

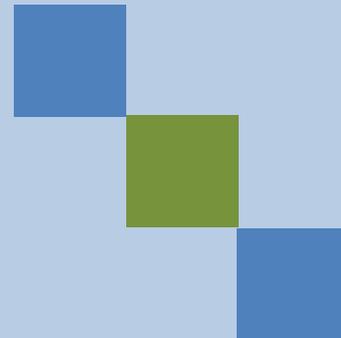
Reform and Regional Integration of Professional Services in East Africa

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Introduction

Professional services matter for development in East Africa.

- Even though the share of business services in the GDP of East African countries is small, the sector is among the most dynamic. Over the period 2001-2007, business services have grown at 8 percent per annum in Kenya, 14 percent per annum in Tanzania and nearly 18 percent per annum in Uganda.
- Business services are key inputs for other sectors, and greater use of professional services is associated with higher labor productivity. Input-output tables suggest that they are among the top fifth of economic sectors in terms of direct and indirect usage.
- Business skills and services, such as accounting and legal services play a critical role in reducing transaction costs considered to be the most significant impediment to economic growth in Africa.

- Engineering services, encompassing civil, mechanical and electronic engineering, contribute to the development of infrastructure, the dynamism of manufacturing and engagement in the emerging knowledge economy.
- Professional services could also become an important avenue for export diversification by some East African countries.

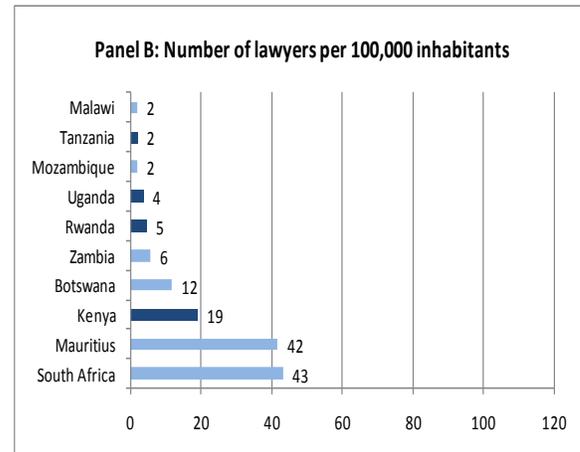
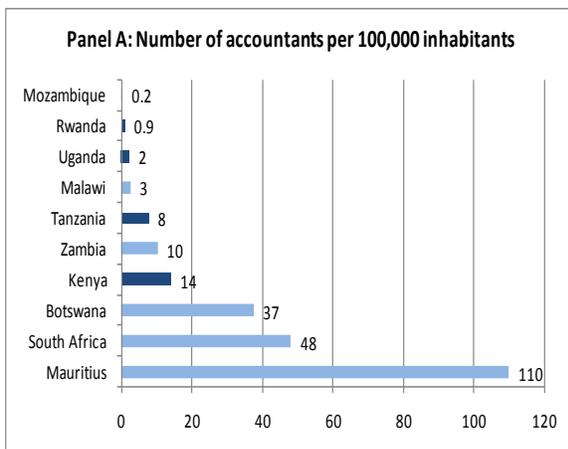
But there is a large gap between the potential contribution these services could make and the meager contribution they make today. Policy makers in East Africa have recognized the critical importance of developing professional services. Along with reform of backbone services like telecommunications, 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 of the East African economy. It shows why national markets for professionals and professional services in East 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 the four areas: education, regulation of professional services, trade policy, and labor mobility.

Striking Differences in the Level of Development of Professional Services in East Africa

There are striking differences in the level of development of professional services across countries in East Africa in terms of availability and wages. Kenya has a relative abundance of professionals, whereas in Rwanda there is a relative scarcity of professionals. However, per capita availability of professionals in each of these countries is only a fraction of that in more advanced African economies, such as Mauritius and South Africa (Figure 1).

Figure 1: Professional Density in Africa



Source: World Bank Survey of Providers of Professional Services in East Africa, 2009.

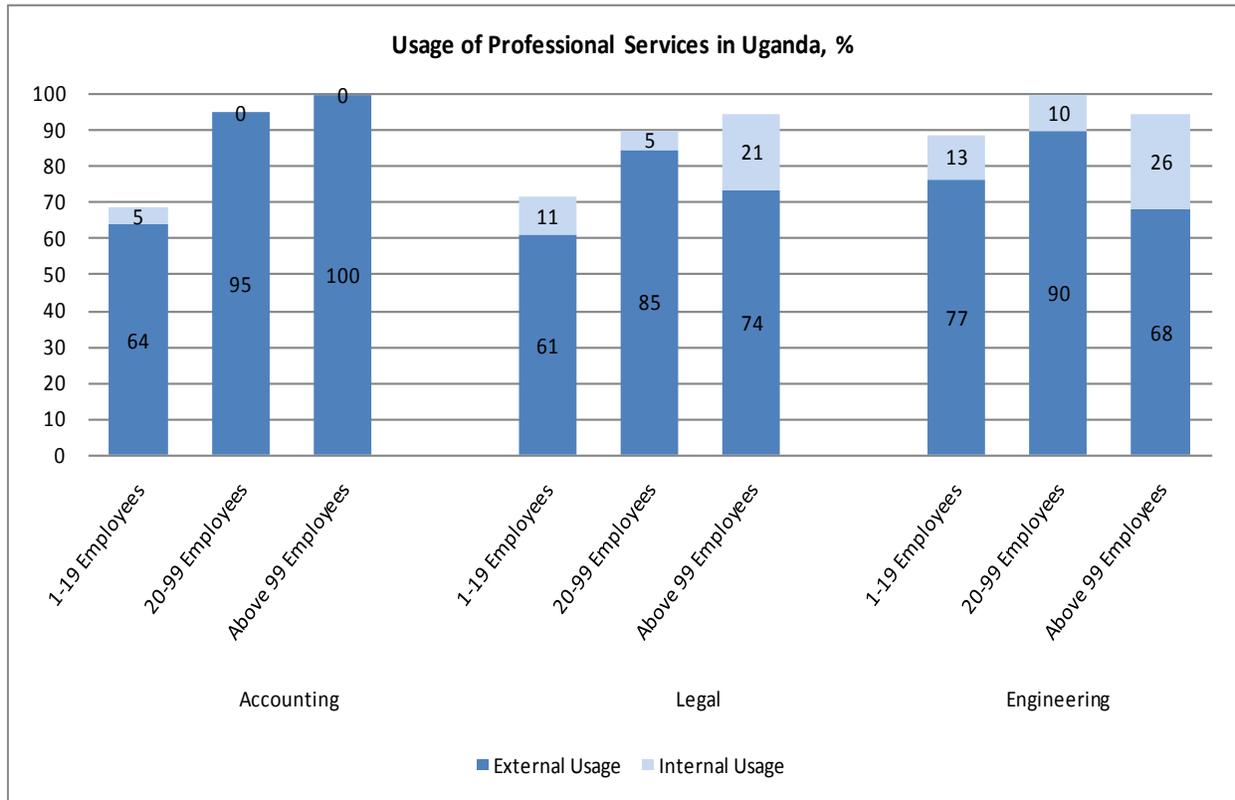
Although professionals in East Africa receive low nominal wages relative to their counterparts in developed and other developing countries, once their wages are adjusted for purchasing power, professionals in Kenya and Uganda are comparatively well paid – reflecting perhaps their scarcity relative to the demand for their services. A wage premium for professionals over the earnings of other workers with a university degree is evident in all East African countries.

With the exception of accounting technicians in Kenya, East Africa faces a middle-level skills vacuum. Middle-level professionals can play a crucial role in providing services to often underserved groups of clients. Skills mismatches seem to be a serious issue in all examined countries. For example, accounting associations in Tanzania and Kenya report that there are jobless accountants despite high demand for qualified accounting professionals.

High Demand for Professional Services in East Africa

Evidence from recent firm-level surveys in East Africa suggests that a surprisingly large

Figure 2: Usage of Professional Services in Uganda, %



Source: World Bank Survey of Users of Professional Services in East Africa, 2009.

number of formal sector firms in all sectors use professional services.¹ A large proportion of the demand for accounting and auditing services seems to derive from mandatory legal requirements, pertaining to financial reporting and taxation. The relationship between the usage of externally outsourced professional services and firm size in many cases exhibits an inverted U-shape relationship: usage increases with firm size until a certain point after which it declines. Whereas smaller firms rely primarily on external service providers, more than a fifth of the largest firms rely exclusively on in-house engineers and lawyers. Uganda is broadly representative

¹ The fact that the firm-level surveys cover mostly urban formal sector firms may help explain the high usage.

of the pattern of service use by firms of different size (Figure 2).

Market structures show elements of both oligopoly and competition

Accounting and auditing services are dominated in all countries by the large affiliates of the “Big Four” multinational firms.² In Kenya, however, local mid-sized accounting firms are gaining market share at the expense of the Big Four after initially working as sub-contractors for them. The

² The Big Four firms are Deloitte Touche Tomatsu, Ernst & Young, Klynveld Peat Marwick Goerdeler, and Price Waterhouse Coopers. They retain a partnership model that relies on local members and their professionals to understand the language, rules, and operating procedures of the respective market (World Bank, 2008).

engineering and legal sectors are dominated by domestic providers, which are often small firms and microenterprises. The combined capacity of these small firms,

Limited Trade in Professional Services

The heterogeneity of professional endowments and the earnings differentials across countries for each profession suggest that there is substantive scope for trade in professional services in East Africa. Foreign professionals and foreign professional firms could help address the underdevelopment of the sectors and the unmet demands in East Africa. However, data on the presence of foreign professionals in East Africa suggests that in Kenya, Tanzania, and Uganda, foreign professionals represent less than 10 percent of the total number of professionals in accounting and engineering. In Rwanda, in contrast, foreign professionals account for more than 60 percent of the total number of professionals. In legal services, there are virtually no foreign professionals in any of the East African countries.

Similarly, in terms of commercial presence, there is only a limited presence of foreign engineering firms and there is an almost complete absence of foreign legal services firms. Evidence from World Bank-supported civil works procurement contracts since 1994 reflects the lack of integration of the East African market for engineering services. Domestic companies generally win most of the contracts, except in energy and mining and transportation where non-African companies have the lion's share. There is virtually no intra-East African foreign firm participation in these contracts, with the limited exception of Kenyan firms in a few Tanzanian and Ugandan projects and Ugandan firms in a few Rwandan projects.

though large, is too scattered to meet demand for large, possibly more sophisticated, projects.

Explaining Skills Shortages and Skill Mismatches in Professional Services in East Africa – Weakness in Education

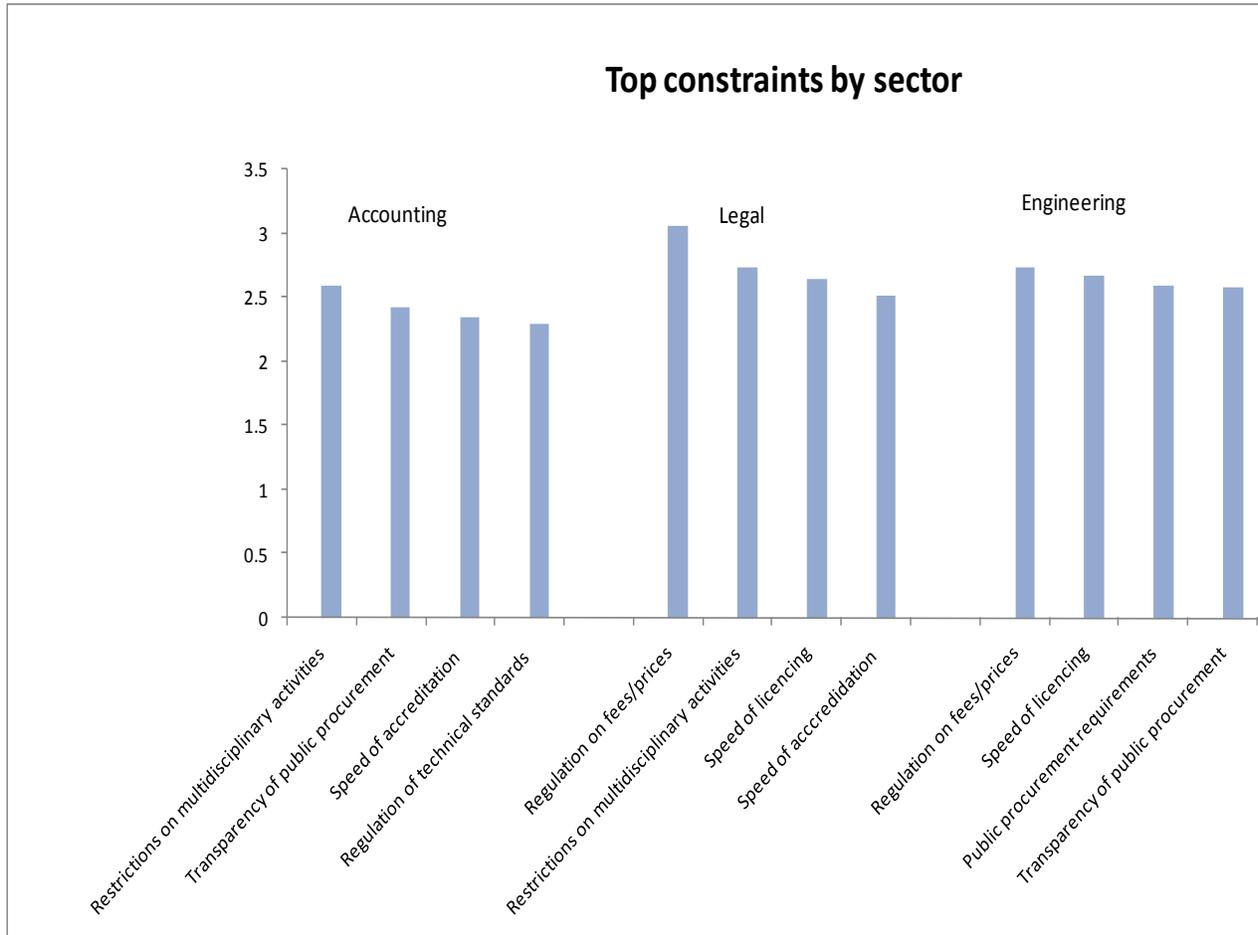
First, professional education is expensive in all East African countries. While skills premia for professionals exist and internal rates of return to education are high in the region, the median cost to become a professional worker ranges from USD 14,000 to USD 26,000. This makes attaining professional qualification unaffordable for the majority of the population in these countries, especially given the underdeveloped nature of the markets for educational loans.

Second, the weaknesses in secondary education across East 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 East 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 absence leads to the production of nominally qualified but effectively unemployable professionals. Stakeholders from the private sector

Figure 3: Restrictiveness of Regulation in East Africa - Top Constraints by Sector



Source: World Bank Survey of Providers of Professional Services in East Africa, 2009.

emphasize the severe lack of coordination between employers, professional associations, and education institutions with regards to the content of educational programs for accountants and engineers and accountants.

Explaining the Underdevelopment of Professional Services in East Africa – Domestic Regulation

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 East Africa. Kenya, Tanzania and Uganda seem to impose particularly severe entry restrictions in engineering and legal services. Rwanda remains on the light side in all three sectors. Each country grants exclusive rights to certain professions over certain activities. Licensing and educational requirements and quantitative constraints also inhibit competition. Regulation affecting operations of legal and engineering providers (conduct regulation) include 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.

Firm-level surveys of private providers of professionals services in East Africa reveal that restrictions on multidisciplinary activities are an important constraint in the accounting sector, while regulations on fees and prices are the major constraints in the engineering and legal sectors. Non-transparent procurement procedures also hurt accounting and engineering services providers while inappropriate standards hurt accounting services providers (Figure 3).

Explaining the Segmentation of Markets for Professional Services in East Africa – Trade Barriers

Trade barriers limit competition and the efficiency of professional service providers in East Africa. Countries in the region differ in terms of their openness to trade: Kenya and Tanzania generally exhibit the most restrictive policies on trade in professional services while Uganda is relatively open and Rwanda much more so.

Trade in professional services through the movement of natural persons (mode 4 in GATS) across national borders is restricted in East Africa by explicit trade barriers, regulatory requirements, and immigration policies. Chief among them are discretionary limits through labor market tests on the entry of any type of foreign professionals in Kenya, Tanzania, and Uganda, de jure or de facto nationality requirements to practice domestic law in Kenya and Tanzania, limited recognition of foreign-licensed professionals and work permit issues in most East African countries.

Trade in professional services through the establishment of foreign commercial presence (mode 3 in GATS) is also limited

by different types of restrictions across countries in East Africa. The entry of foreign law firms is not permitted in Kenya or Tanzania. Local members of international law networks face restrictions in Kenya, Tanzania, and Uganda on using the network's brand name. The restrictions imposed on accounting firms are even more stringent, with branches of foreign firms being prohibited in Kenya, Uganda, and even the more liberal Rwanda. Kenya and Tanzania also prohibit ownership or control of foreign accounting and auditing firms by non-locally licensed professionals. Foreign firms providing engineering services face fewer restrictions in East Africa.

All East African countries restrict cross-border trade (mode 1 in GATS) in certain types of professional services, such as advice on matters relating to domestic law, audits, as well as tax representation and tax advice.

Reforming Markets for Professional Services

The East African regional market for professionals remains generally underdeveloped and fragmented by restrictive policies and regulatory heterogeneity. Given these limitations and constraints, policy reform is necessary to allow the market for these professions to develop. An effective reform agenda will require policy action in four areas: education, regulation of professional services, trade policy and labor mobility at both the national and the international level.

Reforms at the National Level

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

Reforms related to *education* should 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 should be a priority.
- Weaknesses in African education systems mean that students are ill-equipped to acquire professional skills, so *enhancing the quality of and capacity of schools, especially in mathematics, sciences, and technical studies*, should be a key item on the policy agenda.
- 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 the job-market relevant skills and the crucial practical training.

Reforms should also focus on incremental, qualitative improvements in *domestic regulation*.

- *Disproportionate cumulative entry requirements should be relaxed*. For example, narrowing the scope of exclusive tasks in certain professions would contribute to accomplishing this goal. The argument in favor of exclusive rights is that they can lead to increased specialization and guarantee a higher quality of service. But exclusive rights that create monopolies can have adverse price and allocation effects, especially if they are granted for services for which

adequate quality can be provided at a lower cost by middle-level professionals.

- *Disproportionate restrictions on competition should be eliminated*.
 - Price regulations are supported by the East African countries' professional associations which claim that they are useful tools to prevent adverse selection problems. East African countries could adopt less restrictive mechanisms such as increased access to information on services and services providers to accomplish the same goals at lower economic cost.
 - East African 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. East African countries should eliminate regulations that are clearly anti-competitive and may harm consumers by preventing providers from developing new services or cost-efficient business models.
 - Advertising prohibitions are imposed by most East African countries to many of their professional services sectors. East African countries should 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 in East Africa by restrictive policies and regulatory heterogeneity prevent countries from taking advantage of

gains from trade based on comparative advantage, as well as gains from enhanced competition and economies of scale. Policy action is required in the following key areas.

Steps must be taken to relax the explicit trade barriers applied by East African countries to the movement of natural persons, establishment of commercial presence, and cross-border supply of professional services, as well as through discriminatory procurement. Examples of possible reforms 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; developing a transparent and consistent framework for accepting professionals with foreign qualifications. The reduction of explicit trade barriers should be complemented with the reform of immigration laws.

Trade liberalization should be coordinated with regulatory cooperation at the regional level. Trade barriers would ideally be liberalized on a most favored nation (MFN) or non-preferential basis since that would generate the largest welfare gains. But such liberalization may not always be technically feasible or politically acceptable, especially when impediments arise from differences in regulatory requirements. Deeper regional integration through regulatory cooperation with neighboring partners, which have similar regulatory preferences, can usefully complement non-preferential trade liberalization. Regional integration would also enhance competition between services providers, allow these providers to exploit economies of scale in professional education, and produce a wider variety of services. Regional integration brings further

benefits in that a larger regional market is able to attract greater domestic and foreign investment, and regionalization may help to take advantage of scale economies in regulation, particularly where national agencies face technical skills or capacity constraints. Regulatory cooperation to overcome regulatory heterogeneity within the EAC would be particularly useful in the following areas:

- East African Community countries have taken the first steps towards *mutual recognition of qualifications and licensing* in professional services in the adoption of the Common Market Protocol in 2009. While some progress on mutual recognition has been made in accountancy, EAC countries should continue to work towards implementing a regional framework for mutual recognition in other professional services even if the process is lengthy and difficult.
- Inappropriate standards can stifle demand for services. *The development of an appropriate standard may be desirable at a regional rather than national level* in order to exploit economies in regulatory expertise, prevent fragmentation of the market by differences in standards, and limit the scope for regulatory capture. Common regional standards would reduce the costs to market participants of operating across national borders. A framework for regional cooperation on accounting and auditing standards already exists in the form of the Eastern Central and Southern African Federation of Accountants (ECSAFA). All countries could benefit from the development of the ECSAFA Guide on Accounting for SMEs and from common training standards for accounting technicians such as the Occupational Standards for Accounting

Technicians in the ECSAFA Region or the accounting technician scheme recently introduced by the Association of Accountancy Bodies in West Africa (ABWA).

- *Regional cooperation on the removal of restrictions on the free movement of labor including visa and immigration laws is crucial for East Africa.* The mobility of business people is a key factor in the promotion of free and open trade. Through the Common Market Protocol, East African economies have committed themselves to enhancing labor mobility by streamlining immigration and temporary residence processes for foreign workers but these commitments need to be implemented in practice.
- *Regional cooperation to improve the financing and capacity of professional education is desirable.* Cooperation among countries in terms of sharing information and experiences to increase the recovery rate of student loans while increasing students' access to higher education could improve the impact of educational loan schemes in East Africa. 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 East Africa. The Inter-University Council for East Africa (IUCEA), a regional inter-governmental organization established in 1980 with the aim of facilitating contact between the universities of East Africa, already provides a forum to address these issues.

While the economic benefits of regional integration are evident, the pace of integration is largely dependent upon member countries' political motivation and conviction that the various reforms are beneficial to their domestic constituencies. So far, East African countries have committed themselves, at least in principle, to liberalization and deeper regional integration in a number of services sectors. However, much more work is needed to accomplish this goal. The policy discussion and recommendations presented here are intended to facilitate more informed policy choices, which could lead to a reformed and dynamic professional services sector that contributes to East African development.

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