



# Economic Premise

SEPTEMBER 2010 • Number 32

56746

## Reform and Regional Integration of Professional Services in East Africa

Nora Dihel, Ana Margarida Fernandes, Aaditya Mattoo, and Nicholas Strychacz

*Professional services matter for development in East Africa. Business services, including professional services, are among the most dynamic services sectors; and are a key input for other sectors. Greater use of professional services by East African firms is associated with higher labor productivity. But there is a large gap between the potential contribution these services could make and the meager contribution they make today. National markets for professionals and professional services in East Africa remain underdeveloped, whereas regional markets are fragmented by restrictive policies and regulatory heterogeneity. 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 international levels.*

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 2001–07, business services have grown at 8 percent a year in Kenya, 14 percent a year in Tanzania, and nearly 18 percent a year in Uganda (World Bank 2010).
- 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 (World Bank 2010).
- Business skills and services, such as accounting and legal services, play a critical role in reducing transaction

costs that are 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 also could become an important avenue for export diversification by some East African countries.

But there is a large gap between the potential contributions these services could make and the meager contribution they do make at present. Policy makers in East Africa have recognized the critical importance of developing professional services. Along with reforming backbone services like

telecommunications, banking, and transport, governments are adding professional services to their lists 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 there remain underdeveloped, at the same time that 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.

### Striking Differences in the Levels of Development of Professional Services

In terms of availability and wages, there are striking differences in the levels of development of professional services across countries in East Africa. Professionals are relatively abundant in Kenya, whereas there is a relative scarcity of professionals in Rwanda. However, per capita availability of professionals in each of those countries is only a fraction of that in more advanced African economies, such as Mauritius and South Africa (figure 1).

Although professionals in East Africa receive low nominal wages relative to their counterparts in developed and other developing countries, professionals in Kenya and Uganda are comparatively well paid when their wages are adjusted for purchasing power—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.

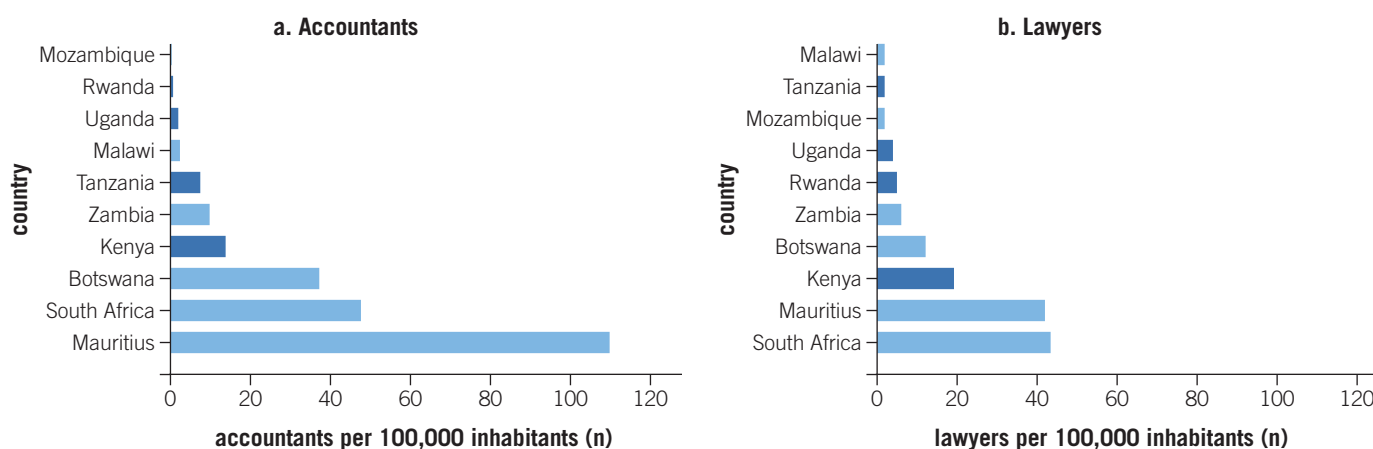
With the exception of accounting technicians in Kenya, East Africa faces a middle-level skills vacuum. Middle-level professionals can play a crucial role in providing services to groups of clients who often are underserved. Skills mismatches seem to be a serious issue in all examined countries. For example,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

### High Demand for Professional Services

Evidence from recent firm-level surveys<sup>1</sup> in East Africa suggests that a surprisingly large number of formal sector firms in all sectors use professional services.<sup>2</sup> A large proportion of the demand for accounting and auditing services seems to derive from mandatory legal requirements pertaining to financial reporting and taxation. In many cases, the relationship between the use of externally outsourced professional services and firm size exhibits an inverted U-shape: use 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 of the pattern of service use by firms of different sizes (figure 2).

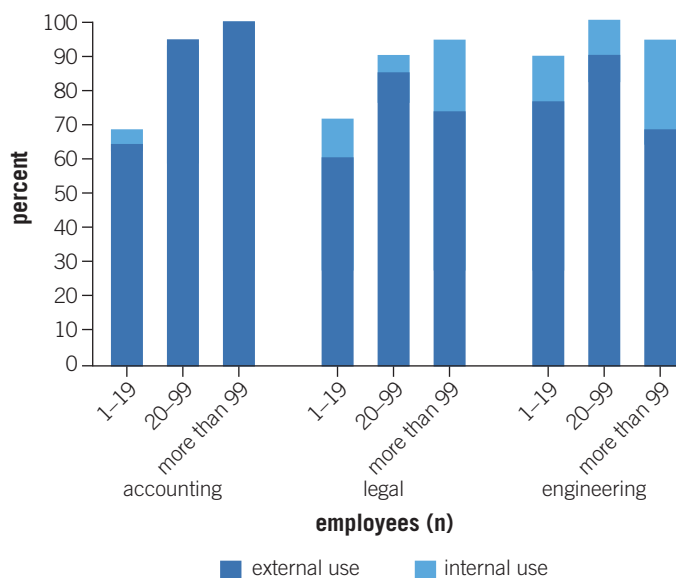
Market structures show elements of both oligopoly and competition. Accounting and auditing services are dominated in all countries by the large affiliates of the “Big Four” multinational firms.<sup>3</sup> In Kenya, however, local mid-size accounting firms are gaining market share at the expense of the Big Four, after initially working as subcontractors for them. The engineering and legal sectors are dominated by domestic providers—often small firms and microenterprises. The combined capacity of these small firms, though large, is

Figure 1. Professional Density in Africa, 2008



Source: World Bank Surveys of Market Conditions in Professional Services in Eastern and Southern Africa, 2009.  
Note: East African countries are indicated by dark-blue bars.

**Figure 2. Use of Professional Services in Uganda, by Sector, 2009**



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

too scattered to meet demand for sizable and possibly more sophisticated projects.

### 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 region’s unmet demands. However, data from World Bank regulatory surveys of professional services in East Africa in 2009 (World Bank 2010) suggest that foreign professionals in Kenya, Tanzania, and Uganda represent less than 10 percent of the total number of professionals in accounting and engineering. In Rwanda, by 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 in East Africa. 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 essentially 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.

### Explaining Skills Shortages and Skill Mismatches in Professional Services—Weakness in Education

First, professional education is expensive in all East African countries. Although 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 US\$14,000 to US\$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 students’ ability to acquire professional skills. The general erosion of mathematics 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 postgraduate courses and ones 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 emphasize the severe lack of coordination among employers, professional associations, and educational institutions with regard to the content of educational programs for accountants and engineers.

### Explaining the Underdevelopment of Professional Services—Domestic Regulation

Domestic regulation of the entry and 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 on engineering and legal services. Rwanda remains on the light side of regulation in all three sectors. Each country grants exclusive rights over certain activities to certain professions. Licensing and educational requirements and quantitative constraints also inhibit competition. Regulations affecting the operations of legal and engineering providers (conduct regulations) include restrictions on prices and fees, advertising, form of business, and interprofessional cooperation; and they are particularly

heavy when compared with those in emerging economies and in countries of the Organisation for Economic Co-operation and Development.

World Bank firm-level surveys of private providers of professional services in East Africa reveal that restrictions on multidisciplinary activities are an important constraint in the accounting sector, whereas regulations on fees and prices are the major constraints in the engineering and legal sectors. Nontransparent procurement procedures hurt both accounting and engineering services providers, and inappropriate standards hurt accounting services providers (figure 3).

### Explaining the Segmentation of Markets for Professional Services—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, whereas Uganda is relatively open and Rwanda is much more so.

Trade in professional services through the movement of natural persons (mode 4 in the General Agreement on Trade in Services [GATS]) across national borders is restricted in East Africa by explicit trade barriers, regulatory requirements, and immigration policies. Chief among those 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.

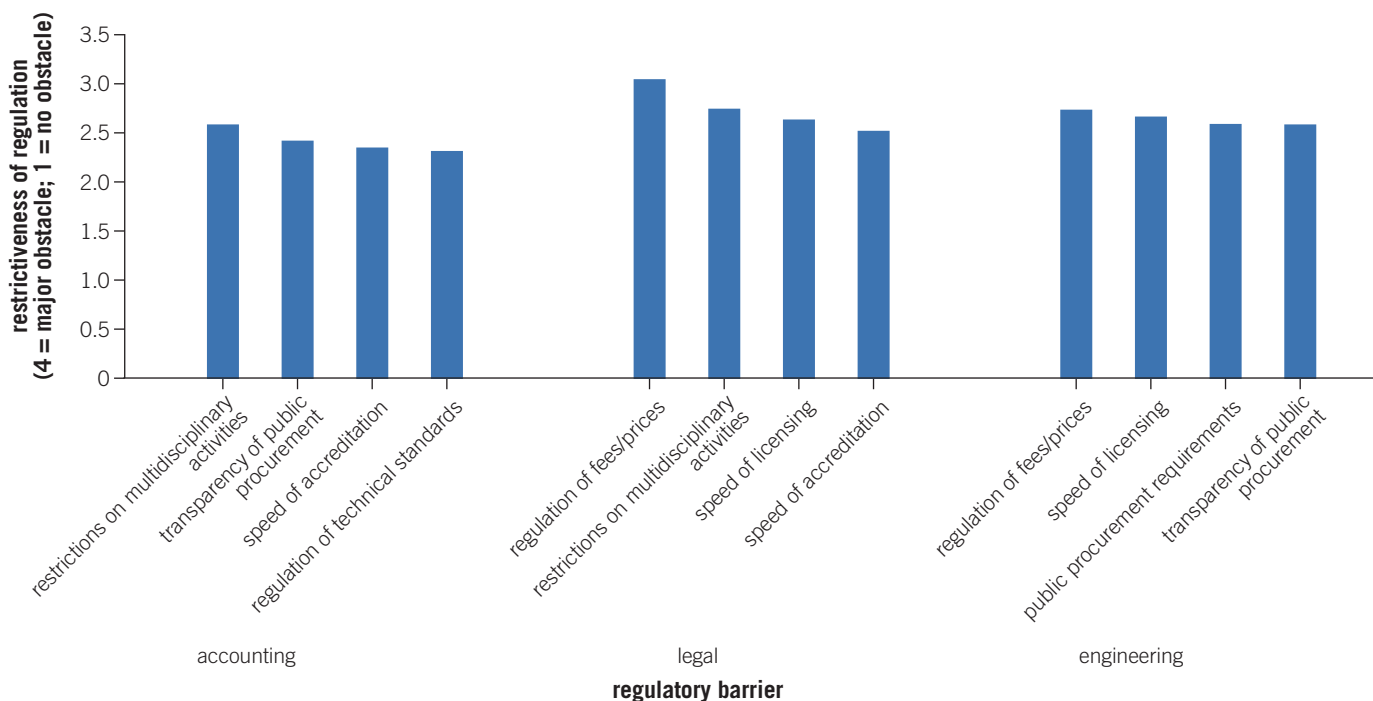
Trade in professional services through the establishment of foreign commercial presence (mode 3 in GATS) is also limited by different types of restrictions across countries in the region. The entry of foreign law firms is not permitted in Kenya or Tanzania. In those countries and in Uganda, local members of international law networks face restrictions 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 professionals not licensed locally. Foreign firms providing engineering services encounter 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, tax and tax representation.

### Reforming Markets for Professional Services

The East African regional market for professionals remains generally underdeveloped and fragmented by restrictive

Figure 3. Restrictiveness of Regulation in East Africa—Top Constraints, by Sector, 2009



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

policies and regulatory heterogeneity. Given these limitations and constraints, policy reform is necessary to allow development of the market for these professions. As noted above, an effective reform agenda will require policy action in four areas: education, regulation of professional services, trade policy, and labor mobility at both national and international levels.

### **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 that 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 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)* 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 educational institutions* could help professionals acquire the job market–relevant skills and the crucial practical training.

Reforms also should 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 who claim that they are useful tools to prevent adverse selection problems. Countries could adopt less-restrictive mechanisms (such as increased access to informa-

tion 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. These countries should eliminate regulations that are clearly anticompetitive and that may harm consumers by preventing providers from developing new services or cost-efficient business models.
- Advertising prohibitions are imposed by most East African countries on many of their professional services sectors. These 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 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. Policy action is required in the following key areas.

*Steps must be taken to relax the explicit trade barriers applied to the movement of natural persons, establishment of commercial presence, and cross-border supply of professional services; and those applied through discriminatory procurement.* Examples of possible reforms are (1) articulating the economic and social motivation for nationality and residency requirements; (2) developing transparent criteria and procedures for applying any quantitative restrictions on the movement of professionals, such as economic needs tests; (3) minimizing restrictions on the forms of establishment allowed; and (4) 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 ideally would be liberalized on a most-favored-nation or nonpreferential 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 nonpreferential trade liberalization. Regional integration also would enhance competition among services providers, enable those 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 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 East African Community (EAC) would be particularly useful in the following areas:

- EAC countries have taken the first steps *toward mutual recognition of qualifications and licensing* in professional services by adopting the Common Market Protocol in 2009. Although some progress on mutual recognition has been made in accountancy, EAC countries should continue to work toward 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* 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 market participants' costs 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 small and medium enterprises; 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.
- *Regional cooperation in removing restrictions on the free movement of labor (including visa and immigration laws) is crucial* for East Africa. The mobility of businesspeople 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 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 programs in East Africa. In general, the fragmentation of the re-

gional market for education by differences in regulation can prevent the emergence of regional hubs for higher education, so smoothing these regulatory differences may lead to a greater variety of higher education services becoming available at lower costs. The Inter-University Council for East Africa—a regional intergovernmental organization established in 1980 with the aim of facilitating contact among the region's universities—already provides a forum to address these issues.

Although the economic benefits of regional integration are evident, the pace of integration is largely dependent on EAC 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 that 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.

## About the Authors

Nora Dihel is a trade specialist with the Africa Poverty Reduction and Economic Management (PREM) unit of the World Bank. Ana Margarida Fernandes is an economist in the Development Research Group—Trade and Integration of the World Bank. Aaditya Mattoo is research manager, Development Research Group—Trade and Integration. Nicholas Strychacz is a consultant in the PREM unit.

*This work is funded by the Multi-Donor Trust Fund for Trade and Development, supported by the governments of Finland, Norway, Sweden, and the United Kingdom; and by the Bank Netherlands Partnership Program. The views expressed in this paper reflect solely those of the authors; and are not necessarily the views of the funders, the World Bank Group, or its executive directors.*

## Notes

1. In 2009, the World Bank conducted two types of firm surveys, covering users and providers of accounting, legal, and engineering services in Kenya, Rwanda, Tanzania, and Uganda. The survey instruments were developed by the World Bank and were implemented in all countries by TNS Opinion, an international research group. The surveys are described in detail in World Bank (2010).

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

3. The Big Four firms are Deloitte Touche Tomatsu, Ernst & Young, Klynveld Peat Marwick Goerdeler, and PriceWa-

terhouseCoopers. 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.

## Reference

World Bank. 2010. "Towards an East African Reform and Regional Integration in Professional Services." Washington, DC.