branches in other countries in East Africa—Tanzania (10), Uganda (11), Rwanda (nine) and Southern Sudan (six). KCB's Tanzanian operation is the oldest of its regional subsidiaries having been established in 1997;
- In March 2009, Commercial Bank of Africa merged with First American Bank, the latter had a Tanzanian subsidiary, United Bank of Africa (the bank has since been renamed Commercial Bank of Africa – Tanzania);
- Fina Bank began its regional expansion into Rwanda in 2004 and has recently entered Uganda in 2009 with five branches already established. The bank now has a total of 11 branches regionally; and,
- In 2009 Equity bank completed the acquisition of Uganda Microfinance in a deal worth US$26.9 million. The microfinance institution had over 45 field offices and branches. Equity Bank Uganda currently operates 15 branches.

A survey conducted to gauge the operational integration of banks operating in the EAC revealed that 56 percent of the banks interviewed have their operations in the East African region hubbed, mostly in Kenya. Most of the banks surveyed have yet to achieve full integration of their operations in the region, but partial integration has taken place in the areas of ICT, risk management, customer service, and treasury operations. A few banks have not significantly integrated their operations, with most of their operations carried out at the individual country level.

Table 14.1 > Regionalized Banking Operations in the EAC

	2009				
Bank	Burundi	Kenya	Rwanda	Tanzania	Uganda
Barclays (UK)					
Bank of Africa (Mali)					
Citigroup (USA)					
Diamond Trust (Kenya)					
Ecobank (Togo)					
Equity (Kenya)					
Fina (Kenya)					
Kenya Commercial (Kenya)					
Standard/Stanbic (South Africa)					

Source: Various bank websites.

For the purposes of this report it is especially significant that two-thirds of the banks state that regionalization has facilitated the introduction of financial products and services that would not have been possible in the absence of scale. Establishment of a single licensing regime (which would remove barriers to entry posed by separate capitalization requirements for each subsidiary and enable cross-border branching) is favored by a majority of the banks as a measure that would promote integration.

The major impediments to attaining full integration cited by banks are: the lack of a common tax regime; resistance from bank supervisors (particularly in Tanzania and Uganda, who are averse to banks under their jurisdiction being managed by Kenyan parents); IT connectivity problems (caused by weak physical infrastructure); differing regulatory requirements; restrictions on the mobility of labor; and, the existence of differing capital movement polices within the EAC.

Non-Banking Financial Sector

There are indigenous Kenyan insurance companies with branches within the region. These include: APA Insurance, Insurance Company of East Africa, (ICEA), Jubilee Insurance, Phoenix of East Africa, Real Insurance, and UAP Insurance. The estimated number of Kenyan insurance company branches within the region is about 30. There are no Tanzanian or Ugandan insurance companies with a regional presence. Similarly, several Kenyan stock brokerage firms have subsidiaries within the EAC region. These include, Dyer and Blair Investment Bank (Uganda and Rwanda), Faida Securities (Rwanda), and Kingdom Securities (Rwanda). Each of these stockbrokers has only one branch in the regional countries they operate in.

The integration of the EAC stock exchanges is planned to take place in 2012. The first move to integrate the exchanges was to develop common automated trading and clearing platforms. This adoption is currently underway, with Uganda adopting the same automated trading system (ATS) that is used by Kenya, and Tanzania and Rwanda expected to follow suit (Burundi does not yet have a stock exchange).

Prior to implementation of a common trading platform, cross-listing of shares in the EAC is already occurring and has increased private capital flows within the region. The total market capitalization for cross listed shares in the EAC region stands at about US$2.88 billion with 99.84 percent being taken up by the Nairobi Stock Exchange (NSE) while 0.16 percent is shared between Dar-es-Salaam Stock Exchange (DSE) and the Uganda Stock Exchange (USE). All companies that are cross-listed and traded regionally are from Kenya. To date there have been no cross-listings of companies based in other EAC countries. Kenya defines a local investor as an EAC citizen and allows foreign participation of up to 75 percent. Tanzania allows foreign participation of up to 60 percent of shares in primary or secondary issues. There are no restrictions in Uganda or Rwanda.

Unlike Kenya, Tanzania does not allow foreign participation in IPOs. Rwanda and Uganda require citizens to seek approval from their central bank to buy foreign IPOs. Sale or issue of shares by foreigners is not restricted in Kenya, Uganda, and Tanzania but Rwanda requires central bank approval. There are no restrictions for foreigners to buy debt instruments in Kenya, Uganda, Rwanda, and Burundi. Tanzania however restricts purchase of government bonds but allows foreign participation for corporate debt instruments.

Institutional investors, national pension funds, fund management firms, and insurance companies usually dominate participation in EAC stock and bond markets. Information provided by Kenyan investment banks suggest that the participation of Kenyan investors in other EAC markets is about 10 percent, whereas that of Uganda investors in other EAC markets is between two and five percent, and of Tanzania a maximum of 0.5 percent. Due to the lack of restrictions on capital flows from Kenya, a greater number of its retail investors participate in EAC markets; this contrasts to Tanzania and Uganda where mainly institutional investors participate. Indeed, in 2008 citizens from all EAC countries were able to participate in the Kenyan IPO of Safaricom with the same status as Kenyan local investors. EAC citizens were allowed to take up 40 percent allotment for local investors and pay five percent withholding tax on dividend income as opposed to the 10 percent that foreign investors are required to pay.

Path to Deeper Regional Financial Integration

Several factors have come together to propel the regionalization of financial markets in the EAC. The signing of the Common Market Protocol and the initiatives of the private sector banks together create a favorable climate for further integration, especially between the three original members of the EAC (issues pertaining to the integration of Rwanda and Burundi are dealt with separately in the following section). However, several factors still constrain the growth and integration of the regional market. At the same time there is reason to stay alert to the risks that come with increasing cross-border financial links. Thus, the path forward should involve taking steps that on the one hand facilitate the movement of funds between EAC members, and on the other ensure a more careful oversight of the volumes and consequences of these flows:

Harmonization of legal and regulatory frameworks: The banks surveyed cited differential tax regimes and other regulatory discrepancies as a major hindrance to further integration. Further work needs to be done to align regulatory and supervisory frameworks and reporting requirements to address this issue.

Adopting single licensing regime: Banks surveyed during in the preparation of this report cite single licensing as an important aid to further integration. If introduced for banks, single licensing should also be extended to other market participants such as brokers and insurance companies in order to significantly reduce cross-border transaction times and costs and barriers to entry.

Mutual recognition among regulators: Adopting single-licensing will have to be accompanied by mutual recognition among regulators and this will require that national regulators converge around some broadly defined international principles such as the Basle core principles for bank supervision, the International Organization of Securities Commissions (IOSCO), and others.

Building-up regionally compatible financial infrastructure: Kenya, Tanzania, and Uganda have already made substantial progress in integrating their real time gross settlement systems (RTGS). Rwanda and Burundi also need to align their payments systems with the regional system. Similarly, it is necessary to ensure that other parts of national financial infrastructures, including central securities depositories (CSDs) and trading platforms for national exchanges, are compatible at the regional level.

Strengthening cross-border supervisory practices: Deepening links between financial institutions warrants a similar deepening of cooperation between supervisors. As indicated by surveyed banks, instances of scrutiny by supervisors in other countries are rare. Home-host supervisory communication and consolidated supervisions are important to ensuring that weaknesses in one financial institution/market do not put the regional financial system at risk.

Strengthening data gathering: Information on current volumes of cross-border trade in financial products is generally sketchy and incomplete. This data gap is problematic, not just because policymakers are working with limited information on the issues and opportunities that lie ahead, but also since it also masks the benefits and costs of further integration by obscuring the extent of cross-border linkages. Porous borders, high volumes of unrecorded informal trade, and the widespread use of physical cash in transactions further compound these issues. There is ample scope to build additional capacity on this front both at the national level and at the EAC Secretariat.

Integrating Burundi and Rwanda

The financial sectors in both Burundi and Rwanda are at a lower level of development than those in other EAC countries—in Burundi, the financial sector consists of seven banks, of which three are commercial banks, with four very small insurance companies; in Rwanda, the 12 banks operating also dominate the financial sector, but with a more developed insurance sector compared to Burundi. Overall, the financial sector in Rwanda is larger, offers a broader range of financial services and products, and is developing faster than Burundi's. The degree of cross-border banking sector integration with the rest of the EAC is also higher in Rwanda than in Burundi, with three EAC-headquartered banks operating in Rwanda versus one in Burundi.

The integration of Burundi and Rwanda into the EAC's financial system brings the problems posed by small scale into sharp relief. Of the two countries, the awareness of the need to achieve scale to support high quality regulation and supervision, to support capital markets development, and to build physical infrastructure such as payments and settlement systems, is clearly most advanced in Rwanda. Burundi still lacks a coherent vision of how its financial system will be integrated with the EAC and as a consequence needs to do much work to formulate a strategic vision and move forward with implementing its strategy. The alternative is to see the direction and development of the financial system largely passed to institutions in other EAC countries.

Unlike communities such as the European Union, the EAC has worked on a post-membership convergence principle, with countries joining and then seeking to harmonize their laws and regulations for the financial sector with other member states. One consequence of this approach is that parts of the financial sector may be exposed to cross-border activity and competition before the regulatory and supervisory frameworks are in place (as in the Rwanda and Burundi insurance sectors), another is that financial institutions may enter from larger markets with a degree of sophistication greater than that of the host regulator, posing a risk that supervision will be inadequate. As a result, countries—such as Burundi and Rwanda—may be called upon to build capacity on a "crash basis." These circumstances in turn may require a greater willingness to seek capacity-building solutions which may require some willingness to surrender a degree of sovereignty in order to gain the benefits of scale: as discussed above, both Burundi and Rwanda could benefit from forming joint regulatory institutions.

Going Forward

The following are key steps towards integrating Rwanda and especially Burundi into the emerging EAC financial system:

Develop an EAC Integration Strategy for the Burundi Financial Sector. Burundi needs assistance in developing a coherent strategy for integrating the financial sector with the EAC. This assistance should focus critically on assessments of: (1) the financing needs of the real sector, including manufacturing, housing, agriculture, and trans-shipment trade, (2) the capacity of the financial sector as presently constituted to meet financing needs and identification of capital shortfalls and financial products needed, (3) government strategy towards inward investment in the financial sector and an associated licensing policy for foreign entrants from within the sub-region.

Support to Accelerate Burundi's Convergence with EAC Financial Sector Law. Given the work already done in Rwanda to prepare EAC-convergent laws and regulations for the financial sector, it would make sense—given the common legal heritage of the two countries—for Burundi to use these laws (on banking, payments, collective investment schemes, and capital markets functions) as models for its own reforms. Technical assistance could therefore be provided to draft new laws and regulations for Burundi using the Rwandan models.

Financing for Supervisory Development. For both Burundi and Rwanda flexible technical assistance credits could be created to deliver capacity building support on a flexible basis,

using a framework contract. This would allow the regulators in both countries—over a period of three to four years—to draw technical assistance and finance equipment and software on an *ad hoc* basis.

Financing for Burundi's Payments System. As discussed above, the Burundi authorities see the logic of purchasing a payments system that is fully compatible with that procured by Rwanda. The Rwandan authorities have already absorbed a substantial cost in preparing the specifications for a new system, and financial support could be given to Burundi to "piggyback" on the Rwandan procurement. This might also enable the costs of the Rwandan procurement to be reduced by increasing the total size of the hardware, software, and services contract(s) by the addition of duplicated systems for Burundi

The EAC Financial Sector Development and Regionalization Project

Drawing extensively on this analysis and in response to strong interest expressed by the EAC, the World Bank is implementing the Financial Sector Development Regionalization Project I (FSDRP I), which comprises a three-year US$16 million regional technical assistance grant to the EAC to support the move towards a single market in financial services. The project development objective of FSDRP I is to establish the foundation for financial sector integration among EAC Partner States. FSDRP I consists of six components as follows:

Component 1: Financial Inclusion and Strengthening Market Participants will leverage the establishment of a single market and the benefits of scale associated with regionalization to make a broader range of formal financial services/products available to a more diversified client profile, including those that are currently unserved.

Component 2: Harmonization of Financial Laws and Regulations will move towards legal and regulatory harmonization in banking and accounting, securities markets, insurance, pensions, investment funds critical to achieve an effective functioning of a single market in financial services via EAC Acts.

Component 3: Mutual Recognition of Supervisory Agencies will support the establishment of a system in which a financial institution or market intermediary licensed by the supervisory authority in one Partner State will be allowed to operate in all Partner States upon simple notification to the supervisory authority of the host State.

Component 4: Integration of Financial Market Infrastructure will support the establishment of an efficient market infrastructure, compatible at the regional level.

Component 5: Development of the Regional Bond Market will support the development of the Government bond market in each Partner State, to ensure bond issuers in individual EAC Partner States having access to a deeper pool of liquidity in a single market.

Component 6: Capacity Building will strengthen capacity at both the regional and the national level to ensure that the integrated market functions effectively and that all economic

agents in the regional area aware of and able to realize the benefits from the process of integration.

FSDRP I is envisaged as part of a broader program of continued engagement with the EAC the higher-level objective of which is to support the broadening and deepening of the financial sector through the establishment of a single market in financial services among EAC Partner States, with a view to making a wide range of financial products and services available to all, at competitive prices. This higher-level objective will be achieved through two back-to-back Projects over a nine-year period. Financial Sector Development and Regionalization Project I (FSDRPI) will span 2011 to 2014, and FSDRP II will span 2014 to 2019.

15. Increasing Trade in Banking and Insurance Services in the West Africa Monetary Zone

Thilasoni Benjamin Musuku, Patrick Elat, Andrew Lovegrove, and Oliver Reichert[52]

Introduction

The West African Monetary Zone (WAMZ) was established in 2000 with the objectives of securing monetary union between the five member states (The Gambia, Ghana, Guinea, Nigeria, and Sierra Leone); establishing a regional central bank; establishing a single financial services supervisor; and, developing a common market for goods and services. The development of a monetary union and, also, the willingness of member states to facilitate progress towards a common market in financial services by harmonizing legal and regulatory frameworks, are clearly hampered by the heterogeneous nature of WAMZ. For example, the WAMZ banking market is dominated by Ghana and Nigeria with the combined banking systems of The Gambia, Guinea, and Sierra Leone amounting to only 0.37 percent of WAMZ's total banking assets, 0.45 percent of WAMZ's total deposits and short term funding, and 0.29 percent of WAMZ's total loans.

Some progress has been made towards preparing the basic architecture for financial sector integration in West Africa: first, the West Africa Monetary Institute (WAMI) was established as the precursor to the West African central bank (WACB) and serves as a secretariat for WAMZ's governing bodies and an advocate for integration; second, WAMI has prepared common statutes covering banking and non-bank financial sector regulation; third, the statutes for WACB have been adopted; fourth, a framework for a region-wide payments system has been prepared; and, lastly, in September 2008, financing was secured (from the African Development Bank) for implementation of potentially interoperable new payments systems in Guinea, Liberia, and Sierra Leone. Nevertheless, WAMZ has made little practical progress towards integration as a result of the unwillingness or inability of its member states both to ratify and pass enabling legislation required to implement

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WAMZ decisions or to meet the convergence criteria established as the prerequisite for monetary union.

This chapter identifies a limited number of "quick wins" for integration of the banking and insurance sectors in WAMZ which could be used as confidence building successes from which to build momentum for further integration-centered reforms as well as an agenda for medium-term progress in integration of the sector. The driver for the report's recommendations is ideas raised by private sector financial institutions in WAMZ.

Opportunities for Increasing Cross-border Trade in the Banking Sector

The transformation of the banking sector within WAMZ is being driven by three main factors: (1) liberalization of cross-border banking activities, primarily in the form of the willingness of member states to permit the establishment of subsidiaries of banks domiciled in other African states; (2) a dramatic increase in the capitalization of Nigerian banks (reinforced by increases in the minimum capital of Ghanaian banks) which has encouraged these banks to seek additional markets within West Africa; and, (3) the growth of pan-African banking groups (such as Ecobank and United Bank of Africa) which have moved quickly to establish subsidiaries in countries across West Africa and the rest of the continent.

Cross-border expansion of banks is driven by the direction of trade—for example, Ghanaian banks planning to expand into Niger (following Ghana's trans-shipment trade from the coast to the interior)—or by the perception of market opportunities and the need to service corporate clients expanding abroad, as in the case of Nigerian banks expanding into Ghana.

The size differential among the respective banking markets suggests that either:

- The path to integration of banking systems will have to be driven very much on Nigeria's terms, albeit mitigated by Nigeria's desire (strongly expressed in its Financial Sector Strategy 2020) to conform to global standards for banking regulation, supervision, and financial reporting and to comply with Basle core principles. Given that all other WAMZ countries share the same objectives, eventual harmonization around these same principles should be assured; or,
- A "compromise" where the smaller countries seek to avoid a more or less complete takeover by Nigerian and other multinational banks of their banking systems by harmonizing with each other and maintaining some barriers to entry to protect domestic "champions." Taking the second of these courses (if it is even possible, given that Nigerian and multinational banks are already established in all markets) would deprive the smaller countries—perhaps with the exception of Ghana—of access to Nigeria's large capital resources, advanced banking technology, and the benefits that the application of scale could bring in terms of system development and increased access to finance.

Obstacles to Securing the Benefits of Regionalization of the Banking Sector

The benefits of regionalization of the banking sector come from: (a) greater competition in banking markets leading to the increased availability of banking services and lower prices; (b) increased scale allowing a reduction of risk in the banking sector as a

result of the increased ability to diversify both geographically and across sectors and; (c) increased innovation, resulting both from cross-border transfers of technology and increased competition, and from the availability of the economies scale required to support mass market banking products.

However, there are a number of specific problems which are reducing the benefits of regionalization including: (1) the lack of a functioning official cross-border payments system for WAMZ and no direct link to the UEMOA payments system; (2) continued wide disparities in the bank regulatory framework between WAMZ countries; and, (3) a lack of cross-border credit information flow and a corresponding lack of a legal framework for data protection:

Payments Systems Problems: The long term solution to the high cost of cross-border payments within WAMZ (and also between WAMZ countries and UEMOA states) lies in the creation of a single payments system for WAMZ linked to the UEMOA payments system already in place. The primary cause of delays in building the WAMZ payments system has been an inability to reach agreement on how settlements would be guaranteed in the period before the WACB is formed. Despite ongoing discussions, it seems unlikely that this obstacle can be overcome in the short term. In the absence of an official WAMZ payments system, both traditional and parallel systems continue to operate:

- Payments continue to be routed for settlement via correspondent banks in Western financial capitals.
- For small payments in cross-border trade and between individuals, cash is still extensively utilized.

Increasingly, banks with cross-border operations are operating an internal settlement system. Pending agreement between the WAMZ member states to establish a single payments system, opportunities may exist to develop an interim solution based on the intra-bank net settlement process for cross-border transactions, which has been implemented by banks where the counterparties for payments are both customers of the same bank.

Discussions with banks indicated that there is considerable confusion as to whether or not a net settlement system would be possible due to foreign exchange controls, and some banks stated that existing intra-bank net settlements are also prohibited, whereas the banks performing intra-bank net settlements insisted that the settlements are permitted. The completely open operation of cross-border ATM and debit transactions (using Ecobank's ATM network and VISA) suggests —but not conclusively—that cross-border intra-bank net settlement is allowable. Given this regulatory uncertainty, the banks strongly suggested that this idea be carried forward with participation of the regulators in a pair of pilot countries (Ghana and Nigeria).

Developing a cross-border payments system also requires work to develop uniform regulations and anti-money laundering surveillance mechanisms for cross-border payments through mobile telephone companies. An important feature of this system would be to promote competition between the mobile telephone companies by facilitating mobile payments from one mobile network operator to another.

Lack of a Harmonized Bank Regulatory Framework: The absence of uniform accounting standards, regulatory reporting requirements and minimum capital adequacy requirements

presents yet another challenge to securing regionalization of the banking sector. Progress towards the objective of harmonizing accounting standards has been uneven—countries within WAMZ all have the long-term intention to harmonize their accounting standards with International Financial Reporting Standards (IFRS).

Bank regulations and supervisory practices are not uniform across the region, thereby increasing costs and impeding the supervisor's ability to assess the risks posed by a subsidiary or parent of a bank that they supervise. A number of initiatives could be undertaken to reduce regulatory costs and prepare for harmonized statutes such as standardization of reporting requirements. A detailed mapping of regulatory reporting requirements could be undertaken to develop a single set of reports required by WAMZ bank regulators and designed to meet the requirements of the model banking statute and compliance with Basle core principles, with additional country specific reports included only to the extent that they are required by current law.

To improve the quality of cross-border bank supervision, two measures are suggested: (a) to standardize the memorandum of understanding (MoU) used to establish information sharing arrangements between supervisors; and, (b) establish a "cross-training" program for supervisors to encourage (and in the case of weaker WAMZ supervisors, subsidize) periods spent working with the supervisors in other WAMZ countries.

The supply of credit information: Initiatives are underway in several WAMZ countries to improve the flow of credit information from credit bureaus or central bank administered credit databases (Table 15.1). However, to date, there has been no legislation permitting the cross-border sharing of credit information in any WAMZ country.

This problematic situation is made worse by the absence of uniform data protection laws across WAMZ which would prevent the abuse of customer data stored in regional data centers. These issues suggest that two recommendations need to be implemented in the medium term: (1) WAMZ, preferably working in conjunction with UEMOA under the umbrella of ECOWAS, needs to develop a legal framework for the cross-border movement of customer credit information; and, (2) both WAMZ and UEMOA need to work together to develop a uniform data protection statute which affords equal protections for bank customer information regardless of the location of the data storage or processing facility within WAMZ or UEMOA

Table 15.1 > Credit Information Sharing Activities in WAMZ States

Activity	Gambia	Ghana	Guinea	Nigeria	Sierra Leone
Credit bureau law	X	X		X	X
Private credit bureaus allowed		X		X	X
Central bank credit database exists		X		X	
Private credit bureaus exist				X	

Opportunities for Increasing Trade in the Insurance Sector

The insurance markets of the WAMZ countries are not efficient. There are far too many small insurance companies competing for premiums. Only one company within the entire WAMZ region, Nigeria's NICON, has a gross premium base in excess of $100 million—and NICON is presently under

judicial management. With the possible exception of Nigeria, there seems to be a relatively small base of an educated, trained, and experienced workforce for the insurance industry and the insurance regulators. The Insurance Institute based in The Gambia caters for middle management and senior staff, as do the education and training courses conducted by West African Insurance Companies Association (WAICA).

The insurance regulators are at various stages of development, with the Ghanaian and Nigerian supervisors best staffed and equipped. Consequently the degree to which the industry is supervised varies significantly across the countries. The region's regulators share little information among themselves. There are no formal MoUs whereby information could be shared. Harmonization and improvements in cross border trade could be brought about by implementing certain courses of action, such as a common approach to supervision, licensing, and claims payments.

The region's insurance laws and regulations are diverse. Most of the insurance supervisors seem to be in the process of amending their laws. There are considerable differences in the amount of minimum capital required for obtaining an insurance license in each of the countries, the extremes being in Sierra Leone, where a life license requires $25,000 of capital, and Nigeria, where that same license requires a minimum capital of $13,500,000.

Each of the WAMZ countries has its own set of insurance laws and regulations. The laws presently do not take risk-based capital into consideration—the emphasis is on absolute capital. The relatively high levels of capital requirements in Nigeria impose a significant barrier to entering the insurance market for insurers from other WAMZ countries. Space for regulatory arbitrage in respect of capital requirements is negated by the fact that branch operations are not permitted in any of the WAMZ countries: separate corporate structures need to be established.

Each of the WAMZ countries has an insurance regulator/supervisor. In Ghana, Nigeria, and Sierra Leone, separate quasi-independent insurance regulators have been established. In the case of The Gambia and Guinea, a department within the central bank is responsible for insurance supervision. In Liberia, the insurance regulator is situated within the ministry of transport.

The level of staffing and the quality of the insurance regulatory staff is related to its funding. The insurance regulators within the WAMZ countries recently established a forum although it is not fully operational as yet. A number of regulators do meet informally, and have done so over a period of time. There are no formal arrangements in place between the insurance regulators of the various WAMZ countries, for such purposes as information sharing. The only formal cross border agreement currently in place is the Brown Card Scheme (Box 15.1). Presently, companies operating in more than one WAMZ country have not

Box 15.1. African Insurance Forums

- National level: insurance associations and insurance brokers' associations have been established in each of the WAMZ countries. These appear to be actively supported by the insurance industry as a whole in each country.
- Continental level: there is the African Insurance Association (AIO). The Cameroon–based AIO includes all WAMZ members. The AIO involves its members at a number of levels: annual insurance conferences are held each year in a different country throughout Africa and serves as a discussion forum at the highest level of executives of insurance organizations. Seminars and workshops are held throughout the year to engender discussion on insurance related topics.
- West Africa: There is one insurance treaty signed by all ECOWAS members: the Brown Card Scheme, which provides common third-party motor insurance across the region. An anti-money laundering forum has also been established for financial institutions in West Africa.
- WAMZ: The WAMZ area itself has been active in certain areas, and has established some forums specifically catering for this geographic and geopolitical area.

yet established functions that are centralized across all countries, such as claims handling or underwriting.

Prerequisites for Increasing Cross Border Trade: Almost all of the insurance products sold in the WAMZ region are in compulsory insurance products, few people purchase insurance products voluntarily, and therefore insurance penetration rates are at world-record low levels. There is very little attention to customer satisfaction. Efforts toward creating the right conditions for healthy cross border trade, and benefitting policyholders and the entire insurance industry could be driven through improved supervision and improved insurance laws and regulations, or improved application of existing laws and regulations.

As WAMZ insurance regulators seem to be either replacing, or considering replacing their laws and/or regulations, there is an opportunity to harmonize insurance laws, regulations and supervisory approaches. Those countries that have not adopted the framework law approach (Guinea, Liberia, Nigeria, and Sierra Leone) could consider doing so in the short to medium term. The insurance regulators of all WAMZ countries could improve the environment for growing a viable and healthy long-term insurance industry by making a continuous and concerted regional effort to force insurance companies to pay claims in a timely and fair manner, as measured by a continuously increasing percentage of premiums being allocated to the payment of policyholder claims and benefits. Those countries with very low minimum capital requirements (The Gambia, Guinea, and Sierra Leone) could also consider adopting Ghana's approach of requiring a minimum capital of the equivalent of at least US$1 million for each of their insurance companies/insurance licenses.

Consumer education and understanding also need to be addressed: throughout the WAMZ region, potential policyholders are unaware of the benefits to be derived from owning insurance products. A concerted effort to increase consumer education, drawing attention to the benefit of holding insurance policies, could be carried out throughout the WAMZ region via production and distribution of published material and advertisements.

Conclusions

In spite of the progress realized in both the banking and insurance sectors, WAMZ remains prone to numerous problems associated with banking and insurance sector integration—more specifically these impediments include difficulties in building adequate financial infrastructure such as payment system infrastructure, the lack of harmonization of a legal and regulatory frameworks governing these two sectors, the lack of credit report bureaus to access financial information of banks and assurance clients, and the high costs of transactions related to the transfer of funds through banks and the insolvency regime.

The urgency is for an immediate solution to accelerate the integration process of these sectors and facilitate trade of goods and services within WAMZ. With regard to the banking sector efforts should focus on:

- Reducing the cost of cross-border payments made through the banking system;
- Developing a mechanism for small cross-border payments for traders and individuals;
- Reducing the cost of bank regulation and supervision;
- Improving the quality of cross-border bank supervision; and
- Improving the flow of credit information.

In terms of the insurance sector, focus should be on:

- Taking action in order to make the brown card scheme a success;
- Increasing the minimum capital requirement in some of the WAMZ countries;
- Developing a program whereby insurance companies are forced to play claims fairly; and
- Harmonizing insurance laws and regulation.

16. Beyond the Nakumatt Generation

Distribution Services in East Africa[53]

Nora Dihel[54]

Introduction

Distribution services[55] are an important driver of growth in East Africa. With contributions to GDP ranging from about 11 percent in Kenya, Rwanda and Tanzania to more than 14 percent in Uganda in 2008/09 distribution services are a significant part of all East African economies. The sector also employs an important part of the population (in many East African countries over 10 percent of the active population) and includes a high proportion of informal, unskilled, female and part-time workers. Distribution services are among the most rapidly expanding sectors in East Africa. Over the period 2001–08 (2004–08 for Uganda), distribution services have grown, on average, at eight percent a year in Rwanda, 12 percent in Kenya and Tanzania and 20 percent in Uganda.

There is an emerging recognition amongst the East African countries regarding the importance of this sector. For example, distribution is a strategic sector in Kenya's "Vision 2030"—the country's new development blueprint. In addition, distribution services were identified as a priority sector in the context of the East African Community Common Market Protocol and the negotiations with the EU on services in European Partnership Agreements by Kenya, Rwanda and Tanzania.

Distribution services represent a crucial link between suppliers and producers. With improved efficiency and higher productivity due to the emergence of large supermarket chains and the increased internationalization of the distribution sector across East Africa,

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56 This chapter was prepared by Nora Dihel with input from Richard Gicho and Joseph Kimoto (Kenya), Joseph Butoyi (Burundi), George Gandje (Tanzania), Henry Rugamba (Rwanda). Pumela Salela and Nicholas Strychacz provided assistance with the data collection.

57 Nora Dihel is a Senior Trade Economist in the Africa Poverty Reduction and Economic Management Department of the World Bank.

58 Providers of distribution services generally fall into four categories: retailers, wholesalers, franchisers, and commission agents. Retailers in both the formal and informal sectors sell goods for personal or household consumption; wholesalers sell merchandise to retailers or to other businesses. Franchisers sell specific rights and privileges related to operating a branded business, for example, the right to use a particular retail format or trademark. Finally, commission agents trade on behalf of others, i.e., they sell products that are supplied and usually owned by others to retailers and wholesalers. The main focus of this note is on the retail and wholesale given that they dominate the distribution sector in East Africa.

the sector has great potential to benefit both producers and consumers and contribute to increased food security and alleviation of rural poverty. Modern distribution channels and procurement systems that reduce transaction costs and facilitate market exchanges can increase the access of small farmers to high value markets and accelerate the transition from subsistence farming to market participation. For consumers, organized markets can provide substantial benefits that include better quality products at affordable prices.

So far, however, modern distribution channels have failed to capture a large portion of the retail market in East Africa. Across the region informality still prevails, small-scale farmers have found themselves marginalized by the distribution sector and its new practices, and very poor households (for example, slum dwellers) are often paying more per unit for basic products than wealthier households.

This chapter documents the current state of distribution services in East Africa, including the patterns and the determinants of the diffusion of modern distribution channels and the increased internationalization in the region. It shows why, despite major transformations during the last decade, the distribution sector remains underdeveloped and the impact of reforms is uncertain. To strengthen the contribution of the sector to poverty reduction, policy action that addresses the concerns of the households and producers at the bottom of the income pyramid, especially in the informal sector, should be a priority in all East African countries. Policy action that enables a gradual transition of informal firms to formality, as well as measures that encourage regulatory reform needs to complement the liberalization of the distribution sector in East Africa.

Developing the Distribution Services Sector in East Africa to Reach Poor Consumers

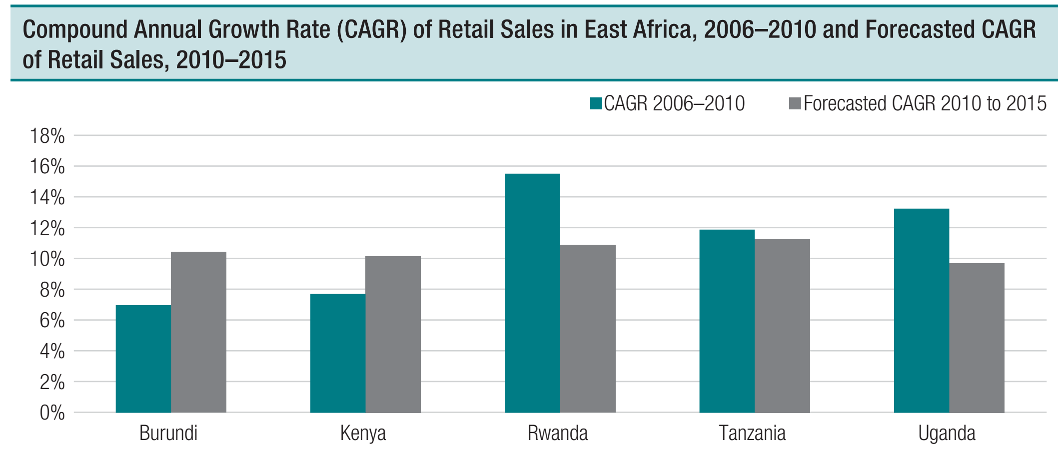
Informality Prevails Despite the Rapid Diffusion of Modern Retail Stores.

Increasing population, continued urbanization, higher incomes, and political stability have propelled the growth of distribution services in East Africa during the last decade. The proliferation of supermarkets and large retail stores are among the most significant developments regarding the evolution of distribution services in the region. Supermarkets in East Africa have sustained impressive growth rates over the period 2006–10: the compound annual growth rates of retail sales reached more than 15 percent in Rwanda, about 13 percent in Uganda, almost 12 percent in Tanzania and about seven percent in Kenya and Burundi; and retail sales in East Africa are expected to grow around 10 to 11 percent per annum over the next five years (Figure 16.1). Total retail sales in East Africa are expected to increase from around US$43 million in 2010 to more than US$70 million in 2015 (Figure 16.2).

Formal distributors in East Africa tend to be large supermarkets and large to medium-size retailers and franchisees. Retail outlets, including supermarkets, tend to grow by first focusing on urban areas and large cities, then branch out to medium-size urban areas, and finally out to rural areas. In this way, although supermarkets generally begin by catering to higher income urban consumers, the growth path of retailers in East Africa has the effect of eventually bringing lower income rural consumers into the retail outlets as well, driving up retail growth rates significantly. For example, the Uchumi supermarket expanded

Figure 16.1 >

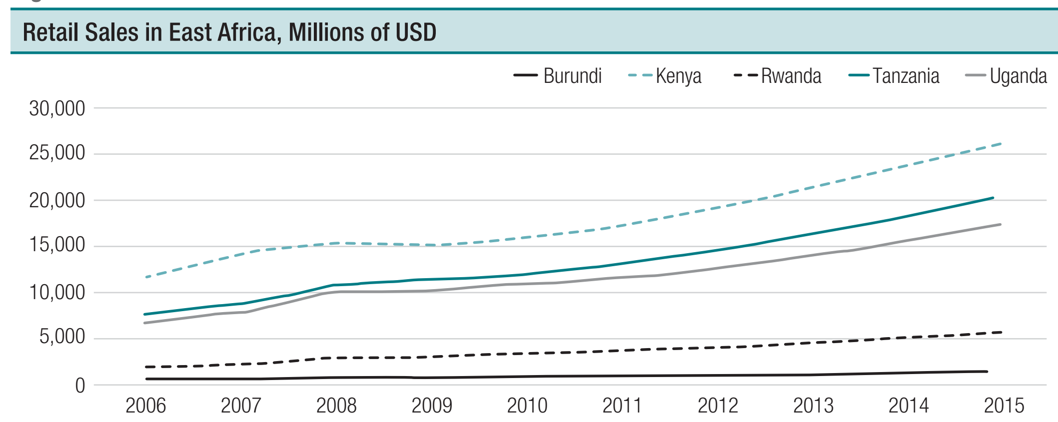
Compound Annual Growth Rate (CAGR) of Retail Sales in East Africa, 2006–2010 and Forecasted CAGR of Retail Sales, 2010–2015



Source: Planet Retail, retail sales data, 2011.

Figure 16.2 >

Retail Sales in East Africa, Millions of USD



Source: Planet Retail, retail sales data, USD, 2011.

in Kenya by first opening stores in Nairobi then shifted its focus by opening smaller stores located near bus stations used by lower income consumers.

Despite the growth of the higher-end supermarket segment, including those rural areas, the number of traditional small stores that sell local produce remains high in East Africa's retail market. In general, the distribution sector includes a small number of large supermarkets, a slightly greater amount of large to medium-size wholesalers and retailers, and a much larger number of independent and often informal small retail shops and street vendors. Such informal retailers can be found in both urban and rural areas and are often the primary enterprises engaging in distribution services outside larger cities. Most businesses in the East African informal sector are engaged in the retail of food and basic retail household appliances, and are single-shop sole proprietorships.

In the wholesale segment, we observe a high degree of duality between traditional and specialized wholesalers. Traditional chains are still widely prevalent in all East African

economies. Farmers and traders supply traditional wholesalers, who then sell to individual retailers and processors. But most modern retail stores have their own direct procurement systems and buying centers. Several supermarkets—for example, Nakumatt—have also developed regional distribution centers to perform the wholesale function for their outlets.

The franchising segment is small and mostly limited to foreign firms. This is partly due to the lack of intellectual property enforcement in African countries, which hampers the process of branding that is required for successful franchising. For example, the weak enforcement of Intellectual Property (IP) and lengthy resolution of IP disputes[56] in Kenya prevents the establishment of international franchises. Some Kenyan firms, however, have been successful in establishing franchises in East Africa, such as Kenchic in the poultry segment and Deacons in the apparel segment.

A common characteristic across the distribution sub-sectors of all East African countries is the large proportion of the informal sector. An estimated 70–80 percent of sales in East Africa still go through informal enterprises, with only about 20 percent of sales going through formal outlets. In Kenya, for example, an estimated 88 percent of businesses in the distribution services sector are considered informal, employing 80 percent of the total labor force in the sector. Low entry barriers and the relative ease of operations are among the factors that could explain the high level of activity in the informal distribution sector. However, informality can be also a byproduct of low productivity. World Bank (2010) shows that as Zambian firms became increasingly productive, they became more formal.

Although informal enterprises handle the large majority of sales, turnover is low for most individual informal enterprises and businesses tend to be very small. Enterprises in the informal sector are more limited in their operational capacities than businesses in the formal sector. Furthermore, the lack of access to finance, uneven cash flows, the absence of management knowledge, highly fragmented and inefficient supply chains, and poor infrastructure are key constraints faced by enterprises in the informal sector that discourage their transition to formal activities.

The prevalence of the informal market can sometimes discourage large formal business from entering this market segment. Additionally, informal retailers are also suboptimal from a governance perspective, since it is difficult or impossible to collect taxes (VAT, excise tax, import duties, etc.) from unregistered businesses without licenses.

Regulatory Barriers Limit the Benefits of Internationalization in the Distribution Sector.

Foreign direct investment (FDI) is starting to play an important role in the distribution sector of most East African economies. The largest businesses operating in the formal sector of all countries except Kenya tend to be companies with substantial foreign equity. For example, South African and Kenyan chains dominate the supermarket segments in Uganda and Tanzania. Kenyan supermarkets are also present in Rwanda, and Nakumatt is preparing its entry into Burundi in 2012. The Burundian distribution sector has already several foreign operators from Belgium, China, India, the Netherlands, and Pakistan. By contrast, the Kenyan market has been challenging to foreign investors in

[59] On average it takes about 8 to 9 years to resolve IP cases in Kenya.

distribution services. Foreign retailers such as the South African Metro Cash & Carry and Lucky 7 exited Kenya's market in 2005 after brief operations. The limited success of foreign companies in Kenya's retail segment has been attributed to strong competition, insufficient and expensive suitable locations, and inadequate market entry strategies among others.

Kenyan supermarkets began establishing foreign operations in the EAC in about 2002 and have since stepped up their efforts to penetrate the regional market. Currently, the three largest Kenyan supermarkets have a combined total of seven branches in Uganda and one in Rwanda. The main market entry strategy employed by these supermarkets is acquisition of existing supermarket chains. In 2011 Tuskys acquired the Ugandan supermarket chains Good Price and Half Price and has now four stores in Uganda.

The estimated Kenyan FDI in the East African supermarket segment amounts to US$22–28 million (Table 16.1). Total Kenyan FDI outflow in distribution services is estimated to be around USD 26–32 million over the period 2002–2009. Expected investment in the EAC distribution services sector over the next five years is projected to be US$30–50 million.[57] Major drivers of investment in East Africa include the adoption of the EAC Common Market Protocol and the harmonization of tax regimes and customs import regulations.

The foreign presence in the distribution sector of the East African economies has been made possible by extensive trade liberalization measures adopted by these countries. Burundi, Kenya and Rwanda are largely free of any major impediments to foreign presence in retail services. Tanzania imposes a few explicit policy restrictions: there is a 50 percent limit on foreign ownership if the foreign firm is acquiring a state-owned retailer, and the licensing criteria tend to favor and promote domestic retailers. (Borchert, Gootiiz and Mattoo 2011).

With a population of more than 140 million people, the East Africa region provides a vast retail market for formal retail traders with important benefits for consumers and producers. According to Nakumatt Holdings Research the current regional population has an opportunity to sustain at least 10 major retail stores in each town. In the next ten years, Nakumatt Holdings is forecasting that close to 25 million customers across the region will

Table 16.1 > Kenyan Supermarkets with EAC Presence

	No. of Branches in EAC Countries		
Kenyan Supermarket	Uganda	Rwanda	Estimated FDI Investment Flows* ($ millions)
Nakumatt	2	1	8.25
Tuskys	4		11.00
Uchumi	1		2.75
Total	**7**	**1**	**22.00**

Source: Consultant Interviews 2010/11.
*Average investment required for establishing a supermarket in EAC is $2.75 million. This figure was calculated using past investment spend of Kenyan supermarkets in EAC. Nakumatt invested about $3 million for each of its Uganda branches, $2.5 million of their Rwanda branch. Uchumi invested about $2 million for its branch in Uganda, and is poised to spend $2.5 million for their planned branch in Tanzania.

[60] Nakumatt plans to invest $20 million in its EAC expansion over the next 5 years, Deacons $10 million. Nakumatt is looking at opening 2 new stores in Kigali, Rwanda by the end of 2011. Uchumi is looking to commence its Tanzania operations in 2011.

have access to formal retail trade facilities with monthly sales reaching the US$700 million mark and selling space reaching close to 40 million square feet, up from 15 million square feet today (Nakumat CBC 2011).

Several regulatory measures obstruct the entry of formal distribution firms and limit their operations in East African markets. Most East African countries have some form of regulation on market access (World Bank 2011). In Kenya, Rwanda, Tanzania, and Uganda new businesses must register with the commercial registry and must notify authorities. These countries also require that a new business obtain licenses and permits in order to engage in commercial activity, with fees depending on the type of business permit required. Multiple licenses are a significant challenge in distribution services. For example, a Kenyan distributor who covers a territory spanning several local authorities will be required to have licenses from each local authority to drop off goods at particular customers and receive payment. A similar problem occurs in the case of exporting. A distributor is required to have documentation for each product regardless of whether it is in the same product category. For instance, if the distributor is exporting yogurt in different flavors, export documentation for each flavor is required.

In Kenya and Rwanda businesses selling certain types of goods must also comply with outlet site regulations, in addition to compliance with local urban planning provisions. Large outlets have an additional set of regulations. In Uganda, foreign retailers are required to establish their outlets in the city area—establishment anywhere outside the city is prohibited. This decelerates the expansion of retailers from urban to rural areas. Rwanda has regulations on tax registration for micro-retail businesses and franchising. By contrast, Burundi has very little regulation in place with regards to distribution services. With the exception of pharmacies, which have to follow zoning and location rules, regulations or registration requirements are absent for most businesses. This lack of regulation has created a legal vacuum that actually constrains business growth and allows many opportunities for unfair competition and corruption.

The main restrictions affecting operations in the distribution sector are related to price regulation. The justification for such regulations is consumer protection, but price restrictions have a negative effect on competition. Price controls exist in most East African countries for essential goods. In Burundi gas and sugar are price controlled; in Rwanda there are price controls on gas, gasoline, and pharmaceuticals. Tanzania has price controls on a large number of goods and services, with fuel, water, electricity, transport fares, and telecommunications all being regulated. More recently, Kenya has introduced price controls on numerous food products to address food security concerns despite a strong opposition from the private sector. Across the region the cartels that control the prices and the flow of certain goods such as sugar or maize are particularly problematic.

Several countries have regulations on the quality and the standards of sourced products. But often such standards do not take into account the technological or economic constraint in the region; producers—especially small-scale producers—are unable to implement the standards and therefore remain informal (see Chapter 10 for an example in the dairy sector).

Finally, it is worth noting that regional imports by modern retail chains face a number of non-tariff barriers related to standards and rules of origin as well as delays due to bureaucracy and congestions at the ports. This has an impact on the cost of importation and stocking of appropriate inventory levels, and limits the role of foreign distribution companies as regional integrators.

The Distribution Sector in East Africa Has Undergone Major Transformations in the Last Decade but the Impact on Poverty Reduction Remains Uncertain.

The emergence of large supermarket chains across East Africa and the increased internationalization of the distribution sector have transformed the retail environment in the region. Numerous middle class consumers benefit from a greater variety of goods at affordable prices in modern retail outlets. The modern procurement systems and buying centers established by supermarkets have also improved the lives of many participating farmers. Several procurement and marketing studies focusing on fresh fruits and vegetables, dairy products, and crops in Kenya, Tanzania, and Uganda document the positive implications of the reorganization of supply chains and transformation of food systems for farmers, food security, and rural poverty (Hooton and Omore 2007 and Ngugi, Gitau, and Nyoro 2007).

However, very poor households at the bottom of the income pyramid pay higher prices for basic goods and services than do wealthier consumers—either in cash or in the effort they must spend to obtain them—and they often receive lower quality as well. Box 16.1 illustrates the price penalty for cooking fat, sugar and maize affecting poor consumers in Nairobi's Mathare and Kibera slums.

Moreover, in all these countries where the majority of the population depends on agriculture, small-scale farmers have sometimes found themselves marginalized by the distribution sector and its new practices. Given the high fixed costs associated with participation in modern chains, many small farmers and traders are not able to participate in modern procurement systems and continue to supply traditional wholesalers, who then sell to individual retailers

Box 16.1 The Bottom of the Pyramid Penalty

Within informal settlements, retailers buy normal goods from wholesalers or retail outlets and break them down into smaller affordable quantities. For instance, consumers living in slum areas cannot afford to buy the 2kg packet of sugar that retails at about KES 200 (or US$2.5) in most shops; however, they can afford to buy a pack of 50 grams at KES 10 (or US$0.12). This makes goods affordable for slum dwellers many of whom live on less than US$1 a day.

Though the smaller quantities are more affordable to consumers in slum areas, they are paying a considerably higher price for these products. The table illustrates this point where a 10 grams pack of cooking fat retails at a 300 percent premium, and a 50 gram pack of sugar at 141 percent. The poorest members of the society pay more for their essential goods than ordinary Kenyans.

Price Comparison of Selected Products in Informal Settlements

Commodity	Kiosk: Price for Units under 250 grams (Kes/grams)	Supermarket: Price (Kes/grams)	Price Differential for Units under 250gms (%)
Cooking Fat	0.50	0.125	300%
Sugar	0.20	0.083	141%
Maize Flour	0.05	0.030	67%

* Some retailers in informal settlements, such as Mathare, have weight scales. But by and large the portions are meted out without the use of weighing scale. Thus the packs found in these retail kiosks weigh sometimes more, sometimes less.

Source: Interviews in the Mathare and Kibera slums of Nairobi, 2011.

and processors. As the supermarkets in the highest tier tighten their demands in terms of consistency in volume and quality, small producers and under-capitalized brokers face tougher competition from larger producers and risk being squeezed out of the system altogether.

Talent Shortages Impede the Development of the Distribution Sector.

The availability of adequate skills remains an issue across the distribution sectors in East Africa. Despite the economic importance of the sectors, targeted training programs remain largely unavailable across East Africa. Only Kenya's Jomo Kenyatta University of Agriculture and Technology (JKUAT) offers a diploma-level retail management training course in East Africa. Consequently, most formal distribution businesses rely on training on the job. Also, there is limited influx of knowledge with regard to best or good practice in the sector. Lack of access to specialized training has led to slow growth and late adoption of modern retailing techniques. For example, many large supermarkets are only beginning to understand the value of and adopt modern retailing techniques such as merchandising, category management, and just-in-time inventory management.

Poor Infrastructure, Insecurity, Cumbersome Import Processes and Lack of Market Data Further Constrain the Development of the Distribution Sector.

Business representatives in East Africa identified the following additional issues as important constraints to the development of the sector:

- High transportation costs due to poor road networks conditions, especially in rural areas, and traffic congestion in main cities.
- Insecurity is a recurrent concern. The frequent hijacking of goods during transport leads to increased insurance, storage and transport costs. A hidden cost associated with insecurity is the growth of organized crime filtering into the distribution services sector. Criminal groups such as the "mungiki" control certain regions and extort money from formal and informal distributors on their territories.
- Cumbersome importation processes due to overly burdensome bureaucracy and congestion at the ports increase the price of imported goods and complicates stocking and inventory planning.
- The limited availability of market data particularly affects distributors at the bottom end where business is highly fragmented. It is extremely difficult to measure the value of goods that move through this channel. Even in the modern distribution segment information is difficult to obtain. Distributors are unable to gather information on their market shares or performance indicators with negative implications for the development of marketing strategies, new product development, and forecasting and strategic planning.

Policy Recommendations

Raising awareness about the importance of distribution services is an important first step in designing a comprehensive reform strategy that is linked with national development

plans. The sector urgently requires a broad development strategy and recognition as a key economic driver to facilitate its growth to the next level. The importance of the formal distribution sector that is heavily contributing to economic growth and is currently the second leading (formal) employer has been acknowledged by several East African countries. Steps must be taken to raise awareness about the importance of the sector in a consistent way on the basis of detailed economic performance analyses and benchmarking exercises, and incorporate the informal sector into the landscape of distribution services. The large size of the informal sectors in all East African countries underscores the importance of distribution strategies that can efficiently reach households at the bottom of the income pyramid and integrate small-scale farmers into the distribution system.

Addressing the concerns of the poorest households and facilitating the inclusion of smallholders in modern distribution chains should be a priority in all East African countries. The majority of the population, who account for a significant percent of overall income, remain at the base of the pyramid and are excluded from the benefits that large distributors have brought to middle class families in terms of wider availability and lower unit prices for basic products. Possible policy actions to address the constraints that prevent informal forms from formalizing, meet the needs of the poorest households and expand their access to basic products at affordable prices include:

- Facilitate access to financial services in the informal sector. Several case studies show that increased access to credit by micro and small enterprises has contributed to the growth in the distribution sector particularly in the informal segment.
- Provide support to traditional and informal operators to acquire relevant skills. For example, training courses offered in the slums and focused on basic hygiene standards, merchandising, sampling, or promotion techniques could improve the skills of retailers in wet markets, kiosk sellers, or hawkers. There are several examples of innovative solutions to localized conditions that rely on consumer behavior and private public partnerships with commercial potential (see Box 16.2 for an example).
- Encourage firms to design and apply business models that deliver the right products at the right price point. For example, to meet the needs of consumers at the bottom of the pyramid,

Box 16.2 Pharmacy Accreditation Programs for Informal Retail Operators – Tanzania

Because they allow access to treatment in areas and conditions where no formal commercial entity could operate at a profit, distribution models that leverage existing physical infrastructures and consumer habits to distribute drugs in remote areas have an enormous development potential. An accreditation and training program and access to microfinance services enabling small rural shops (duka la dawa baridi) to sell essential drugs is a business model that has significant development impact that can also be financially sustainable. Given high retail margins, charging fees for a 40-day training program that allows regular shop owners to sell essential medicines is a viable business model. This has been implemented in Tanzania through the Accredited Drug Dispensing Outlets (ADDO) scheme on a pro-bono basis. However, regular retail shop owners have demonstrated a willingness to pay for this training that includes marketing support in order to enter the lucrative retail drug market. These business models dramatically increase access to drugs for remote populations by increasing the number of medical outlets available. In addition, training programs for small retailers can improve their awareness of counterfeit and substandard products, thus enlisting them as key agents in improving product quality.

Source: IFC 2007.

Box 16.3 Reaching the Bottom of the Pyramid – Innovations in Distribution in India

Business strategy enabling access. Some of the higher prices paid by consumers at the bottom of the pyramid can be ascribed to the difficulties and added costs of distribution in low-income communities. Many companies are finding innovative ways to reach poor consumers. For example, Hindustan Lever Limited (HLL) requires new managers to spend six to eight weeks in a rural area and learn from these consumers as part of their training. HLL uses non-conventional marketing to reach this consumer segment: fairs, festivals, and traveling cinemas have become part of the company's consumer outreach combining entertainment with hygiene education.

HLL has reached deeper and deeper into rural areas and has set up networks that carry its products to the most remote villages by whatever means required—motorbike, bicycle, oxcart—and has also employed direct sales agents. The approach builds brand loyalty and creates employment.

Source: World Resource Institute and IFC 2007.

companies must re-design products and use smaller pack sizes to increase trial purchases and volumes, build strong distribution partnerships and adapt marketing strategies (see Box 16.3 for an example).

Steps should be taken to ensure a gradual transition of informal firms to formality. The transformation of distribution and procurement systems may offer participants higher returns but they also introduce new risks and costs. With fewer and more powerful buyers, small farmers are confronted with reduced negotiating power in addition to important transaction costs. Policy actions to facilitate the access and participation of smallholders in modern distribution chains include:

- Encourage horizontal coordination—such as farmer associations and cooperatives—to increase the bargaining power of small farmers, allow for economies of scale and lower marketing and negotiation costs. Given the mixed experience with such associations, a case by case approach is warranted that puts emphasis on soft skills and contextualized management structures.
- Coordination between farmers that focuses on subcontracting arrangements, different forms of tenant farming (e.g., exchange of labor for a portion of harvest) or reverse tenancy (e.g., leasing of land management to a larger operator in exchange for rent) could be alternatives to associations and cooperatives.
- The widespread duality between traditional distribution chains and modern procurement systems in East Africa could be exploited to increase the participation of small farmers in modern chains. Rather than bypassing traditional wholesale systems and increase the gap between traditional domestic markets and the formal processing sector, encourage the upgrading of traditional wholesale systems to support the interaction between the modern and traditional systems. The main focus should be on improving basic safety standards, increasing the traceability of products and reducing spoilage rates in the traditional markets. This can improve the structure of wholesale markets and enable upstream linkages with producers and downstream linkages with retailers and processors.

Steps should be taken to eliminate the regulatory barriers that limit investment in the sector. Although all East African countries have made progress in removing explicit restrictions to trade, the lack of regulation in critical areas, onerous regulation elsewhere or an unequal enforcement of regulation pose serious problems to competition and affect formal (including foreign operators) in the distribution sector.

Reforms should focus on developing the necessary regulatory frameworks for modern distribution services including rules and regulations affecting the business environment. The lack of licensing and operation rules for distribution companies, inadequate codes on investment, commerce, labor, and taxation, as well as the lack of bankruptcy procedures create significant uncertainty and burden for firms that are trying to conduct business operations in the formal distribution sectors of East African countries.

Improvements to existing regulatory frameworks should eliminate disproportionate entry requirements such as lengthy registration procedures, multiple licenses, or inadequate zoning regulations. Price controls imposed across the region and the cartels in place in several East African countries represent a serious impediment to competition and should be removed.

Address skills issues in the distribution sector. A strong distribution sector will require local know-how and talent. At first, companies will need to bridge the gap by using a mix of local and international employees. In parallel, investments in developing and retaining local talent are required. Developing local training programs and putting in place apprenticeship opportunities will be critical to achieving long-term success.

Address the other constraints identified by the business community. Steps must be taken to address the infrastructure and insecurity concerns raised by the business community. The removal of non-tariff barriers that hamper the imports of distributors should be on the policy agenda of all East African governments. Finally, all governments in the region as well as business associations can play a constructive role in collecting and disseminating relevant market information for distribution operators in the formal and informal segments.

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