

**A PROJECT ON:**

**Capacity Building of Civil Society in Eastern and  
Southern Africa during  
The EPA Negotiations**

**A BACKGROUND PAPER SYNTHESISING STUDIES ON  
POTENTIAL IMPACT**

**OF**

**AN EPA ON THE KENYAN ECONOMY.**

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## **ABBREVIATIONS**

|                   |  |
|-------------------|--|
| <b>ACP</b>        | African Caribbean and Pacific                |
| <b>CAP</b>        | Common Agricultural Policy                   |
| <b>CPA</b>        | Cotonou Partnership Agreement                |
| <b>CEMAC</b>      | Central Africa Monetary Union                |
| <b>CET</b>        | Common External Tariff                       |
| <b>COMESA</b>     | Common Market for Easter and Southern Africa |
| <b>CSS</b>        | Country Support Strategy                     |
| <b>EAC</b>        | East African Community                       |
| <b>EBA</b>        | Everything But Arms                          |
| <b>ECOWAS</b>     | Economic Community of West African States    |
| <b>EDF</b>        | European Development Fund                    |
| <b>EIB</b>        | European Investment Bank                     |
| <b>ESA</b>        | Eastern and Southern Africa                  |
| <b>EPA</b>        | Economic Partnership Agreement               |
| <b>EU</b>         | European Union                               |
| <b>FTA</b>        | Free Trade Area                              |
| <b>WTO</b>        | World trade Organization                     |
| <b>GDP</b>        | Gross Domestic Product                       |
| <b>GSP</b>        | Generalized System of Preferences            |
| <b>IMF</b>        | International Monetary Fund                  |
| <b>KEPLOTRADE</b> | Kenya Post Lome Trade Negotiations Programme |
| <b>LDC</b>        | Least Developed Country                      |
| <b>NDTPF</b>      | National Development Trade Policy Forum      |
| <b>RNF</b>        | Regional Negotiation Forum                   |
| <b>SADC</b>       | Southern Africa Development Community        |
| <b>SAP</b>        | Structural Adjustment Programme              |

## 1. Introduction

The Cotonou Partnership Agreement (CPA), signed in 2000 gave a new momentum to the relationship between the African Caribbean and Pacific (ACP) States and the European Union (EU). The CPA marks a fundamental shift in relations between the EU and seventy-seven countries from across the ACP. The CPA provided for the establishment of new WTO compatible trading agreements to replace the Lome Convention trading arrangements. As the successor to the Lome Conventions, the Cotonou Agreement makes a clear association between the political, trade and development dimensions. It is based on five pillars:

- Reinforcement of the political dimension of relations between the ACP countries and the European Union;
- Involvement of the civil society, the private sector and other Non-State actors;
- Poverty reduction;
- An innovative economic and trade cooperation framework;
- Rationalization of financial instruments and a new system of “rolling programming.”

The aim of future economic and trade cooperation according to the CPA is:

*“Economic and trade cooperation shall aim at fostering the smooth and gradual integration of the ACP States into the world economy, with due regard for their political choices and development priorities, thereby promoting their sustainable development and contributing to poverty eradication in the ACP countries.”<sup>1</sup>*

The European Commission (EC) proposed replacing the system of non-reciprocal trade preferences that ACP countries have enjoyed for the past thirty years under the Lome Conventions with the new Economic Partnership Agreements (EPAs).

### Reciprocity

The salient characteristic of the EPAs is ‘**reciprocity**’. The EU sees EPAs as Free Trade Agreements (FTAs) where Kenya, along with other ACP countries, would have to grant European companies preferential access to its markets in return for the continuation of its preferential market access in the EU.

Kenya is negotiating its EPA under the Eastern and Southern Africa (ESA) group. The other countries in ESA include: Burundi, Comoros, Democratic Republic of Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Uganda, Zambia and Zimbabwe.

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<sup>1</sup> Cotonou Partnership Agreement Article 31:1

Kenya faces major challenges in trying to turn its economy around, particularly:

- Supply side constraints such as poor infrastructure, transport and high costs of inputs
- Unfair competition in key sectors
- Improving market access

For Kenya to tackle these challenges and rebuild its economy we need to be able to protect key groups and sectors from competition both at home and on the regional markets which are vital to achieving this goal.

### **Multiple Memberships**

Kenya is a member of several groups including the Common Market for Eastern and Southern Africa (COMESA) and the East African Community (EAC). Kenya, Tanzania and Uganda are members of the EAC but Tanzania is a member of SADC not the ESA, causing potential problems for further integration in the EAC.

In Southern and Eastern Africa there are two blocs negotiating an EPA, the ESA bloc which does not correspond to any pre-existing trade bloc and contains both COMESA and SADC members, and the SADC bloc, which contains the rest of SADC members. This situation threatens to drive apart the regional integration processes of COMESA and SADC as a country cannot be a part of two customs unions. This situation is exacerbated by the overlapping membership of COMESA and SADC.

## **2. Structure for Negotiations of EPAs**

EPAs will require ESA countries to liberalize most of their trade over a short period of time with the new trading arrangements expected to come into force at the beginning of 2008 with an implementation period of at least 10-12 years.

To support and facilitate the process of negotiation, Kenya with the support of the EU, has already established its National Development Trade Policy Forum (NDTPF). The Trade Negotiations Support Programme under the Kenya-European Union Post Lome Trade Programme (KEPLOTRADE) performs the functions of the NDTPF. The role of the NDTPF is coordination of the country's preparation for negotiations as well as representing the country at Regional Negotiating Forum (RNF) meetings.

KEPLOTRADE National Structure is comprised of government ministries, public institutions, private sector and civil society groups. To facilitate the preparation of negotiating positions, the structure has six clusters, in line with the Eastern and Southern Africa (ESA) identified negotiating clusters, namely: Agriculture, Trade Related Issues, Market Access, Fisheries, Development Issues and Services. The

primary role of the clusters is to develop negotiation positions through analytical studies.

EPA negotiations are to be undertaken between the EU and ACP countries that consider themselves in a position to do so, either as individual countries or as part of a regional integration grouping. In their desire to promote the unity of the ACP group and take due account for the national and regional specificities, the ACP group countries have decided to conduct the negotiations in two phases.

The first phase, which is at the All-ACP level, began in September 2002 with the launch of negotiations on the objectives and the principles of EPAs as well as issues of common interest to all ACP States.

The second phase, at the regional level will deal mainly with tariff negotiations and other negotiations and commitments at the national and regional level, as well as issues specific to ACP countries or regions. This phase began in September 2003.

### **Regional Groupings**

The ACP region has configured itself into six distinct regional groups under which negotiations with the EU will take place. These regional groups are as follows:

- Eastern and Southern Africa (ESA)
- Southern Africa Development Cooperation (SADC)
- Economic Commission of West African States (ECOWAS)
- Central Africa Monetary Union (CEMAC)
- The Caribbean and
- The Pacific
- 

Kenya is negotiating EPAs under the Eastern and Southern Africa configuration.

### **3. Historical Perspective**

Kenya has undertaken liberalization programmes in the past and this experience should be taken into account before committing to more of the same. As EPAs will be negotiated regionally, they will have an impact on existing regional groupings in Africa.

#### **Past Liberalization Efforts**

The trade liberalization that Kenya underwent during the 1980s and 1990s as part of the Structural Adjustment Programmes (SAPs), debt relief packages, membership of the WTO and regional groupings, had a serious impact on the poorest people. Manufacturing sectors declined, most agricultural production went into a free fall and poverty and unemployment levels rose dramatically. EPAs will force Kenya to liberalize still further, allowing market access to highly competitive

European businesses; these experiences serve to show what is at stake, and what the impacts on Kenya's future development are likely to be.<sup>2</sup>

At independence, Kenya maintained a managed economic system with controls on foreign exchange, high tariff barriers, and import licensing as well as controls on wages and retail and producer prices. In the 1960s, Kenya was at par economically with the current economic giants like Malaysia and Singapore, the Kenyan economy performed well with GDP growth rates averaging 5.5% annually. The manufacturing sector grew at a rapid pace of 10% per annum fuelled by the growth in domestic incomes and the expansion of exports to Tanzania and Uganda under the Common Market fuelled by the first East African Community (EAC). Kenya developed a diverse industrial base, including processed plastics, pharmaceuticals, steel rolling and galvanizing, paper, vehicle assembly, textiles, garments, leather and tanning and food processing.

### **Rapid decline**

In the late 1970s, the Kenyan economy faced a number of shocks; coffee prices began to fall, oil price increases and the break up of the original East African Community (EAC). From the late 1970s, trade liberalization was seen as the solution to many economic and social problems facing the region. However, trade liberalization was to cause terrible economic and social damage throughout the 1990s.

### **Structural Adjustment Measures (SAPs)**

As a remedial measure to the economic shocks, the World Bank and the International Monetary Fund (IMF) prescribed the Structural Adjustment Programmes (SAPs) which seemed to bear little relation to the causes of the shocks. Instead of working to stabilize coffee prices and revive regional trade, the SAPs that were introduced in 1980, required the country to liberalize its trade regime. In return for various loans and debt relief packages over the next twelve years, Kenya underwent a series of trade reforms.

During the 1990s, these reforms were compounded by further waves of liberalization as Kenya joined the World Trade Organization (WTO) and agreed to bind its tariffs. Further liberalization was required as part of regional integration initiatives, notably the Common Market for the Eastern and Southern Africa (COMESA) and the EAC.

The impact of these measures has been devastating with economic stagnation, de-industrialization, decline in agricultural production and massive loss in employment with terrible consequences for society and longer-term development. Tariffs

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<sup>2</sup> EPAS: Through the lens of Kenya. EcoNews Africa and Traidcraft Exchange, September 2005.

remained and still are the main trade policy instruments for the county. During the 1980s and 1990s much of the previous progress was undone with Kenya, which was the most developed of the three East African Economies (Kenya, Uganda and Tanzania) entering a spiral of economic decline.

### **Everything But Arms (EBA)**

However, it is important to note that Tanzania and Uganda are grouped under the Least Developed Countries (LDCs) which benefit from the Everything But Arms (EBA) initiative that allows tariff and quota free access to the EU market for all products except arms. Kenya on the other hand is a developing country and does not benefit from EBA. If Kenya chooses to decline an EPA, it would be forced to accept the Generalized System of Preferences (GSP). The EU committed in the Cotonou Agreement that non-Least Developed Countries such as Kenya who may not consider themselves in a position to sign an EPA would be offered an arrangement with no worse market access. So far no work has been done on what this alternative might look like. This needs to happen urgently if ACP countries are to be offered a real choice. There will be a major review of the EPAs in 2006 and both the EU and ACP member states need to use this opportunity to review the progress made so far and agree on the way forward.

### **4. The Kenyan Economy at a glance**

The backbone of Kenya's economy is in agriculture, which is the main source of livelihood for the majority of Kenyans. Agriculture in Kenya is primarily rain-fed and thus vulnerable to weather patterns. Kenya is the world's largest exporter of cut flowers to the EU commanding a 25% market share. The country is also the world's third largest exporter of tea. Horticulture and tourism are Kenya's most important sources of foreign exchange. The industrial sector is small, but is a growing source of exports to East Africa. Unemployment in Kenya is 25 per cent. This has increased 9 per cent in the last 10 years.

Following the introduction of the East Africa Community (EAC) Common External Tariff (CET) in January 2005, Kenya applies three basic tariff bands to imports:

- 0% for raw materials and capital goods
- 10% for intermediate goods and
- 25% for final goods

Kenya maintains a small list of sensitive products, which attract higher tariffs. These include wheat, sugar and dairy products.

TABLE 1: Kenya's trade with the EU<sup>3</sup>

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<sup>3</sup> "Implications for Kenya of the EC Proposals for Reform of the GSP", Chris Stevens and Jane Kennan, Institute of Development Studies for Traidcraft, September 2004

| <b>Primary Imports</b>         | <b>%</b> | <b>Primary Exports</b> | <b>%</b> |
|--------------------------------|----------|------------------------|----------|
| Machinery                      | 26       | Tea                    | 17.3     |
| Chemicals                      | 20       | Fresh roses            | 16.4     |
| Vehicles                       | 9        | Vegetables             | 13       |
| Pulp and Paper                 | 6        | Coffee                 | 8.1      |
| Food and Agricultural products | 5        | Other flowers          | 5.3      |

## **5. Kenya's future Policy plans**

The framework for Kenya's economic recovery is contained in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) 2003-2007.<sup>4</sup> The ERSWEC recognizes that in order to revitalize the economy, the country must maintain a stable 'macroeconomic environment'.

The ERSWEC focuses on tackling corruption, HIV/AIDS and reviving education and health in order to boost domestic competitiveness, export performance and ultimately economic growth. Amongst the main drivers identified for the Kenyan economy are the manufacturing sector and regional and international trade. Micro and Small Enterprises (MSEs) are seen as the engine of growth.

The structure of exports influences the extent to which a country benefits from trade. For example, while the price of primary products tends to stagnate, the market for manufactured goods tends to expand. The strategy therefore is to maximize Kenya's penetration into industrialized markets without jeopardizing regional market share, which is fundamentally important for Kenya's industrialization efforts.

If EPAs are to contribute to Kenya's economic development they must be designed specifically to complement this strategy and not place additional pressure on Kenya to adopt new or different approaches.

## **6. Market Access**

Market access describes the extent to which goods or services can compete with locally made products in another market. The market access for goods is regulated through border measures namely: - tariffs, quantitative restrictions, and non-tariff barriers to trade. Market access constraints to the EU are based on three main sectors namely: Agriculture/Horticulture, Manufacturing and Services.

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<sup>4</sup> "Economic Recovery Strategy for Wealth and Employment Creation." Government of Kenya. June 2003

Kenya's manufactured exports are mainly competitive in the Regional Trading Arrangements (RTAs) of EAC and COMESA. Through the ESA-EU trade arrangement, the EU manufactured goods will have access to these blocs giving stiff competition to Kenyan exports in the region. This will reduce the revenue Kenya gets from exports in the region.

Kenya's export revenue accounts for 10% of her total revenue. Therefore, erosion of preferences will have a negative impact on revenue generation from exports to the EU. The government should seek alternative revenue collection points or seek compensation for the loss of revenue.

Subsidies given to EU farmers under the Common Agricultural Policy (CAP) reduce the market access of the Kenyan unprotected farmers to the European Union market.

The EU has now ten more members from Eastern European Union who are at the same level of development as ESA countries. The question for Kenya is whether this translates into more market access or more competition in the face of reforms of CAP by the EU and erosion of preferences. The erosion of preferences might also lead to unemployment as some firms go out of business and others cut down jobs.

### **Welfare effects of an EPA**

The welfare effects of an EPA may be:

- Consumption expansion
- Trade diversion and
- Trade creation

Kenya is attempting to diversify its reliance on Europe as a destination for its exports. The East Africa and COMESA regions offer market opportunities for Kenya's agricultural surplus and markets for manufactured goods as Kenya revives its industrial base putting thousands of people into work. COMESA is Kenya's most important export market (with 35 percent by value in 2002), followed by the EU (28 percent).<sup>5</sup> The EU is already expanding its processed agricultural and manufactured goods in these markets. While this penetration is likely to increase the variety of goods from which consumers can choose from, with the liberalization involved in an EPA, increased competition will make it difficult for Kenya to use regional trade as a springboard for national development and poverty eradication. More efficiently produced goods from the EU will replace the less efficiently produced goods in Kenya.

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<sup>5</sup> "Comparative study of G8 preferential access schemes for Africa", Chris Stevens and Jane Kennan, Institute for Development Studies for DFID, April 2004.

EPAs will make it difficult for Kenya to use tools such as tariffs to protect local producers. The scope within an EPA to protect sensitive sectors may not be enough. Kenya will not be able to protect grain, sugar, dairy, textiles, leather and the manufacturing industry. In the key stages of Europe's industrial development, countries imposed high tariffs on key items in order to protect infant industries.

The EU Eastward expansion will involve substantial financial support for Eastern European countries to improve commerce and industry so that they can meet EU standards and compete with its industries. It is expected that equal levels of investment are needed for Kenya and ESA if the EU-Kenya ESA-EPA is going to be successful.

### **Sanitary and PhytoSanitary (SPS) Measures**

SPS measures are another form of technical barrier to trade, which the EU has used effectively to regulate imports into the EU market for its own benefit. Perhaps unsurprisingly given its importance as a market, it is the EU's SPS requirements that attract most the most significant volume of complaints from Kenya. The principal problem is not that the standards are unattainable, but that the regulations change so fast that it is difficult for Kenya to keep up.

Although SPS measures may be imposed outside the territory of the importing country, their purpose must be to protect health within the territory of the importing country. They must not be applied in a manner, which would constitute a means of arbitrary discrimination or a disguised restriction on international trade but should have scientific validity

Since 1993/94, the EU has repeatedly tightened rules on permitted pesticide residue levels on imported fruits and vegetables, and for most Kenyan produce these are now set at zero.

Kenya lacks adequate monitoring, testing and certification facilities to adequately demonstrate compliance with all the import regulations. The problem is particularly acute for small-scale producers who may, for instance wish to export organically grown products. In the case of horticulture, compliance with the stringent Maximum Residue Levels (MRLs) also causes serious problems to small-scale farmers who may not fully appreciate the problems of the export market. The EU needs to hasten the accreditation of local institutions such as KEPHIS, which should be mandated to check conformity to various EU regulations.

### **Tariff Escalation**

Tariff escalation has often been used to deny access to markets for imported commodities and EU countries frequently use these measures to protect their agricultural and industrial sectors. Tariff escalation is evident when tariffs for raw materials are lower as compared to tariffs for processed products. Thus as one moves along the value chain, the import tariffs applicable to the same commodity

rises steeply. The effect of tariff escalation is to make imported processed commodities more expensive than the same commodity processed within the EU and accordingly give protection to processors of these commodities within the EU.

EU coffee and rice imports provide some good case studies in tariff escalation. The import of green coffee beans is not subject to a tariff in the EU, for example, while a tariff of 7.5% applies to roasted coffee and 9% to decaffeinated coffee. In 2003, EU imported coffee worth US \$ 2.84 billion but green coffee beans accounted for 97% of these imports. Thus tariff escalation clearly favours importation of unprocessed coffee from countries such as Kenya.

Kenya should negotiate for the removal of tariff escalation on account of the potentially negative implications on industrialization and poverty alleviation strategies and its contradiction with the broader WTO/EU development agenda for promoting industrialization in developing countries.

## **7. Agriculture**

### **Common Agricultural Policy (CAP)**

Under CAP European farmers continue to demand higher prices and incomes from their politicians. There is little that the Kenyan farmer can do to change matters in his favour. Twenty-five years of ACP-EU cooperation (Lome I-IV) have done little to address economic decline in the South. Kenya and the rest of Sub-Saharan Africa have been in steady decline whatever indices one looks at: per capita income, life expectancy, HIV/AIDS, pre-natal and maternal mortality, forest cover, agricultural output, water availability, education and security.<sup>6</sup> The EU- CAP has done very little to address these issues and the levels of poverty in Kenya continue to rise.

Kenya used to have a quota under the ACP-EU Sugar Protocol, which enabled it, like Mauritius, to export cane to Europe, where it received a price related to the domestic EU level, which is significantly above world market levels. However, Kenya is a net importer of sugar. A 100 per cent duty on non-COMESA states and quotas on COMESA imports protect the domestic sugar industry in Kenya. Whilst deliveries to the EU must be domestically produced, there is no provision in the sugar protocol that prohibits a country importing an equivalent amount to satisfy domestic consumption. But in cases where a country fails to deliver its quota it must file documents to invoke a *force majeure* clause in the Sugar Protocol, and Kenya failed to do this.

One then asks the question of whether even with continued preferences, Kenya can continue to benefit if she cannot even maintain the sugar quota under the ACP-EU Sugar Protocol. Maybe the answer lies in opening up the market to competition. The sugar industry in Kenya supports directly and indirectly about six

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<sup>6</sup> Keplotrade Research Paper No. 8, J. Kariuki. The impact of EPAs on Agriculture

million Kenyans. Opening up the market will cause a collapse of the industry given that Kenya does not have a comparative advantage in the production of sugar.

Some studies suggest that the EU-ESA EPA is unlikely to negatively affect Kenya's exports to the EU. Exports of horticultural products, coffee and tea are likely to either remain the same or to substantially increase, especially if the EU withdraws subsidies extended to its horticultural producers (e.g. on fruits and vegetables) and also reduces the high tariffs on processed products of commodities such as tea and coffee. Kenya must build its capacity in adding value to commodities that are currently exported in primary and bulk form. For instance, attaining a value addition level of 50% for Kenya tea exports would increase export earnings by more than Kshs 12 billion (using 2003 export figures). The EU-ESA EPA is however expected to pose significant challenges for Kenya's major food commodities such as wheat, rice, sugar, dairy, maize and even meat and meat products. The EU is currently heavily subsidizing production, processing and export of all these commodities. Kenya should negotiate for negative listing of these major food commodities because they are very critical to the economy especially in terms of ensuring food security, livelihoods and rural development. Further, it is important that Kenya negotiates for more time, before reciprocity takes effect, to address supply constraints currently dogging the agricultural sector.

### **Safeguard Measures for Agricultural Products**

Safeguard measures are needed for those sectors of the economy that will come under severe threats from imports under the EPA. In the case of Kenya, for varying reasons, the following sub-sectors in agriculture will come under threat: maize, sugar, dairy, wheat, oil crops, beef and veal, coffee, tea, pyrethrum, sorghum, millet, cassava, potatoes and poultry. Kenya needs to develop for all these products both primary and processed, special safeguard measures for negotiations with the EU.

### **8. Supply Side Constraints**

Supply side constraints are factors that limit an enterprise from supplying to the market in a competitive manner. Supply side constraints limit competitiveness of Kenyan products in the international markets. These supply side constraints include; poor and inefficient transportation infrastructure, poor communication and power infrastructure, low technology advancement, inadequate financing, low human and entrepreneurial skills and high cost of transaction and inadequate business support.

During the previous agreements of the ACP-EU, Kenya did not manage to exploit the full potential of the markets access provided for by the Lome (I-IV) due to supply side constraints. The success of EPAs will depend on the removal of supply side constraints. It is only then that the benefits from bilateral and multilateral economic liberalization will be realized. To minimize the negative long-term effects

arising from EPA-induced competition, Kenya should negotiate for funds under the development component that will be utilized to address supply-side bottlenecks.

The table below shows how each of the supply side constraint affects the competitiveness of Kenyan products.<sup>7</sup>

**Table 2. Impact of Supply Side Constraints**

| <b>Supply side constraint</b>  | <b>How they impact on competitiveness</b>   |
|--|---|
| <p><b>1. Transportation</b></p> <ul style="list-style-type: none"> <li>• Lack of harmonization in the legal framework for transportation</li> <li>• Poor road/rail infrastructure</li> <li>• High operation costs due to high taxation</li> <li>• High transportation costs</li> <li>• Irregular and infrequent transportation due to poor roads.</li> </ul> | <ul style="list-style-type: none"> <li>• Uneven development between the various modes of transportation</li> <li>• Unreliable transportation infrastructure causes delays and concerns about quality.</li> <li>• Transportation lead-times and freight rates influence delivery and impact upon the cost of acquisition to the customers.</li> <li>• Transportation services available on demand bring additional flexibility and business opportunity to the farmers and business community.</li> <li>• Irregular transportation causes organizations to maintain buffer stock to avoid interruption in production. This adds to the cost of production</li> </ul> |
| <p><b>2. Energy</b></p> <ul style="list-style-type: none"> <li>• High costs of energy</li> <li>• Poor and inconsistent power quality</li> <li>• Over reliance on hydro electric power</li> </ul>   | <ul style="list-style-type: none"> <li>• Inefficient and expensive energy reduces overall competitiveness.</li> <li>• Frequent power cuts disrupt production and cause delays.</li> <li>• In case of drought, there is unreliability</li> </ul>   |

<sup>7</sup> “Background Study on the Supply Side Constraints affecting Kenya’s ability to compete under future EPAs”. Research Paper No. 12 by Rosemary Mwangi Mburu for KEPLORADE.

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|---|---|
|   | in production.  |
| <p><b>3. Communication</b></p> <ul style="list-style-type: none"> <li>• Lack of legal framework on information and communication technology (ICT)</li> <li>• State monopoly hence inefficiency and unreliable connectivity</li> <li>• High taxation of ICT equipment</li> </ul>   | <ul style="list-style-type: none"> <li>• ICT is not highly regarded hence the development of the sector lags behind and reduces overall competitiveness.</li> <li>• Poor communication infrastructure causes delays. Reliable communication is essential.</li> <li>• Poor internet- based connectivity limits operations based on e-commerce and the advantage of reduced cost of acquisition.</li> </ul> |
| <p><b>4. Technology</b></p> <ul style="list-style-type: none"> <li>• Low levels of technology innovation and capability</li> <li>• Low levels of FDI.</li> <li>• Level of spending on licensing of foreign technology is low.</li> <li>• Registration of local innovation is low.</li> <li>• Limited investment in research and development.</li> </ul> | <ul style="list-style-type: none"> <li>• Lack of technological innovation limits Kenya’s ability to develop diverse products and services, which will enhance competitiveness.</li> <li>• Technology helps improve on the methods of production and thus reduces costs of production.</li> </ul>  |
| <p><b>5. Working capital and investment financing.</b></p> <ul style="list-style-type: none"> <li>• Legal framework doesn’t adequately address issues of investment and finance.</li> <li>• Weak financial systems</li> <li>• Under investment in</li> </ul>  | <ul style="list-style-type: none"> <li>• Discourages competition, causes high inflation and interest rates; a strong currency has a direct impact on the prices of the goods and services Kenya sells.</li> <li>• Investors use the financial system as a source of information on</li> </ul>   |

|  |  |
|--|--|
| <p>infrastructure, transportation, ICT</p> <ul style="list-style-type: none"> <li>• Lack of adequate finance</li> <li>• High interest rate</li> </ul>  | <p>macroeconomic conditions and company performance. When local banks cannot provide this information effectively foreign investors stay away from the country.</p> <ul style="list-style-type: none"> <li>• Inadequate infrastructures increase the risks and costs of doing business.</li> <li>• Inadequate access to finance in Kenya affects supply capabilities causing delays. Suppliers may not be in position to offer credit facilities, reducing competitiveness</li> </ul>              |
| <p><b>6. Human and skills resources</b></p> <ul style="list-style-type: none"> <li>• Compared to countries in Europe, America, the supply of skills is low in Kenya across the board and especially in the areas of trade and ICT</li> <li>• Less than 2 percent of the labour force are university graduates.</li> </ul>  | <ul style="list-style-type: none"> <li>• Skills shortage leads to use of sub-standard labour with a consequent impact on quality.</li> </ul>   |
| <p><b>7. Entrepreneurial and management Gap.</b></p> <ul style="list-style-type: none"> <li>• A weak legal framework for integrating the education set up with industrial sectors.</li> <li>• Outdated colonial legal framework that has become irrelevant to the current environment.</li> <li>• Inadequate institutional support to entrepreneurs in the areas of marketing, financing, technology, research and development.</li> </ul> | <ul style="list-style-type: none"> <li>• Local learning institutions cannot meet the needs of industry since the curriculum taught is not relevant to the dynamic business world. This leads to import of highly paid expatriates, low levels of technology transfer and loss of employment for Kenyans.</li> <li>• Outdated legal framework adds to the cost of business.</li> <li>• Inadequate support to entrepreneurs leads to lack of innovation and thus reduced competitiveness.</li> </ul> |
|  |  |

|   |   |
|---|---|
| <p><b>8. Transaction costs</b></p> <ul style="list-style-type: none"> <li>• Too many regulatory institutions managing trade and all charge a fee and cause delays.</li> <li>• Bureaucracy</li> <li>• Corruption</li> </ul>  | <ul style="list-style-type: none"> <li>• Fees, delays and corruption add to the cost of doing business and lead to lack of competitiveness.</li> </ul>  |
| <p><b>9. Access to business support</b></p> <ul style="list-style-type: none"> <li>• Generally there is lack of involvement of private sector in policy formulation and identification of the type of support required.</li> <li>• Institutional framework for trade support services does not match exporters' needs and degree of satisfaction with existing supply is not high.</li> </ul> | <ul style="list-style-type: none"> <li>• Lack of involvement of the private sector in policy formulation process, reduces the effectiveness of and the support for the policies and risk undermining their legitimacy</li> <li>• Incentives and technical support play a key role in an export oriented development strategy. A lack of support works against the strategy</li> </ul> |
| <p><b>10. Hard infrastructure</b></p> <ul style="list-style-type: none"> <li>• Lack of institutional capacity and facilities across all hard infrastructure in the country</li> </ul>   | <ul style="list-style-type: none"> <li>• Performance of the infrastructure is undermined and this affects competitiveness of the country.</li> </ul>  |

## 9. Manufacturing Sector

Kenya's manufactured exports include textiles, miscellaneous food, sugar and confectionery, metal products, non-electrical machinery, pottery and glass products, electrical machinery, bakery products, beverages and tobacco, transport equipment, non metallic mineral products, chemical and plastic products.

The huge ESA-EU gap in industrial competitiveness implies that the ESA-EU partnership will have to address industrial issues related to the capacity of Kenya to generate higher value added and produce better quality goods, to upgrade their manufacturing technologies and shift industrialization efforts increasingly towards export orientation. Market access is not currently a major constraint to the

performance of the manufacturing sector, it is rather the limited domestic supply response to existing market opportunities. One of the most distinctive features of Kenya's export structure is the failure to diversify both in terms of products and in terms of markets. Over time there has been a shift in the export profile away from the relatively more dynamic European markets and towards the less dynamic African markets.

The sectors that will experience a fall in effective protection with the coming into force of an EPA include food preparations, clothing, leather and foot wear, wood products, paper for printing and publishing, rubber products and non-metal mineral products, paints, detergents and soap. Products that show higher price responsiveness include paper and paper products, chemicals, iron and steel, non-ferrous metals, textiles, food products and leather products. These products could be considered as vulnerable to a lower tariff regime as they are sensitive to price changes under an EPA.

Trade liberalization through an EPA is likely to increase Kenyan manufactured exports to EU by about 7.2%. However, the increases in EU manufacturing exports will be within the range of 8% to 24%. Hence, an EPA would significantly worsen the balance of trade (or industry-level terms of trade) with the EU in the case of manufactures.

Kenya has a well developed financial infrastructure compared to other ESA countries. The country therefore, has the capacity to ease any credit constraints that may arise from increased supply of Kenyan exports. There is the possibility that some Kenyan firms in the financial sector will access the ESA market either through exports of financial services or foreign investment. An EPA provides a wider market within which Foreign Direct Investment (FDI) can operate with minimal transaction costs.

Kenyan firms are more export oriented than their neighbours and strategic competitors (especially India, China and Pakistan). This gives Kenya the competitive edge in the export sector and it is likely to continue servicing regional markets without much intra-ESA competition. Given the large EU share in intermediate inputs and machinery and equipment imports, it would be expected that liberalization through EPAs would increase Kenya's competitiveness through cheaper intermediate inputs and capital equipment.

### **Sensitive Products**

Kenya defines sensitive products in terms of their contribution to employment and revenue generation. Definitions of sensitive sectors and products remain highly arbitrary as no clear standards and benchmarks exist. Most of the industrial products in Kenya are sensitive and vulnerable and therefore require some form of protection. Given the vulnerability of Kenya's industry to external competition to be brought about by an EPA, policy intervention will be necessary to assist producers

and sectoral participants to adjust and therefore help to mitigate the costs of adjustment. Kenya can negotiate for continued protection of sectors likely to experience EPA-induced contraction and sectors identified as sensitive.

## **10. Services Sector**

Services are an increasingly important export sector in Kenya. The growing importance of the services sector in national output has been accompanied by an expansion of the share of commercial services in total trade. There is potential for greater growth if restrictions are reduced or removed. A lack of detailed studies makes it difficult to know which services have a comparative advantage in the various services sectors and modes. This notwithstanding, tourism is the best example of a sector with comparative advantage in Kenya and earns the country high revenue.

## **11. FINANCIAL PROVISIONS**

Unlike in the Lome' Agreement where finance was provided to the ACP through several cooperating instruments, in the Cotonou Agreement, it will be made available through two cooperation instruments: - the grant facility and the investment facility.

The grant facility will be allocated on the basis of need and performance. The resources will be used to assist in case of shortfalls in export earnings and to finance other macroeconomic support operations. Unlike in Lome, STABEX and SYSMIN no longer exist as separate instruments. Assisting the vulnerable ESA countries address fluctuations in export earnings will be done through the overall programming process (consultation) between the EU and each ESA government.

This process will be based on a single Country Support Strategy (CSS) for each ESA state covering all operations and based on indicative resource allocation covering a 5-year period. Countries are to initiate their own development strategies, plans and priorities that must be coherent with what other donor countries are doing, incorporating a flexible and regular review.

The following issues of concern arise with the above financial assistance:

- The first financial assistance will be closely linked to country performance and needs. Performance based financing may overlook the development perspective of financial assistance, hence missing out its essential tasks and impact on people. The need criterion is also bound to be subjective.
- The issue of absorption capacity also needs to be addressed. ESA countries have low absorption capacity mainly related to the low accessibility of the Lome financial provisions. Over the years there have been financial balances unused from previous economic development funds.

- ESA countries also need to address the ineffectiveness of financial assistance. Considering the ACP group has a population of over 609 million, the 25 billion Euros provided over a period of seven years is a relatively small amount of money (less than 6 Euros per capita per annum). To reduce ineffectiveness, critical areas for support should be well identified: the institutions implementing different programmes also need to be coordinated to improve on coherence and promote synergies. Transparency and accountability needs to be well observed if the available financial assistance is to make a difference.

## **12. Conclusion and Recommendations**

It is difficult to envision a situation where, however much a poor country like Kenya tries, the negotiations between her and the EU can be said to be truly just and fair. The only relevant criterion then is whether Kenya is worse off or better off than she is at the moment with or without an EPA. Were Kenya's economy reasonably diversified and not so dependent on coffee, tea, horticulture and tourism, a case could be made for the country being better off without an EPA. In the present circumstances, it is difficult to believe that there is much of a choice.

Some critics have argued that not signing an EPA is not a good option in view of the importance of the EU to Kenya's agricultural exports. The stability and nature of the Lome Agreements generated greater predictability for Kenya's exports but the Generalized System of Preferences (GSP) is unilateral in measure and this can be withdrawn any time and hence lacks predictability. Kenya may also lose substantially in the absence of an EPA and resorting to the GSP, through steep tariff escalation in the EU. The best option therefore, is to go for a contract that would ensure predictability.

Due to the high cost of trade liberalization, Kenya should negotiate to be allowed a longer transition period (under the principle of reciprocity in the EPA negotiations). There is also need for adjustment financing, including support for policies to remove supply-side constraints. This will enable local producers to generate higher value added and produce better quality goods, to upgrade their manufacturing technologies and to shift industrialization efforts towards an export orientation.

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