TRADE DISCOURSE IN KENYA

SOME TOPICAL ISSUES

Volume 1

WORLD TRADE ORGANIZATION
ORGANISATION MONDIALE DU COMMERCE
ORGANIZATION MONDIAL DEL COMMERCIO

Kenya
Key Macroeconomic Indicators
(Growth Rate)

Variable	2007	2008: Actual	2009	2010: Estimate	2010: Projections
GDP	7.0	1.6	2.6	4.9	5.3
GDP per capita	4.3	-1.1	-0.2	2.3	2.6
Government Consumption	7.3	-0.4	3.8	5.1	3.9
Private Consumption	7.2	3.7	5.5	4.1	3.4
Gross Fixed Investment	13.3	8.9	0.6	13.8	12.6
Exports, GNFS	6.0	3.6	-0.7	12.0	8.9
Imports, GNFS	12.7	5.3	-0.2	14.5	8.6
Current account Balance (% of GDP)	-3.8	-6.6	-5.5	-5.8	-6.0
Population	2.7	2.7	2.8	2.7	2.7
Potential GDP	4.3	5.5	5.4	5.4	5.4

Editors: Jasper A. Okelo and Tabitha Kiriti-Ng'ang'a

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UNIVERSITY OF NAIROBI
SCHOOL OF ECONOMICS
P.O. Box 30197-00100, Tel: +254-20-318262 Ext. 28131/28122,
website: http://www.uonbi.ac.ke/projects/WTO/.

©2012
School of Economics, University of Nairobi
30197-00100 University Way
Nairobi, Kenya
Telephone: 254-2-318262 Ext. 28122/ 28131
Fax: 254-2336885
Website: http://economics.uonbi.ac.ke/
http://www.uonbi.ac.ke/projects/WTO/

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FORWARD

The School of Economics at the University of Nairobi was awarded the WTO Chairs Program in 2010 and decided to use 75% of the yearly grants on research. This book which is the first volume is the final output of research carried out by some members of the research team. The research papers arose out of proposed research areas from concept papers prepared by members of the WTO Chairs program in the school. This volume is an important and exciting assessment of the topical issues in international trade in Kenya.

The world has witnessed the resurgence of regional development in terms of regional economic integration groupings at the global level over the past decades. The fundamental objectives for the formation of these sub regional and regional integration schemes are to enable the economies of the member countries participating in such arrangement to achieve, individually and collectively higher levels of economic development that would have otherwise proved elusive. The gains and losses of these integration movements particularly the Tripartite Agreement signed to enhance these developments is the thrust of this paper by Dr. Agonda.

Foreign direct investment (FDI) is believed to promote exports of host countries by augmenting domestic capital for exports, helping transfer technology and new products for exports. It also facilitates access to new and large foreign markets, provides training for the local workforce and thereby upgrading technical and management skills. In the Kenyan context little is known on the role of FDI in the export orientation of firms. How do FDI impact on the export propensity and intensity of Kenyan firms? Dr. Abala examines the export propensity and intensity of Kenyan manufacturing firms using a panel of firms from 1993-2002. Using a probit model, the results show a significantly positive effect of FDI on firms' propensity to export. The random effect results finds no significant impact of FDI on how much firms export, but shows that firm size is an important factor in export intensity. The results clearly show that FDI is very relevant in influencing export propensity. The findings have important policy implications in terms of promoting initiatives to encourage FDI inflows into the country.

The global financial crisis of 2008-2009 had various channels of transmission to Kenya and one of them was through remittances. However, Dr. Kiriti Nganga, found that data from the Central Bank of Kenya shows that remittances from the Diaspora only reduced for the first six months of 2009 after which they started rising though not at the same rate as before. After that remittances have taken an upward trend and they comprise a sizable proportion of Kenya's Gross Domestic Product (GDP). Remittances have been shown to smoothen consumption (food) on the part of recipients. Recipients also use the remittances to pay for health services, built new houses, improve old ones, buy livestock and buy other household assets. The data shows that only a very small proportion of remittances in Kenya is used for improvement of land though Kenya is an agricultural country. With the looming debt crisis in the Euro zone (2011), the future of remittances in Kenya looks bleak unless the crisis is sorted out fast.

Informal Cross-Border Trade in agricultural commodities between Kenya and her neighbors has been growing with time, but knowledge of its magnitude, determinants and consequences remain largely inadequate. This has acted to inhibit formulation of appropriate policies and strategies to help exploit its impact particularly on food security. It has also led to possible undervaluation of

the national accounts. On the basis of surveys and relevant government, scholarly and civil society documentation and studies, Dr. Gor's paper attempts to assess the direction and volume of informal trade flows, the types of agricultural commodities involved and the existing supportive trade infrastructure. The paper also derives the incentive to informally trade between Kenya and her neighbours.

The findings show that Informal Cross Border Trade (ICBT) is so deeply entrenched in the region that it almost equals in size to formal trade, yet it continues to expand. The study identifies maize as the most traded good. Other leading agricultural commodities traded include beans, rice and livestock. In addition, it was found that Ethiopia and Sudan have the highest incentive to informally import while Kenya and Uganda have the lowest incentive. The latter two however, also have the highest incentive to informally export within the region.

The term non-tariff measures (NTMs) is defined to include export restraints and production and export subsidies, or measures with similar effect, not just import restraints. In Kenya many internal processes by trade facilitation agencies have been reported to be inefficient, adding to cost of doing business and eroding Kenya's firms competitiveness in the domestic, regional and international markets. The regulations, processes, procedures and operations of the trade regulatory agencies sometimes act as trade hindrance to domestic and intra- East African Community (EAC) trade. There are challenges because of many duplicative roles played by these agencies all which add to the cost of doing business and restricts the expansion of the domestic trade as well as EAC intra trade.

Dr. Kiriti Nganga found that product export/import bans and discriminatory sourcing, corrupt practices, road blocks, clearance of exports goods, documentation on private businesses, lengthy clearance processes, arbitrary/multiple documentation, administrative levies, lengthy classification and valuation of import processes, inefficient port operations, numerous police road blocks, variable documentation requirements, road toll charges and uncompetitive port entry taxes/charges have very severe impact on business in Kenya. There is therefore need to harmonize the documentation procedures with other trading partners and to reduce the lengthy clearance procedures that end up frustrating trade instead of facilitating it.

Integration is once again a concept so much in vogue as argued by Dr. Kiriti Nganga and Mr. Okelo. Regional trade agreements have multiplied worldwide. Almost all countries are members of at least one agreement and many are party to multiple agreements. Existing agreements are re-invigorated and expanded while new ones are being negotiated and formed. Integration measures have extended their reach beyond traditional free trade in goods to a number of domestic regulatory sphere including services, investment and intellectual property rights, to deepen the integration among partner countries. For most countries, integration is just an agreement among a group of countries to remove various kinds of trade barriers. Developing countries such as Kenya are active participants in the regionalism movement. They see regional integration as an essential avenue towards economic growth, development and poverty alleviation. The overarching concern of these arrangements is the formation of a body with a common purpose, usually to increase human welfare.

Dr. Nyandemo contends that the tourism sector has become an important sector towards contributing to overall development in many countries, in terms of foreign exchange earnings, employment generation and so do the region's domestic product. The World market for tourism services has been steadily growing over time.

The paper gives an overview of African tourism and its contribution towards the overall development efforts, trends and patterns of the sector, challenges and potential prospects and the way forward.

The publication of this volume is timely as Kenya tries to gain momentum towards achieving the status of an industrialised nation by the year 2030 and also tries to fulfil the last of the Millennium Development Goals. Volume Two will go beyond Kenya and will look at topical trade issues in the East African region.

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Acronyms and Abbreviations

AEC	African Economic Community
ACP	Africa, Caribbean and Pacific
AGOA	Africa Growth and Opportunities Act
AU	African Union
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Community
EACU	East African Customs Union
ECOWAS	Economic Community of West Africa States
EEC	European Economic Community
EPAS	Economic Partnership Agreements
EPZs	Export Processing Zones
EU	European Union
FDI	Foreign Direct Investment
FAL	Final Act of Lagos
FTA	Free Trade Area
GTFTA	Grand Tripartite Free Trade Area
HS	Harmonized Systems
ICBT	Informal Cross Border Trade
ICT	Information and Communication Technology
IDDA	Industrial Development Decade for Africa
KIPPRA	Kenya Institute of Public Policy Research and Analysis
KMES	Kenya Manufacturing Enterprise Survey
LDCs	Least Developed Countries

LPA	Lagos Plan of Action
MUB	Manufacturing Under Bond
NAFTA	USA-Mexico-Canada Free Trade Area
NTMs	Non-Tariff Measures
OAU	Organization of African Unity
PBTPI	Pacific Basin Trade Preference Initiative
REC	Regional Economic Communities
R & D	Research and Development
RPED	Regional Programme on Enterprise Development
SACU	South African Customs Union
SADC	Southern African Development Community
SAP	Structural Adjustment Programme
SCAD	Single Customs Administrative Document
UNECA	United Nations Economic Commission for Africa

Chapter 1: Regional Economic Gains and Losses from the Tripartite Agreement

Ochola Agonda

1. Introduction

Regional integration has been seen as a means of achieving industrialization and fostering faster economic growth and development through increased trade and realization of economies of scale and market access, an idea which African countries embraced whole heartedly. As a result a large number of regional arrangements sprung up all over Africa (Aryeetey, 1997). The fundamental objective for the formation of these economic integration schemes is to enable the economies of the member countries participating in such arrangements to achieve individually and collectively, higher levels of economic growth that would otherwise prove elusive under autarky regimes.

Such an approach is particularly compelling for African countries whose economies are still characterized by a general low level of economic development, fragmented small domestic markets, widespread human poverty (HDR, 1997), low share (about 2%) of world trade in goods and services, and the highest number of least developed countries (LDCs), which for Eastern and Southern African region currently numbers 15 out of the 49 LDCs in the World.

Historically, the establishment of some regional economic groupings such as the East African Customs Union (EACU) and the South African Customs Union (SACU) predate the formation of the European Economic Community (EEC) in 1957. However, the creation of EEC still became the driving force behind the decisions in the 1960s by many developing countries to form regional groupings in Latin America (e.g. LAFTA and CARICOM) and in sub-Saharan Africa (e.g. EAC, UDEAC, CEAO, ECOWAS, PTA/COMESA and SADC).

The transformation of the EEC into a single market of the European Community (EC) in 1992 and its unprecedented overall impact on industrialization and economic recovery process in Western European countries played a crucial role in the resurgence of regional economic integration at the global level (Inotia, 1991). The regionalization trend was witnessed by the establishment of the USA-Mexico-Canada Free Trade Area (NAFTA) in North America. In Latin America, the revitalization of regional cooperation was undertaken at regional and bilateral levels. In Asia, where, in the past, emphasis had been put on extra-regional economic and trade relations, steps were taken to create a regional common market. The other regionalization trends were reflected by the emergence of the Pacific Basin Trade Preference Initiative.

In Africa, the initiative undertaken under the Lagos Plan of Action (LPA) and the Final Act of Lagos (FAL) to establish an African Economic Community (AEC) by the year 2000 moved closer to its realization by the signing in Abuja in June 1991 of the Treaty establishing the AEC. The Abuja Treaty was the first bold and comprehensive continental initiative attempt to establish AEC by 2027. The Abuja Treaty aimed to foster integration of African economies, free movement of factors of production across the continent, promote cooperation among the member states and coordinate and harmonize policies.

One of the strategies proposed to achieve the above objectives was the "strengthening of existing regional economic communities and the establishment of other communities where they do not exist" (OAU

1991: 8). The five regions recognized by the Abuja Treaty are: North Africa, West Africa, Central Africa, East Africa and Southern Africa. These ambitious goals of the Abuja Treaty have further been consolidated and renewed by the transformation of the OAU into the African Union (AU) and the establishment of NEPAD.

In addition to the regional initiatives within Africa, there were proposals and actual negotiations aimed at establishing North-South integration arrangements between Africa and developed countries and regions. These include the Economic Partnership Agreements (EPAS) presently being negotiated between four groups of African countries and the European Union (EU). At the global level, almost all African countries became members of the World Trade Organization (WTO). As a result, regional initiatives will have to adhere to the rules of the multilateral trading system, which *inter alia* are important for the North-South trade arrangements. Another important and relevant point is the extent to which regional initiatives would help African countries to participate more effectively and take full advantage of the global economy.

Currently, there are 14 regional economic communities (REC's) on the African continent. Each has its own mandate, vision and mission. Out of Africa's 53 countries, 27 belong to two RECs, 18 belong to three, and one country belongs to at least four. Only seven countries hold membership in only one REC. The spaghetti bowl approach to African countries membership in regional economic communities (ARIA 11, UN ECA ,2006) indicates that on average, 95% of the members of one regional economic community belong to another. The result is that such multiple memberships constrain economic efficiency, blurs collective vision and stifles the march towards the establishment of the African Economic Community (AEC). UNECA (2006) further identifies the drawbacks of overlapping membership to include: increased cost of membership in regional economic communities, unhealthy rivalry for donor funds, contradicting loyalties for member countries, inconsistent objectives and conflicting operation mandates, duplication of efforts and reduced ability for regional communities to pursue coherent and effective integration programmes. In other words, the overlapping memberships between the various regional arrangements have costs.

Arguably, the elimination of overlapping membership will significantly improve the effectiveness and efficiency of the RECs. UNECA (2006) further points out that the potential gains of rationalization of the RECs would lead to efficient allocation of resources; increase trade between member countries, as well as countries outside the region; gains in economies of scale, strong negotiation position, improved productivity, increased welfare, policy credibility, more provision of public goods, and fewer regional conflicts. Lately, the political leadership in Africa has tended to support the need for rationalization and harmonization of the integration initiatives. Consequently, the leaders imposed a freeze in recognizing any new regional economic communities at their 2006 African Union Summit (AU, 2006).

The implementation of the Abuja Treaty that came into force in May 1994 has not resulted in the success of integration schemes within the various sub-regions, as many of them were still struggling to fulfill their intended objectives among the rival arrangements which have contributed to a lack of progress in many areas (Iqbal and Khan eds., 1997).This led to the emergence of new initiatives, such as the Sirte Declaration of the Extra Ordinary Summit of African Heads of State and Government which was held in Sirte, Libya on the 9th of September, 1999. The thrust of this Declaration was to re-emphasize the Abuja Treaty by establishing: the African Union with all its related institutions: the African Central Bank; the African Monetary Union; the African Court of Justice; and the Pan African Parliament within the shortest possible time with a view to accelerating the process of continental integration. The Constitutive Act of the African Union, setting out the framework under which the African Union is to conduct itself, was signed on 11th July 2000 in Lome, Togo.

For example, to fast-track the process of integration in the region, the West African sub-region agreed on the creation of a single monetary zone by 2004 as well as making the sub-region borderless. In 2006, the African Union Summit at its meeting held in Banjul, the Gambia, passed a resolution further directing the African Union Commissions and the Regional Economic Communities (RECs) to harmonize and coordinate their policies and programmes as important strategies for the rationalization of RECs, and to put in place mechanisms to facilitate the process of harmonization and coordination within and among the RECs.

The purpose of this paper is to review the literature in order to examine and discuss prospects and challenges for trade expansion in the three RTAs in Eastern and Southern Africa –COMESA-EAC-SADC. The paper is also intended to elicit discussion on the process of regional integration in the Eastern and Southern African region, under the theme: Deepening COMESA-EAC-SADC Integration, and a corresponding vision: Towards A Single Market. The communiqué for the Second COMESA-EAC-SADC Tripartite Summit adopted a developmental approach to Tripartite market integration based on the Tripartite Free Trade Area (FTA), infrastructure development to enhance connectivity and reduce the cost of doing business, and industrial development to address the productive capacity constraints (Tripartite Summit, 2011). The review of these issues will, therefore, be organized under different sections. The first section (1.0) is the introduction; the second section (1.1) looks at the basic economic structure and status of regional integration processes in COMESA-EAC-SADC; the third section (1.2) examines Africa's regional integration in the context of globalization and how that impacts on Africa's own integration efforts; section four (1.3) reviews the challenges and potential of establishing the Grand FTA; section five (1.4) undertakes a review of the possible costs and benefits of the Tripartite Initiative; and section six (1.5) concludes by making recommendations on the way forward.

1.1. Economic Structure and Status of Integration in COMESA-EAC-SADC

The three RECs: COMESA, EAC and SADC constitute an integrated market of 26 countries, with a combined total population of approximately 700 million people, which is about 57% of the total population of the African Union. By 2010 the combined GDP of the 3 RECs was about US$ 875 billion and is projected to reach US$ one trillion within a few years, which is currently over 58% of the African Union's (AU's) total GDP and a GDP per capita averaging US$ 1,184. The 3 RECs as the building blocks for the AEC, account for a significant share of the continental economy, contributing approximately 60% of the total output of the continent. The membership of the 3 RECs overlaps significantly. Only nine of the 26 countries belong to one REC, while the remaining 17 countries each belongs to 2 of the 3 RECs. As can be seen, the central objective of the proposed arrangements is predicated on the need to overcome challenges of overlapping memberships.

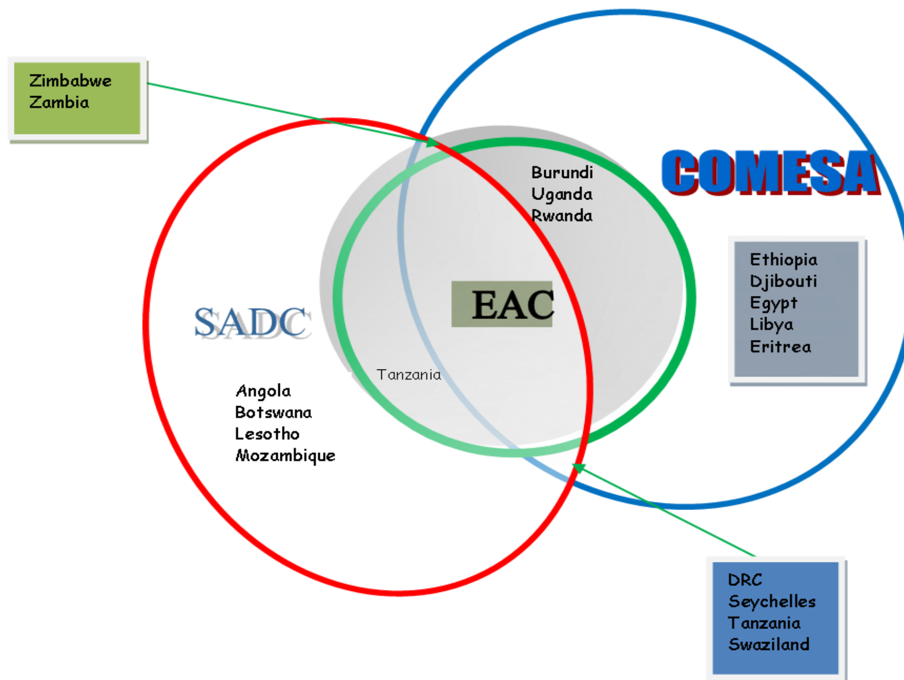

FIGURE 1: MEMBERSHIP OF COMESA-SADC-EAC

As indicated,

- COMESA has 19 countries, of which 4 are EAC members and 8 are SADC members.
- EAC has 5 members, of which 4 are in COMESA and 1 is in SADC.
- SADC has 15 member states, of which 8 are in COMESA and1 is an EAC member.
- All the 3 RECs consist of small developing economies with very low per capita incomes as well as a small share of export trade with the rest of the world. Most of the countries, 15 of them, fall into the category of LDC's, and 11 of them are landlocked.

TABLE 1: BASIC ECONOMIC PERFORMANCE AND STRUCTURE OF COMESA, EAC AND SADC

Country	Average value added (% of GDP) 2000-2006			% of average GDP growth (2000-2006)	GDP per capita in 2006 (Constant 2000 US $)	Population in 2006 (in millions)	GDP country share % in 2007
	Agriculture	Industry	Services				
Angola	7.88	68.71	23.41	10.62	1069.51	16.56	7.05
Burundi	--	--	--	--	103.03	7.83	0.12
Botswana	2.24	54.76	43.00	5.36	4423.10	1.86	1.65
Comoros	49.48	11.79	38.02	2.19	379.21	0.61	0.06
Congo, Dem. Rep.	50.03	23.23	26.75	2.64	90.78	60.64	1.37
Djibouti	3.56	16.11	80.33	2.88	817.45	0.82	0.12
Egypt, Arab Rep.	15.74	35.51	48075	4.38	1724.1.	74.17	17.21
Eritrea	16.37	23.90	59.73	0.61	159.66	4.69	0.17
Ethiopia	45.41	13.81	40.78	6.24	146.44	77.15	2.13
Kenya	29.07	17.88	53.05	3.54	440.09	36.55	3.39
Lesotho	16.99	41.89	41.11	3.44	527.67	1.99	0.24
Libya	--	--	--	3.30	7066.50	6.04	8.06
Madagascar	28.92	15.04	56.04	3.23	237.56	19.16	0.88
Malawi	36.79	18.48	44.73	2.04	144.63	13.57	0.36
Mauritius	6.25	29.73	64.02	4.04	4522.30	1.25	1.03
Mozambique	26.13	25.15	48.72	7.44	330.21	20.97	1.28
Namibia	11.04	29.68	59.28	4.33	2166.10	2.05	1.03
Rwanda	41.29	21.00	37.71	5.47	261.58	9.46	0.40
Seychelles	3.00	27.91	69.09	0.14	7004.90	0.08	0.12
South Africa	3.30	31.58	65.12	4.09	3562.10	47.39	40.84
Sudan	38.07	23.62	38.31	7.51	501.69	37.71	6.02
Swaziland	12.71	46.07	41.21	2.29	1400.90	1.14	0.42
Tanzania	45.28	16.47	38.26	6.25	334.56	39.46	2.05
Uganda	33.55	20.18	46.28	5.61	274.88	29.90	1.49
Zambia	22.50	27.88	49.62	4.81	371.25	11.70	1.75
Zimbabwe	14.66	22.54	60.35	-5.75	--	13.23	0.80

Source: Karingi and Fekadu, p.9

Table 1, which summarizes the basic economic performance and structure of COMESA-EAC-SADC, indicates that agriculture contributed about 23% of the 3 RECs GDP between the period 2000-2006 on average.

The countries that are highly dependent on agriculture at a level greater than fifty percent (>50%) are: DRC, Comoros, Ethiopia, Tanzania, and Rwanda, while Botswana, Seychelles, South Africa and Djibouti are less agriculture-dependent (<4% of the GDP). The industrial sector contributed about 26% of the GDP of

COMESA, EAC and SADC on average, while the industrial sector contributions to the GDPs of Angola and Botswana are 68.7% and 54.8% respectively. The service sector accounts for about 47% of the REC's GDP and grows at an average of approximately 4%. Further analysis shows that in each of the 3 RECs, three countries accounted for a significant percentage of the GDP. In COMESA, Egypt accounts for about 44.7% of its GDP, while Kenya accounts for 63.3% of the EAC's GDP. South Africa on the other hand accounts for about 73.2% of the SADC's GDP. But when the total GDP of the COMESA-EAC-SADC Tripartite area is considered, only two countries become the main players. In the context of the new tripartite arrangement, South Africa accounts for 44.5% of its total GDP, while Egypt accounts for about 20.5% of its GDP. With regards to the size and level of industrialization, South Africa not only dominates the 26 countries that belong to the Tripartite FTA, but completely dominates other African economies as well.

All in all, only five countries, namely: Botswana, Libya, Mauritius, Seychelles and South Africa are upper-middle income economies. Table 1 also shows that member countries are at different stages of development.

1.1.1. Status of integration in COMESA-EAC-SADC

Based on the classical stages of economic integration, as defined by removal of tariff and other quantitative restrictions; creation of a common external tariff; free movement of factors of production, harmonization of fiscal, monetary and other instruments of economic policies; and unification of policies and political institutions, including: preferential trading arrangements, and the establishment of a free trade area, customs union, common market, and an economic and monetary union, intended to culminate in the formation of a political federation, the EAC is ahead of COMESA and SADC. However, COMESA launched its FTA in October 2000. Since then, fourteen (14) out of its 19 member states participate in the FTA, while the remaining (5) namely: DRC, Eritrea, Ethiopia, Swaziland and Uganda are working towards becoming members of the FTA.

The Common Market of Eastern and Southern Africa (COMESA), which started as a preferential trade area (PTA) in 1982 launched a customs union in June 2009 which will be fully operational by July 2012. It is intended to be transformed into a common market in 2014 and eventually into an economic union in 2025. The key elements of REC's customs union include, inter alia:

Instituting common external tariff (CET) bands of :

- 0% duty rates for capital goods;
- 0% duty rates for raw materials;
- 10% duty rates for intermediate goods; and
- 25% duty rates for finished products.

Allowing member states a period of three years to align their national tariffs with CET – provided that after 18 months from the date of the launch, the period of three years may be reviewed for a period not exceeding five years from the date of the launch.

Allowing member states with a 5% tariff band to continue applying it after the launch of customs union during the transitional period.

Establishing national task teams to steer national and regional processes leading to the finalization of sensitive products lists and tariff alignment schedules.

Establishing a standing committee on regional trade policy- tasked with the formation and operation of the customs union.

In order to ensure that the customs union functions smoothly, the REC has to apply rules and regulations to support trade and investment promotion in the customs union. The rules and regulations include: competition, law and policies, harmonization of national product standards and adoption of regional standards, regional safeguards and trade remedies, including development support measures for the Customs Union (such as infrastructure development, payment systems and sectoral programmes).

The East African Community (EAC) has a much deeper integration compared to COMESA and SADC and has already attained the stage of a customs Union. The EAC countries started trading on duty-free and quota-free terms from January 2005. The customs union was due to become fully-fledged beginning 2010 when the five year transitional period with asymmetry in favour of Uganda and Tanzania in the Kenyan market would come to an end. The trade among EAC member countries is conducted on an FTA basis for approximately 99% of the tariff lines. The REC aims to establish a monetary union in 2012.

Table 2 below captures the similarity in the structure of the EAC customs union and the proposed COMESA customs union.

TABLE 2: COMPARISON OF TRADE POLICIES IN THE COMESA, SADC, EAC

COMESA	SADC	EAC
CU requirements are in place, council of regulation and custom management. June 2009	The SADC CU to start in 2010. The region is in the process of setting up the required institutions. Plan to start CU by 2010	Uganda, Tanzania, Rwanda and Burundi had to eliminate tariffs on category A (0% tariff) and gradually phase out tariffs on goods in category B (20-10% tariffs). January 2005
Have CET bands as : 0% for raw materials. 0% for capital 10% for Intermediate goods. 25% for finished goods		CET bands as : 0% for raw materials. 0% for capital goods 10% for intermediate goods 25% for finished goods.
Have list of sensitive goods to be protected, including: sugar, milk, wheat flour, maize, rice	Yet to Start	The list of sensitive goods to be protected include: sugar, milk, wheat flour, maize, rice, palm oil, and worn clothing.
Harmonization of trade procedures	Harmonization Process still on going	Harmonization of trade policies , procedures and world trade organisations

Source: Constructed from COMESA-EAC-SADC data

The main elements of the EAC development strategy are the removal of internal tariffs and non-tariff barriers on intra-EAC trade, introduction of CET and an agreement on a list of sensitive products. Furthermore, the COMESA and EAC rules of origin are identical and so are documentation and customs procedures related to intra-regional trade. This in our view makes the two RECs effectively one customs union. Hence there might be no need for member states to choose between the two. As can be seen in Table 2, SADC is in the process of setting up the required institutions.

Southern African Development Community (SADC) launched its FTA in 2008 and aimed at establishing a customs union in 2010. The FTA was envisaged by SADC protocol on trade to liberalize intra-regional trade in goods and services. The specific strategy to achieve this objective includes the elimination of tariffs; adoption of common rules of origin; harmonization of customs rules and procedures; attainment of internationally acceptable standards, quality, accreditation and metrology; harmonization of sanitary and

phytosanitary measures; and liberalization of trade in services. The SADC member states started implementing the trade protocol in 2001 with the aim of gradually liberalizing 85% of intra-regional trade on goods by 2008. The remaining 15%, which constitutes sensitive products, of intra-regional trade would be gradually reduced to zero by 2012.

However, the FTA arrangement does not so far include liberalization of services, despite the fact that services contribute in the range of 35% to 70% of SADC GDP. It is therefore very clear that what was left out of the FTA is quite significant. The other challenges to full implementation of the FTA include:

- Individual countries introducing non-tariff barriers such as :
- Levies for environmental conservation;
- New duties on a variety of goods;
- Regional transporters facing a proliferation of taxes on trucks; and
- Private standards on food safety and quality.
- Lack of progress on tariff harmonization with some countries reporting data at new Harmonized Systems (HS) versions while others still use older and nearly outdated HS versions.

Even though SADC was to launch a customs union by 2010, some actions which were still in the pipeline to fast-track customs procedure include regulations on SADC rules of origin, transit regulations, Customs Act, transit customs bond guarantee scheme, the single customs administrative document (SADC-SCAD), the SADC certificate of origin, transit documentation and the voucher of correction of SADC-SCAD.

Beyond the FTA and customs union, the SADC overall regional integration road map also includes: the establishment of a common market by 2015; monetary union by 2016 and a regional central bank and common currency by 2018.

An overview of the 3 RECs shows the stages that each of the RECs has reached in their integration process. Figure 2 shows FTA Distribution in COMESA-EAC-SADC and also indicates the multiple and overlapping membership of the 26 African countries that are to be covered by the Grand Tripartite FTA.

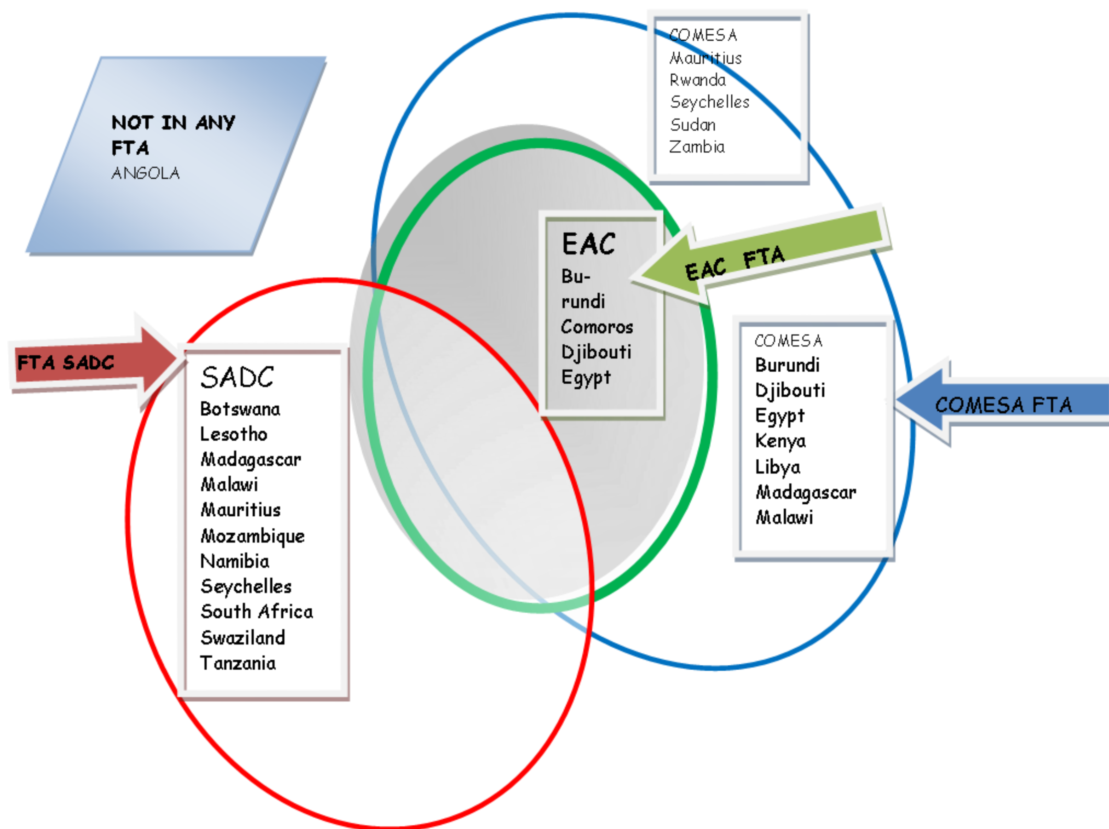

FIGURE 2: OVERLAPPING MEMBERSHIP OF COMESA-SADC-EAC FTAS

In general, all the 26 countries in the Tripartite FTA submit to the tenets of the agreement and have demonstrated their willingness to undertake trade liberalization. What has equally been observed is that some member states exercise caution in dealing with other member countries by not eliminating tariff completely or having 100% liberalization. Instead, they show some inertia in their trade dealings and have only reduced upto 80% of the products. Figure 2 also shows countries within the Partner RECs in the Tripartite FTA that have signed up to the respective FTAs. The figure shows that four countries: Angola, DRC, Eritrea and Ethiopia are not in any FTA, while 14 countries in COMESA, 5 in EAC and 13 in SADC are in FTAs.

Indeed, while the establishment of the Tripartite FTA has faced a number of challenges including issues of multiple membership which affect trade liberalization, negotiations, and the rules of origin, other challenges include the low level of technology in the region, limited human capital, poor infrastructure, the preponderances of non-tariff barriers (NTBs) to trade, and financial constraints facing member states, especially those in the category of the LDCs. In addition, cases of corruption, delays and disruption by unauthorized road blocks by the army, police and customs officials were also reported.

These notwithstanding, the United Nations Economic Commission for Africa (UNECA) study (2011) has reported that the prospects for increased intra-African trade under inter-RECs FTAs trading regimes are found to be high. This optimism, the study concludes, is buttressed by reported boost in intra-regional trade following the formation of FTAs in the tripartite region in which exports rose from US$ 7 billion in 2000 to

US$ 27 billion in 2008. The trade boost is attributed to the trade liberalization and the accompanying supportive policies initiated in the three RECs. Over the same period, imports grew from US$ 9 billion in 2000 to US$ 32 billion in 2008. The COMESA Annual Report 2010 also reported substantial increase in growth in intra-regional trade in COMESA which grew from US$ 3.1 billion in 2000 to US$ 13.7 billion in 2009 (COMESA, 2010). The United Nations Economic Commission for Africa (UNECA) study (2011) further indicated an increase in the three REC's share of intra-African trade in which the EAC's share rose from 15.6% in 1995 to 21.7% in 2005, and up to 33.4% in 2009. The corresponding figures for COMESA were 14.8%, 21.2% and 23.2% in 1995, 2005 and 2009 respectively, while those of SADC were 16.6%, 19.9% and 16.4% in 1995, 2005 and 2009 respectively.

1.2 African Regional Integration in the Context of Globalization

The resurgence of regional trading blocs at the global level underscores the need for African countries to cooperate in order to enable the region to participate more fully in the merging new international relations that are increasingly being restructured along regional lines (Oyejide, 2000). The new wave of liberalization and globalization has created a new regionalism which is grounded more on a general process of increased openness to trade and investments, and less on import-substitutions, protection of national and regional markets and managed trade. This open-regionalism is viewed as a complement to, or even catalyst for multilateral trade liberalization.

The first lesson is that new regionalism should not necessarily be concerned with past preferential trade arrangements, but should focus more broadly on cooperation on a much wider range of issues, since no significant gains have been derived from such preferential trade arrangements. The nature of trade denies Africans the benefits of preferential trade due to the fact that:

- The African exports are not significant imports in other African countries;
- The high degree of non-complementarity of the region's exports and imports restrict the potential positive impact of preferential trade arrangements;
- Such schemes turn out to be counterproductive, thereby retarding industrialization by diverting regional imports of intermediate inputs from low (outside the region) to higher cost sources;
- Undermine the transfer of technology due to limited export of manufactured goods from African countries to other African countries using technology which is already packaged from the TNC's parent companies;
- Make transfer of technological skills and technology extremely limited.

The second lesson is that new regionalism should engender domestic reforms of the member states rather than perpetuate the old order. It has been argued that protectionist trade regimes in Africa have created anti-export bias which have rendered preferential liberalization meaningless (Jebuni, 1997). For example, in East Asia, the World Bank states that integration with the global economy provided a very strong impetus to the expansion of intra-regional trade when formal regional preferential arrangements were established (World Bank, 2004). The momentum to establish RTAs has picked up, driven partly by global the trends and partly by the negotiation of EPAs with the EU (Khandelwal, 2004).

In its Policy Research Report (2004), *Assessing Regional Integration in Africa*, The United Nations Economic Commission for Africa (UNECA) states that, for Africa, with its small and fragmented economies, regionalism is a question of survival in the new global economy. More than any other region, Africa needs to integrate sub-regional markets, promote sustainable development and build the capacity and

competitiveness to participate meaningfully in the emerging multilateral trading system. It has equally been argued that, to tackle its development challenges effectively, Africa needs multilateralism as well as regionalism. African countries should promote regionalism to enlarge markets and exploit economies of scale, as well as participate fully in the WTO process to benefit from market access and gain safeguards against unfair protectionist measures.

Regionalism in Africa, according to ECA (2004:23), can promote multilateralism in several ways:

- "By going beyond the narrow issues of trade and global welfare to measures promoting foreign investment, human capital, technological development, infrastructure development, efficient exploitation of natural resources and effective responses to environmental challenges;
- By acting as a restraint that locks in welfare-enhancing trade reforms;
- By creating larger political economic units that can bargain more effectively in international forums;
- By building pro-export constituencies to counter domestic protectionist constituencies;
- By increasing competition in domestic markets, lowering prices, improving quality, and making products that are more competitive in global markets.
- By strengthening regional integration, moving towards being an integral part of the global economy and avoiding further marginalization."

However, much work is still needed to ensure that Africa's regional integration arrangements conform to the WTO requirements under Article XXIV of the GATT. In this regard, RTAs should be designed in a manner that maximizes their benefits (Schiff and Winters, 2003 and World Bank, 2004). These desirable attributes of RTAs may encapsulate the concepts of integration, regionalization, internalization, and globalization, which may broadly be described as outward-oriented regionalism or simply as open regionalism and deep integration.

The concept of integration is a process that provides an avenue for risk sharing, diversification and specialization in production across regions, better allocation of resources that leads to stronger economic growth and facilitates investment of opportunities by stimulating competition between domestic and foreign firms by creating a wider market. The concept also includes harmonization and convergence of macroeconomic policies.

Regionalization is the concentration of economic activities – trade in goods and services, movement of capital and people –within a particular region or country. An indicator of this process is the increase in intra-regional trade as a percentage of world trade and of the region's own trade. It can also be conceived as the growth of societal integration within a given region, including the undirected processes of social and economic interaction among the units, such as nation states.

Internationalization simply refers to the increasing geographic spread of economic activities across national boundaries. It is also the process of increasing involvement of enterprises in international markets.

Globalization is characterized by an accelerated pace of interdependence and connectivity aided by innovation in communication technology. Indeed, globalization or economic activity is a more advanced and complex form of internationalization, which implies a degree of functional integration between internationally dispersed economic activities. It is the integration of global markets through the reduction of

trade barriers, improved communications and the ability to make use of that information, as well as direct foreign investment.

Box 1. Open Regionalism and Deep Integration

Open regionalism is broadly characterized by a commitment to most-favoured-nation (MFN) liberalization; comprehensive product coverage in goods and services with few exclusions; a strong focus on reducing transaction costs at borders; and liberal, clear, and consistent rules of origin (World Bank, 2004).

Open regionalism forms a key ingredient in the success of an RTA and plays an important role in expanding the scope of competition and trade creation and minimizing trade diversion.

Deep integration is the inclusion in regional arrangements of liberalization commitments that go far beyond the multilateral agreements. Commitments in areas such as investments, intellectual property rights, competition policy, standards, and trade facilitation at a regional level help reconcile divergent national practices and can create supranational implementation mechanisms.

When deep integration is tailored to the level of development of a country, it has the potential to improve institutions and impart credibility to trade reforms beyond what would be possible in the multilateral context (World Bank, 2004; and Lawrence, 1997). In addition, regional cooperation has the potential to alleviate trade development and supply constraints.

Source: IMF WORKING PAPER 0F DEC 2004 . NO WT/04/227

The outward-oriented regional integration arrangement, which is a variant of open regionalism and deep integration whose key features are described in Box 1, serves two key purposes:

- It permits the economies of scale to be fully exploited in the larger and integrated regional market; and
- It is a form of regional integration that can help African countries to integrate themselves into the world economy (Francoise and Subramania, 1998).

This new approach allows for greater flexibility in the strategy that should be adopted in the design and implementation of regional integration arrangements. However, deeper integration has its own problems. It can create greater vulnerability of individual countries to external shocks which may in turn negatively affect the overall economic performance. In other words, globalization does not necessarily offer the same potential opportunities to all countries. It is in this respect that African countries should carefully examine the terms and conditions under which they link themselves to the world, including the RTAs. This is not a question of to belong or not belong, but it is a question of how to survive within the subsystem.

1.3 The Potential and Challenges of the Tripartite Agreement: COMESA – EAC – SADC

The tripartite initiative is in line with the African vision of establishing African Economic Community as envisioned in the Lagos Plan of Action and the Final Act of Lagos 1980, the Abuja Treaty 1991, and the Banjul Resolution 2006, all of which reaffirmed the political and economic imperative of using sub-regional economic groupings as the building blocks towards achieving the Abuja Treaty, for the establishment of an African Economic Community. While negotiations among the three Eastern and Southern African economic groupings have been going for a long time, the first breakthrough was achieved by holding the First Tripartite Summit COMESA-EAC-SADC in Kampala, Uganda on 22nd October, 2008. The Summit examined programmes in trade; customs and economic integration; free movement of business persons and infrastructural development amongst the three RECs. The second Tripartite Summit which was held in the Republic of South Africa on 12th June 2011 reviewed the progress made in the implementation of the decisions of the First Tripartite Summit, and adopted a roadmap, the negotiating principles, process and institutional framework and directed that a programme of work and roadmap be developed on the industrialization pillar.

In line with the theory of customs union , the establishment of a Tripartite Free Initiative seeks to enlarge the African markets and create economies of scale in production, increase investment opportunities, enhance competitiveness, boost cross regional infrastructure development to enhance connectivity, and reduce the cost of doing business as well as unlocking the productive potential of member states by harnessing the utilization of human and natural resources in order to take advantage of the enlarged market. Furthermore, it will empower member states to increase their economic and political muscle in international negotiations and achieve an African Common Market. The assumption is that a trade-creating customs union will improve welfare and not make it worse.. The expectation is also that the establishment of COMESA-EAC-SADC would motivate other RECs to establish inter-RECs FTA within the region, which will boost intra-African trade and enhance regional integration.

Judging the record of regional integration in Africa, the conclusion that can be reached is that, these regional schemes have not succeeded in expanding intra-African trade, increase Africa's total trade or generate the region's overall economic growth. The apparent failure of regional integration arrangements can be traced to a number of critical factors, namely:

- That regional integration schemes deployed are not perhaps the most appropriate mechanisms for achieving the goals enumerated above;
- That the type or the formal structure of the arrangements adopted are unsuitable;
- That the initial conditions prevailing in Africa and the structural characteristics of the African countries involved in the various integration schemes could not facilitate their successful implementation ; and
- That the schemes have not been faithfully and fully implemented as designed.

This should not be surprising since many of the preconditions as suggested by economic theory were not present at the outset (Fine and Yeo, 1997). However, regional integration still remains the best strategy for African countries to overcome the four Collier's "development traps", namely: the conflict trap; the natural resources trap; the trap of being landlocked with bad neighbours; and the bad governance trap,

in order to launch themselves at the next level of economic development through deeper economic integration. In other words, the two broad goals of regional integration are:

- To expand intra-regional trade, and
- To accelerate the process of industrialization and overall economic growth.

The first goal is achieved through liberalization of trade barriers within the integrated area, while the second goal requires the achievement of industrialization through the process of import-substitution within the integrated area.

The assumption is that the infant industries that develop and grow under the regional import-substitution industrialization environment would provide the learning ground for production and exportation activities within the protected regional market, and provide the confidence to eventually face world competition without further help. This is in line with the training theory hypothesis (Inotai, 1991). However, Collier (2007) has put a caveat, to the effect that whereas this was possible in the past, the current global environment which has been raided by China and East Asia's manufacturing dominance is more hostile to the new entrants.

Consequently, African countries might find it difficult to make a breakthrough given their "everything-goes attitude" particularly with respect to China's investments in Africa. This model of economic integration assumes the complete elimination of all forms of trade barriers, free mobility of factors of production, and reduction to the minimum, all intra-regional transaction costs as well as the additional conditions that must be satisfied for this model to succeed, namely that:

- Prior to integration, there should be high levels of trade between the regional partner states;
- There should be substantial complementarities in goods and factors of production amongst the regional partner states; and
- Intra-regional trade expansion should be enhanced by the differences amongst regional partners in terms of per capita income and consumption patterns that would promote potential for product differentiation, and hence, trade.

The success of regional integration has also been stifled by what Yeats (1998) has termed the African low levels of income and lack of complementarities that restrict the gains to be derived from specialization within and across industries as a result of regional integration. Indeed, individual African countries are so small, in economic terms, that even when they are combined in the various regional integrations schemes, the enlarged markets are still quite small by international standards. These enlarged markets are therefore not large enough to serve as a viable basis for achieving high levels of industrial growth and efficiency to be able to compete effectively in the world market.

Furthermore, it has been suggested that the design and implementation of many of the African regional integration arrangements in effect constrain rather than promote intra-regional trade (Oyejide, 1997), as a result of : consensual decision-making arrangements; over-lapping and sometimes conflicting memberships; lack of monitoring mechanisms on the implementation of decisions at regional level; unwillingness of governments of the member countries to cede authority to regional bodies; and lack of power and resources by the regional secretariats to take initiative and promote regional integration schemes. The absence of effective compensation mechanisms has also hindered the implementation of certain trade liberalization measures in some regional integration groupings.

While some internal trade barriers have not been completely eliminated, the free movement of factors of production still remains a pipe dream. At the same time, infrastructure and other constraints continue to guarantee that intra-regional transaction costs remain prohibitively high. Indeed, the problems of overlapping membership and the rivalry that it generates, do contribute to lack of progress, regardless of the instrument being used to promote collaboration among any groupings of regional integration schemes. It is within this context that the Tripartite Agreement between COMESA-EAC-SADC strikes the right cord in the symphony of the integration effort in African and within the spirit of Abuja Treaty. But what are the challenges that are likely to constitute a discordant note in the implementation of this integration symphony.

1.3.1 Challenges

A study by the United Nations Economic Commission for Africa (2011) states that evidence from the field suggests that the feeling of nostalgia which exists in some countries and which can be interpreted as the natural inertia that greets any new process is still prevalent, as some countries want more time to study: the full implications of their participation, while others strive to have more information on the likely impact of the Tripartite FTA on their economies and the welfare of their people. There are others that fear domination by wealthier states. Others are simply reluctant to cede power to a supranational body. There is also the challenge arising from trade negotiations with countries that do not belong to any of the FTAs at the moment. The experience in COMESA-EAC-SADC shows that 20 of the 26 countries in the region do belong to some type of FTA, while others are not in any trade arrangement. Four of these countries are: Angola, DRC, Eritrea and Ethiopia.

The challenge is how to convince these remaining countries to be included in the negotiations. A review of some of the challenges will shed further light on what confronts the tripartite initiative. Some of these include: low levels of technology; multiple and overlapping membership; varying stages of economic integration among the RECs; multiple and undifferentiated products; and lack of political will, including paucity of skilled manpower.

1.3.1.1 LOW LEVELS OF TECHNOLOGY

The African trading environment is characterized by a number of impediments such as lack of productive capacity, and limited or virtually non-existent value addition mechanisms in production. For example, Kenya, which is a member of EAC and COMESA, both of which are trading on FTA terms, became vulnerable when her borders were opened. The country could not withstand the intensive competition in its highly protected and subsidized sugar industry. While the price of locally produced sugar stood at Kshs 53 per kilogram, the CIF value of sugar landing at the port of Mombasa was only Kshs 30 per kilogram. The same price differential translated into US$ 590 per metric ton for locally produced sugar versus the landing cost of US $225 at the port of Mombasa for sugar imported from Swaziland, Mauritius and Zambia.

The non-competitiveness of the sugar industry in Kenya is simply attributable to the issues of limited capacity and inefficiency. The same protection has been extended to the cement plants in Malawi, Zambia and Zimbabwe, which also face the same problems of inefficiency and lack of competitiveness. The solution being advanced for Kenya is privatization and the removal of the sugar safeguard policy in 2012. However, the real answer is not to denationalize the industry, but to address the issues of inefficiency and lack of productive capacity, including use of archaic machinery.

1.3.1.2 MULTIPLE AND OVERLAPPING MEMBERSHIP

REC membership arrangements that are multiple and/or overlapping constitute obstacles to achieving the goals of regional integration in Africa because they hinder the harmonization, normalization and enforcement of rules of origin. For example, the EAC, which is already a common market, has four of its members (Burundi, Kenya, Rwanda and Uganda) in COMESA, and one (Tanzania) in SADC. On the other hand, five SADC members are also members of SACU as shown in Figure 1 (section 1.1). In addition, there are 7 other countries of COMESA and SADC, namely: Angola, DRC, Malawi, Mauritius, Swaziland, Zambia and Zimbabwe. The picture is made more complex by the fact that 17 countries which are in some customs unions are currently engaged in negotiations that may lead to more complex arrangements.

In the context of EPAs negotiations, Egypt is not an ACP country but is a member of COMESA, while South Africa is in SACU, but not an ACP member. As can be seen, the matrix of negotiations becomes complex due to these overlapping memberships. As South Africa also has an FTA with the EU, it may be easier for them to participate in the Agreement.

1.3.1.3 VARYING STAGES OF ECONOMIC INTEGRATION AMONG RECS

At the regional level, some RECs are at different stages of trade liberalization. For example, while EAC, which is already a customs union with its CET arrangement might be charging duties on some imports from outside the region, some of which could be as high as 100%, both COMESA and SADC are advocating for free trade with outside countries. This same situation also obtains with respect to trade liberalization at country level. Whereas many countries subscribe to Abuja Treaty, some countries have gone very far in their trade liberalization in order to boost intra-African trade. Mauritius, with its limited resources, adopts a duty-free and zero-tariff policy and trading system that encourage exports to its trading partners. The same applies to Seychelles.

Kenya has also adopted a similar trade policy and has given as much as 90% liberalization and only 10% at most-favoured nation (MFN) rate. In COMESA, the countries are at different levels of liberalization, including Ethiopia (10%), DRC (0%) - which means DRC is charging duty at 100% on the imported goods -, Uganda (80%), Eritrea (10%), and Swaziland is under derogation. In SACU, members have liberalized as much as 90% of their trade, and even Mozambique, which is not a member of the customs union, has liberalized up to 86% of its products. It is at once clear that there is lack of policy coordination.

1.3.1.4 MULTIPLE AND UNDIFFERENTIATED PRODUCTS

Africa is widely dispersed geographically, with a large number of different product types that undergo some improvement and value addition. In SADC South Africa has well developed agricultural and industrial manufacturing sectors with high export earnings. The countries in SADC also have huge differences in natural resource endowments. Except for South Africa, most of the countries still export products in their raw forms. These commodities if processed within Africa will attract better prices, create jobs and significantly boost intra-Africa trade. The complementarity study of products in COMESA and SADC implied that the more developed economies of Egypt, Kenya and South Africa are in a much better position to market their exports in COMESA and SADC, while the less developed countries are unable to find significant markets in COMESA/SADC (Khandelwal 2004).

The asymmetric product complementarity in favour of the more developed members is likely to raise concern over possible polarization as investment may be attracted towards the more industrially diversified economies in the region.

1.3.1.5 TARIFF LIBERALIZATION AND HARMONIZATION

The dependence on trade taxes for fiscal revenue constitutes a major obstacle to tariff liberalization in the region. An examination of the proportion of trade taxes in relation to total revenue and GDP shows that for all the countries in the region, except South Africa, the trade taxes account for over 100% of total fiscal revenue. Dependence on trade taxes is as follows:

- Rwanda, South Africa, Tanzania, Uganda < 2% of GDP
- 8 out of 24 countries trade taxes > 20% of GDP
- Lesotho, Namibia and Swaziland are the most dependent on trade taxes: up to >50% of GDP.
- Egypt and South Africa are not dependent on trade taxes.

It has been argued that the proposed trade arrangements are likely to bring change in the structure of individual economies that could result in the contraction of import substituting industries that have so far acted as important sources of revenue (Chauvin and Gaulier, 2002), and estimated that a SADC FTA may lead to as much as 6% decline in total revenue. However, this should not be used as an excuse to delay the implementation of the initiative since alternative sources of revenue can be obtained by broadening the tax base and putting in place better expenditure control mechanisms. The diagram below summarizes the great disparities in the restrictiveness of trade regimes across the region.

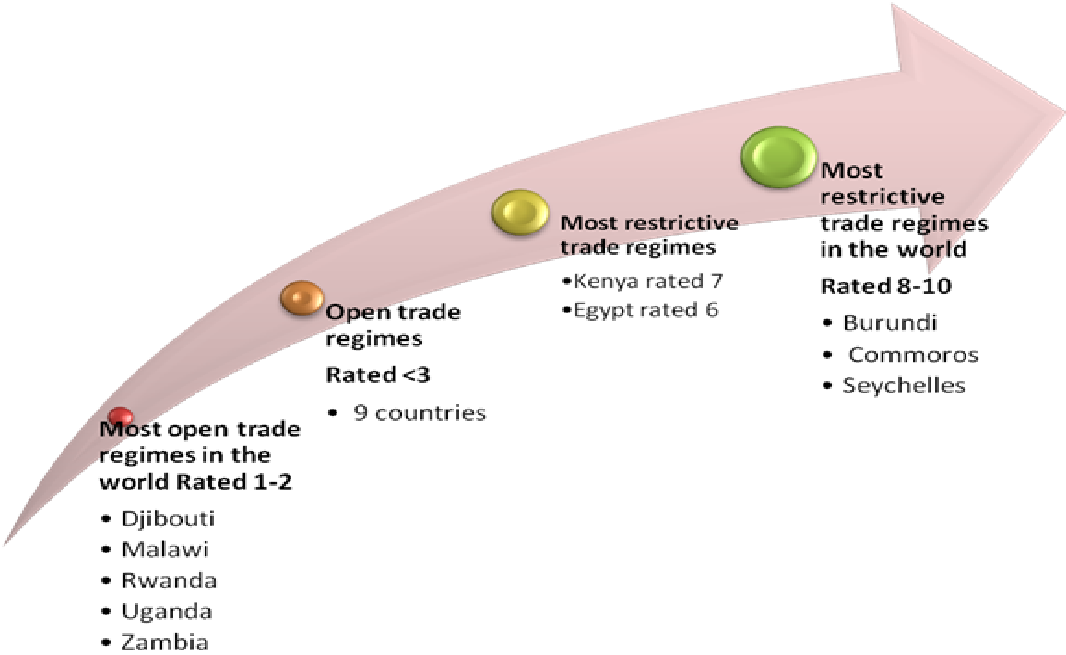

FIGURE 3: DISPARITIES IN THE RESTRICTIVENESS OF TRADE REGIMES ACROSS SUB-SAHARAN AFRICA

The negotiation on the implementation of Tripartite FTA will be complicated by the very different starting positions of the countries. The overall TRI rating is between 1-10, and the higher the figure, the more restrictive the trade regime and the lower the figure the more open the trade regime. These differences also slow down the realization of the TFTA.

1.3.1.6 LACK OF POLITICAL WILL

While strong political support exists for the establishment of regional integration initiatives at national levels, a major challenge that still remains is the translation of this political will into commitment and action. It is for this reason that it has been argued that rhetoric on continental unity has not been matched by practical action. Moreover, the member states have sometimes not seconded top notch staff to the secretariats of these RECs. Some countries however, do commit time and resources to the implementation of the respective RECs. Be that as it may, a major challenge for the new arrangement will be how to wind-up the current configurations, since they are all legal entities which have mandates bestowed upon them by member states. Perhaps the modus operandi will be spelt out in the MOU that the Summit has directed to be developed, and we dare suggest that a bold move will be required to create a new institutional framework which is equal to the task.

The challenges discussed above at the same time offer opportunities to accelerate the process of implementing the TFTA. For example, rationalizing and harmonizing the trade arrangements through an FTA could minimize and eventually eliminate the contradictions brought about by overlapping membership. It would simply mean that countries would not have to choose one trading bloc over another. Furthermore, since all member states belonging to the three RECs are involved in bilateral and multilateral trade negotiations, it is important to understand the different configurations under which these negotiations are being conducted. This should be used as a vehicle towards greater convergence and interfacing regionally with third parties during the second and subsequent phases of these negotiations. For example, EPAs negotiations could be a catalyst for achieving regulatory convergence in trade in services, investment and other related areas which are the subject of the current and future phases of the EPA process. Cooperation among the three RECs is therefore essential for their interaction with key partners.

A Review of the Possible Costs and Benefits of the Tripartite Agreement Initiative The communiqué of the Second COMESA, EAC, and SADC Tripartite Summit held on 12th June 2011 adopted a developmental approach to the Tripartite integration process that will be anchored on three pillars, namely: market integration - based on the Tripartite Free Trade Area (TFTA); infrastructure development - to enhance connectivity and reduce the cost of doing business; and industrial development - to address the productivity constraints. The Tripartite initiative is a decisive step in deepening the COMESA-EAC-SADC integration process towards a single market and to achieve the African vision of establishing the African Economic Community as envisioned in the Lagos Plan of Action and the Final Act of Lagos (1980), the Abuja Treaty of 1991 and the decisions of the African Union Summit held in Banjul in 2006, which directed that the African Union Commission and the Regional Economic Communities (RECs) should harmonize and coordinate the policies and programmes of the RECs as a strategy for the rationalization of their activities (COMESA-EAC-SADC, 2011) and facilitate industrial development (Herrera, 1987). Furthermore, COMESA-EAC-SADC adopted Tripartite FTA Negotiating Principles, Process and Institutional Framework as guidelines for negotiating the Tripartite Free Trade Area among the member/partner states of the three RECs (COMESA –EAC-SADC,2011).

It is envisaged that the 26 countries will engage in negotiations for the establishment of a Tripartite FTA, in recognition of the fact that substantial progress on trade liberalization has been achieved within the three RECs. In other words, the establishment of the Tripartite FTA will build upon and consolidate the RECs *acquis*. The Declaration launching the negotiations for the establishment of the Tripartite FTA also adopted a developmental integration approach built on three pillars of industrial development, infrastructure development and market integration (COMESA-EAC-SADC, 2011).

The objectives and principles for negotiations would use the Tripartite FTA as a proxy for inter-RECs FTA principles for the establishment of the COMESA-EAC-SADC Tripartite FTA Agreement whose objectives will form the core components of the guideline and inform the actions to be undertaken.

The broad objectives are as follows:

- Promote the social and economic development of the region through wealth and job creation; elimination of poverty; development of skills, innovativeness, hard and soft infrastructure; and promotion of national, regional and foreign investment as well as creating trade opportunities;
- Create a single market with free movement of goods and services and business persons, and eventually establish a customs union;
- Resolve the issues of multiple memberships and expedite and rationalize the process of regional and continental integration; and
- Promote cooperation in all sectors of economic and social activities among the member states.

The specific objectives require that member states enter into agreement to:

- Eliminate all tariff and non-tariff barriers to trade;
- Liberalize trade in services and facilitate cross-border investment and movement of business persons;
- Harmonize customs procedures and trade facilitation measures;
- Establish and promote cooperation in all trade-related areas among member states;
- Enhance cooperation in infrastructure development;
- Promote industrial development and establishment of enterprises that can compete at regional and global levels and exploit the investment opportunities in the utilization of the continent's vast natural resources;
- Adopt and implement common policies in all sectors of economic and social development that promote social justice;
- Establish and maintain an institutional framework for the implementation and administration of the Tripartite Free Trade Area and Customs Union; and
- Undertake cooperation in other areas that would advance the objectives of the Tripartite FTA Agreement.

It is clear from the Negotiating Principles that the inter-REC FTA is to be established on a tariff-free, quota-free and exemption-free basis. In order to fast-track the process of establishing the COMESA-EAC-SADC FTA, it was planned that the existing FTAs in the three RECs be combined to form a single FTA using the principle of variable geometry. What then would be the costs and benefits of creating such a new regional economic integration framework?

1.4 Liberalization

1.4.1 Trade liberalization

The traditional economic approach to regional trade integration assumes 'perfect' competitive markets and the formation of a regional integration arrangement for the allocation of resources in a static sense. The static analysis distinguishes between trade creation and trade diversion. If the partner country is already the low-cost supplier, then preferential trade liberalization leads to the same trade creation effect as in unilateral trade liberalization.

Trade creation takes place when preferential liberalization enables a partner country to export more to the home country at the expense of inefficient enterprises in that country, whereas trade diversion occurs when imports from a country which was previously subjected to tariffs are displaced by higher cost imports which now enter tariff-free from partners (Lunogelo and Mbilinyi, 2009). In the context of forming inter-REC FTAs the greatest potential lies in the extensive trade liberalization and trade facilitation to be achieved through the Tripartite FTA programmes.

The three RECs in the Tripartite FTA have separate FTAs which are to be merged into a single FTA market. As pointed out, EAC is already a customs union and SACU, which comprises 5 members of SADC, is also a customs union. Besides SADC, member states have negotiated and resolved that goods in intra-SADC transactions will attract zero tariffs by 2012.

In 2009 COMESA launched a customs union which would be in full operation in 2012 (COMESA, 2010). The progressive advancement of intra- and inter-regional trade in the three RECs following the establishment of their respective FTAs is commendable. It is this positive development in trade that underpinned the aggressive steps being undertaken to establish the Tripartite FTA. The GTFTA will be competitive in the regional and international markets if investments are made in the production of viable products in which it has comparative advantage, and investing in value adding products will, in addition to triggering increase intra-African trade, help in the differentiation of the products and diversification of the market.

According to Dinka and Kennes (2007), increased trade among member countries is a central feature of integration. Even though intra-African trade within the integration groupings has only averaged around 10% of the total trade, there is high optimism that intra-African trade will increase from its current low level of about 13% to a much higher level with the formation of the Tripartite FTA. The explanation often given is that intra-African trade is at a lower level because of the non-complementarities of exports. African countries mostly export primary commodities while their trading and integrating partners require manufactured products. Dinka and Kennes (2007) further observe that the relative success of Kenya's exports to Uganda and Tanzania was among the causes that led to the breakdown of the former EAC and left traces of lingering apprehensions. South Africa's success in industrialization and its exports to Africa and beyond are being viewed in the same light as trade domination (ECA, 2011), hence the need to address the question of compensation of those who may lose as a result of economic integration.

The trend in growth of regional trade in COMESA-EAC-SADC following the liberalization of trade through the launching of the COMESA-EAC-SADC will result in the aggregate increase in exports and imports for the three RECs according to Karingi and Fekadu (2009) (Placeholder2) calculations. In monetary terms COMESA-EAC-SADC (2009) reported that, exports between the three RECs grew from US$ 7 billion in

2000 to US$ 27 billion in 2008. At the same time imports grew from US$ 9 billion to US$ 32 billion in 2000 and 2008 respectively, due to trade liberalization.

Over the same period, the positive effect of trade liberalization and the regional integration has been widely felt within the three RECs. According to the Uganda Minister for East African Affairs, the successful implementation of the EAC Customs Union in 2005 and EAC Common Market in 2010 has boosted trade among the member countries in the region (Anon, 2011).

The conclusion being reached is that the regional FTAs and the TFTA will, through increased trade liberalization, trade facilitations and harmonization, eliminate the current obstacles to trade and result in faster economic growth.

The other principal benefits of the inter-RECs FTA and intra Africa FTA including CU are the potential they create for the expansion of intra-African trade, increased investment flow of foreign direct investment (FDI), economies of scale in production as well as improved competitiveness. Other benefits include improvement in trade and development of infrastructure, more efficient and sustainable use of energy, improved communications within Africa and beyond, enhanced human resource capacity and technical capability to support industrial development and expansion, and enhanced institutional capacity for manpower development.

United Nations Economic Commission for Africa (2011) further asserts that trade liberalization resulting from inter-RECs FTA will boost cross-border trade, particularly in favour of women and youth who constitute approximately 70% of the African population, but marginalized from the mainstream of economic development. It is an accepted fact that cross-border trade usually guarantees price stability by moving food, especially cereals from surplus to deficit areas and improves farmers income as well as the welfare of consumers. This helps to alleviate food problems during the times of famine. Intra-COMESA informal trade was estimated at US$ 19 billion, an amount which exceeded the formal trade figures estimated at US$ 14.3 billion in 2008 (COMESA 2010).

1.4.2 The Rules of Origin

In an FTA, the Rules of Origin help to delineate products that will be accorded preferential treatment within the trading regime. They specify conditions that products must fulfill to become eligible for preferential treatment in a specified FTA. They are used as instruments to guard against possible deflection. The Tripartite FTA COMESA-EAC-SADC specifies principles that should govern the application of the Rules of Origin in the establishment of their inter-RECs FTA. The principles stipulate that: The Rules of Origin shall be objective, simple and predictable; facilitate intra-regional trade; and shall be administered in a consistent, uniform, impartial, transparent and reasonable manner.

Overall, getting the Rules of Origin right will reduce loss of revenue from tariffs, duty and taxes that might arise from trade distortion and malpractices. When the rules are properly applied, manufacturing industries will receive adequate compensation and reward for their value addition. The history of negotiation in the establishment of PTA-COMESA indicates that the Rules of Origin was the longest negotiated protocol as it took four years before the protocol could be accepted. This was because the countries wanted to know what products entered a given country and what percentage of the products come from member states (so that duty may not be charged) and which ones come from outside so as to attract the due percentage of duty rate.

Apart from such considerations, the underlying purpose was to force each member state to utilize more of its own raw materials either from the country itself or from the region. This was to ensure that the double transformation rule holds, in which case both the raw material and the intermediate and final products produced in the region will increase domestic production in those countries, create employment and indirectly help export labour and services which otherwise cannot be exported.

It is reported that the boost in Lesotho's export of textile products to the USA is due to the relaxed Rules of Origin that apply to that industry if rules are operated under the Aid for Trade arrangement as in the case of Lesotho. As integration and development packages, they contribute significantly to increased trade, increased aid and investment, and overall development of the less developed countries, and foster regional integration. As pointed out, the increased textile production and export in some SADC countries like Mauritius and Lesotho, as well as in COMESA countries like Kenya, are due to the Africa Growth and Opportunities Act (AGOA).

The AGOA programme helps to empower poor countries with sufficient comparative advantage in textile production in the region to seize the opportunity offered by trade liberalization in the programme to increase their intra-Africa trade. The programme allows import and export not just between the partner country and the United States but also between the AGOA beneficiary countries themselves (Flatter, 2002). It should however be noted that Kenya has not derived maximum benefit from the AGOA programme because it failed to rehabilitate its cotton growing programme in order to support its textile industry.

1.4.3 Trade facilitation

Among the African economic communities, COMESA has the most extensive programme for trade facilitation and promotion. Since four-fifths of the EAC members also belong to COMESA, EAC applies many of the COMESA trade facilitation and promotion measures. The SADC sub-committee on Trade Facilitation is studying COMESA programmes since nine SADC members also belong to COMESA. The primary goal of trade facilitation is to reduce the cost of doing business, with a view to optimizing the efficiency and effectiveness of government to control revenue collection (COMESA-EAC-SADC, 2009). The Tripartite member states have made specific undertakings regarding trade facilitation as spelt out in the Tripartite Agreement. According to COMESA-EAC-SADC (2009), the Partner RECs resolved to:

- Reduce the cost of processing documents and volume of paper work required for trade among member states;
- Ensure that the nature and volume of information required for trade within the FTA does not adversely affect the economic development of or trade among member states;
- Adopt common standards of trade procedures within the free trade area where international requirements do not suit the conditions prevailing among member states;
- Ensure adequate coordination between trade and transport facilitation within the FTA;
- Keep under constant review procedures adopted in international trade and transport with a view to simplifying and adopting them;
- Collect and disseminate information on international development regarding trade facilitation;
- Promote the development and adoption of common solutions to problems in trade facilitation instruments;

- Initiate and promote the establishment of joint programmes for training of personnel engaged in trade facilitation; and
- Establish and promote one-stop border posts.

Indeed, the effect of customs measures on easing trade can be remarkable as demonstrated by some examples in the sub-Saharan Africa. In Ghana, the introduction of new technology, coupled with simple administrative procedures at the airport, reduced the clearing time from three days to four hours on average, and the income from airport traffic increased by 30%. Similar reforms in Mozambique resulted in a 58% increase in customs revenue (Disenyana, 2009). The Tripartite FTA is premised on the understanding that all the three RECs will be implementing similar customs and infrastructure programmes, including industrial development programmes.

1.4.4 Services and infrastructure development

Regional trade liberalization initiatives on their own cannot have the desired effects in terms of promoting economic growth and poverty reduction (Disenyana, 2009). In other words, inadequate investment in infrastructure services and utilities coupled with skills deficiency and inappropriate reforms of the regulatory regimes have resulted in depressed socio-economic development. Therefore, enhancing interconnectivity becomes a critical factor in speeding up development and facilitating inter- and intra-regional trade. Moreover, providing adequate infrastructure that can be accessed by the poor becomes an important component of an overall poverty reduction strategy.

In an era of rapid globalization and integration of the regional markets, roads, aviation and railway networks can no longer be limited within national boundaries if they are to spur inter-regional trade and economic development. This is of crucial importance in the three RECs where many countries are geographically contiguous and at the same time landlocked. Since the transport systems in the three RECs are poorly integrated and inefficient, they impose a high premium cost on trade, travel and business, thus having a crippling effect on Africa's trade competitiveness and its ability to participate in the world economy. There is, therefore, an urgent need to address infrastructural, operational and facilitation deficiencies in transport. The provision of adequate road and railways infrastructure in the three RECs is important for strengthening economic links among themselves and with other countries in Africa and beyond.

While the shortage of skilled manpower cuts across the entire African economic landscape and remain a major constraint to economic development, its solution can only be addressed through massive government investment in education it its widest sense.

The development of telecommunications infrastructure and services is vital in this digital era, where countries face the greatest challenge of survival amidst rapidly changing technology, including the opportunity to jumpstart development by pursuing knowledge and information and communication technology (ICT)-based activities. The last decade has more than demonstrated the critical importance of the telecommunication sector, not only itself as a growth industry, but also as an enabler for other economic activities especially by enabling the remote communities information access which has empowered them to participate in the development process. What should not be overlooked is the need to ensure that infrastructure development does not impinge on the sustainability of the environment.

1.4.5 Transport, communication and energy services

COMESA, EAC and SADC have put great emphasis on coordination, promotion, development and implementation of joint regional infrastructure, transport, communications and energy.

1.4.6 Road transport

The three RECs have adopted development of corridors as a strategy for facilitating trade as well as movement of people in the sub-regions. The initiative requires a collective approach, given the regional and multinational nature of the corridors, some of which include:

- Djibouti Corridor
- Northern Corridor: Transit Transport Coordination Authority
- North South Corridor (Durban-Lubumbashi)
- Central Development Corridor:Dar es Salaam-Kigoma- Burundi- Rwanda – DRC-Uganda.
- Tunduma-Namanga-Moyale Corridor
- Beira Corridor
- Trans Kalahari Corridor
- Trans Kunene Corridor
- Trans Caprivi Corridor
- Lobito Corridor, etc.

Roads are the dominant form of transport accounting for up to 80% of cross-border freight and for most of the passenger traffic. In Kenya, the road systems account for about 84% freight. The economics of roads has to focus on the imperative of maintenance, as neglect and disrepair have a very high cost. One dollar "saved" in road maintenance translates into roughly three dollars additional costs to users. According to UNECA (1991, 9-10), by failing to redirect public spending to maintenance, and by constructing new roads instead, some African countries have been found to lose between 3-4 km of potentially good roads for every kilometer of new roads constructed". Without maintenance and repair road pavements break-down and eventually disappear. The economic losses imposed by insufficient maintenance are estimated at about US$ 12 billion over the last decade.

Indeed, the combination of improved maintenance with stepped-up investment in upgrading and rehabilitation of priority links and facilitation could reduce transport costs to landlocked countries by as much as 50%. Total transit time could be cut down by the same proportion considering the long delays at border crossings. For a landlocked country like Rwanda, the savings could amount to 10-15 % of the import bills, i.e. US $ 20-30 million. More reliable and cheaper transport services between ports and hinterland and between capital cities will enlarge regional markets and open-up opportunities for economic diversification and regional development.

The economic cost to African countries accruing from road accidents is estimated in the region of over 2% of GNP with a high foreign exchange component. A recent estimate for Uganda yielded a figure of 2.3%. More effective road safety programmes could save lives, prevent disabilities and check related medical costs and material damage to cargo and equipment.

1.4.7 Rail transport

The regional railways are mostly built to the "Cape gauge" of 1,067 mm (3'6) between the rails, with the exception of the Tanzania Railway Corporation system. The Kenya-Uganda and the Ethiopia-Djibouti systems have a 1,000 mm gauge. This shows that there is no railway interconnectivity between Eastern and Southern Africa, which if addressed, is one way of making the rail more effective. Axle loads are generally 15 tonnes to 18 tonnes in the region and up to 26 tonnes in South Africa. To make rail more competitive with road, axle weight should not be less than 20 tonnes. This would allow railway wagon to carry almost twice as much as a large combination road weight.

The immediate major challenge is to reverse the historical poor management of most national public railways, which has led to a huge maintenance backlog estimated at some US$ 300 million in SADC alone, and inefficient and high cost operations, with a view to exposing them to the private sector discipline.

The shift in traffic from rail to road is due to poor management and inadequate use of assets. The Kenya-Uganda railway system was run down partly as a result of corruption. The road system accounts for about 84% volume of cargo, while the railway accounts for about 6%. Since rail transport is normally cheap, the result of this switch is the escalating costs of production in Kenya. In an attempt to halt the decline, almost all the railway services - including those of Zimbabwe, Zambia, Malawi, Mozambique, Tanzania, Kenya and Uganda - have been privatized through concession agreements that focus on improving management rather than infrastructure. This practice has been criticized as being tantamount to replacing an inefficient public sector monopoly with an inefficient private sector monopoly.

The benefit of efficient restructured railways will be the reduction in the total transport cost through more effective competition between railways and roads. Efficiency improvements will also drastically reduce wagon turnaround and transit times of rail cargo. This might open doors to the possibility of further investment to complete the missing links and to expand the rail network.

1.4.8 Ports and habours

The region has a number of natural habours with good access from the sea. While some African ports have been able to realize efficiency gains and the opportunities for multimodal integration offered by containerization, a good number of them are still lagging behind. At the port of Dar-es-Salaam container clearing time went down from an average of 27 days to 11 days within a year after the container terminal was concessioned to a private operator. In Mombasa, through a collaborative effort undertaken in clearing containers, clearing time was brought down from more than 20 days to less than 7 days. This was achieved by locating all document vetting officers in one single room and cutting down the number of separate stamps from more than 25 to less than 10.

Improved port performance will benefit landlocked countries either by giving them better services on their traditional routes or by increasing the competitiveness of alternative routes. This should be encouraged as a matter of policy by countries and RECs.

1.4.9 Information and communications technology

Africa as a region still lags behind the rest of the world in information and communication technology. According to Internet World Statistics, internet penetration in Africa as at December 2007 was about 4.7% compared with 43.4% in Europe, 71.1% in North America and 22% in Latin America/Caribbean.

The situation in Africa is very serious, taking into account the fact that about 14.2 % of the world population are from the continent and that a very high number of the internet users in Africa are nationals of other parts of the world residing in Africa. According to the 2006 Report of the International Telecommunication Union, countries in the COMESA-EAC-SADC region did not meet the 2005 tele-density targets of 4% for fixed telephony and 7% for mobile telephony.

Currently the traffic originating and terminating in the region is routed via Europe and the US, thereby making the call charges more expensive and resulting in foreign exchange drain for the sub-region. It is estimated that the region spends more that US$ 150 million per year in transit charges paid for in hard currencies. The challenge is for the region to minimize such foreign exchange outflows. As part of the regional effort, COMESA-EAC-SADC have been cooperating in the development and implementation of programmes in the areas of:

- ICT policy, legislative and regulatory framework harmonization;
- ICT broadband infrastructure developments;
- Harmonization of ICT infrastructure master plans; and
- Joint programme implementation and resource mobilization.

While COMESA-EAC-SADC have in put place effective legal and regulatory frameworks that can create an environment that ensures stability, transparency, competition, investment, innovation and growth in the ICT sector, and while other countries such as Kenya have made some breakthrough in the application of mobile telephony in terms of banking, the countries cannot yet command the engineering and have to rely on other countries for bail out in the event of any technical hiccups. The three RECs should therefore go beyond the policy regulation levels and establish their own Silicon Valleys.

1.4.10 Energy resources

The three RECs are endowed with huge energy potential waiting to be exploited. The following preliminary data in the various areas will give a broad picture of the enormity of the resources:

- 100,000 Megawatts (MW) of hydro power potential in DRC.
- 79,300 MW total of installed power capacity for the three RECs.
- 79% of the installed capacity is thermal, 18% of which is hydro based.
- 394 billion barrels of proven crude oil reserves are within the 3 RECs.
- 131 trillion cubic feet of gas reserves in the 3 RECs region.
- 2.308 trillion cubic feet of gas is being produced in the 3 RECs per annum.
- 1.414 trillion cubic feet of gas is consumed in the 3 RECs region annually.
- 5515 million short tonnes of recoverable oil reserves in the 3 RECs.
- 4.2 million barrels of oil per day is being produced in the region.
- 1.8 million barrels of oil per day is being consumed in the region.

There is also considerable potential for renewable energy resources such as nuclear, biomass, biofuels, solar, wind, geothermal, biogas in the three sub-regions.

The harsh irony is that despite these vast energy resources, the region continues to face acute shortage of power and the lowest access rates to modern energy for most of its member states. COMESA-EAC-SADC have adopted an integrated approach to power pools in order to benefit from economies of scale. Furthermore the three REC's should take advantage of the collective benefits of the development of the power sector.

1.4.11 Industrial development

The Tripartite FTA Negotiating Principles, Processes and Institutional Framework stated that negotiation will be in two phases. The first phase will deal with the issues of trade liberalization measures and movement of business persons. The second phase would cover negotiations on: trade in services, intellectual property rights, competition policy, trade development and competitiveness, and setting out negotiating principles (COMESA-EAC-SADC, 2011). The Tripartite Vision and Strategy document observed that in order to avoid a situation where member/partner states of the three RECs could take positions in terms of trade policy, trade facilitation or infrastructural development that could compromise the process of continental integration, the three RECs agreed to work closely together under the Tripartite umbrella (COMESA-EAC-SADC, 2011). The declaration launching the negotiations for the establishment of the Tripartite Free Trade Area (COMESA-EAC-SADC, 2011) is the only document that adopted a development integration built on the three pillars of industrial development, infrastructure and market integration. It is the only document that made specific reference to the issue of industrial development.

The sudden disappearance of industrial development debate from the African economic scene is based on the Structural Adjustment Programme (SAP) sermon that came from the "cathedral of free market economics" (Stiglitz, 2010). The first presentation of the lesson to Africa was by Eliot Berg, known as the Berg Report written from neo-liberal perspective. The gist of the message was: to eliminate subsidies aimed at creating new industries even as they provided massive subsidies to their own farmers (Stiglitz,2011-221). The free market ideology turned out to be an excuse for the new forms of exploitation where 'privatization' meant that foreigners could buy mines and oil fields in developing countries at low prices. It also meant they could reap large profits from monopolies and quasi monopolies such as in telecommunication (Stiglitz, 2011-221).

In other words, trade liberalization also meant that foreign firms could wipe out nascent industries, suppressing the development of entrepreneurial talent. Despite the adoption of the Lagos Plan of Action (1980) and the Industrial Development Decade for Africa (IDDA) (1980), which stated that "in order for Africa to achieve a greater share of world industrial production as well as to attain an adequate degree of collective self reliance (LPA, 1980), member states should integrate industrialization strategies in their own national policies." To this end, the member states also proclaimed the Industrial Decades in Africa (1980-1990 and 1990-2000), which was driven by the need to correct the contradiction that a continent endowed with such vast natural resources should still be the home of human suffering.

The two decades of sermon on SAP put African countries in a kind of stupor where they started to forget the history of economic development, and how the developed countries protected their own industries, and how even today they still protect their own farmers. At independence, African governments had conceived bolder plans and programmes for industrialization and had accepted the guiding principles of selecting products for local manufacture for which an import market had already been established. Thus, import substitution was the most common approach to industrialization in SSA in the 1960s as a consequence of protectionist policies. However, the weak link of industries with local resource capabilities and inputs meant

that employment and income multiplier effects of the factor inputs used remained external to the country paying for the final product.

In general, import substitution policies and practices did not positively contribute to the development of national capabilities for industrialization and development management, but they offered learning ground to master new techniques. The IDDA programme constituted crucial components in the design, construction and working of the internal engine of growth that was enshrined by the LPA at the heart of the programme on the production, supply and use of factor inputs for designated core industries and the use of the outputs of the core industries for promoting the growth of strategic sectors.

The basic goals of the second IDDA, was to end the over-dependency which African countries have on the industrialized world and to promote internal engines of growth, building on Africa's wealth and natural resources to progressively achieve self-reliance and self-sustainment.

The Final Act of Lagos adopted in 1980, generated optimism and expectations that the last two decades of the century would witness a major breakthrough in African economic and social development and establish a firm foundation for progress in the twenty-first century. The core element of the Final Act of Lagos was the promotion of regional integration as the principal instrument for Africa's self-sustainment. However, as pointed out by UNECA (1998:21):

…the African experience in economic integration has so far produced very limited results. Progress is scanty in the area of production, infrastructure and other elements that could sustain development efforts. The institutional framework for integration is faced with several difficulties that are far from being resolved. In addition to the lack of funds for their implementation, integration programmes and schemes are so discordant from one sub-region to another that they give rise to a hopeless situation. All actors are not allowed to participate in the integration process, which is seen so far as an affair of governments.

Therefore, Industrial Development is the third pillar of the Tripartite Agreement COMESA-EAC-SADC holds as the key to the development of the region, since economic integration is considered as a "paradigm for industrialization" (Mytelka 1973), and the formation of regional trade arrangements between developing countries will trigger industrialization through product differentiation and market diversification by enhancing trade in manufactures (Puga and Venables 1998), exactly by shifting manufactured trade to the regional market. While de Melo et al (1993) assert that the preferential trade arrangement and the consequent trade diversion that occurs may reduce welfare if they create regional import substitution, Oyejide (1996) on the other hand notes that regional integration would insulate economies from international shocks, while promoting overall economic development through an inward-oriented import-substitution industry strategy (ISI) based on the protected regional markets.

The basic underlying weakness of this line of argument is that it starts the analysis by assuming that a pattern of comparative advantages of regional integration schemes would promote in the developing countries the type of industrialization that would work against their assumed comparative advantage. However, the experiences of newly industrialized countries of East Asian countries negate this line of thought. The apparently changing comparative advantages of the newly industrialized countries suggest the need for a more flexible approach on the issue. What can be said with certainty is that, through industrialization and globalization, the standard of living in the developed world has shifted from bare subsistence to affluence. This can easily be replicated in Africa.

Indeed, while the formation of the COMESA-EAC-SADC FTA creates a larger single market and makes the region a more attractive investment location (Blomstrom and Kokko 1997) and rests on the need to increase the opportunities for profitable domestic and foreign investment, the domination of the industrial sector by foreign firms will tend to concentrate industrial activities in the relatively more developed countries within the grouping, instead of enhancing equal and balanced distribution of industries. In this context, the countries that are likely to benefit more are South Africa, Egypt and to some extent Kenya as the integration scheme tends to cluster benefits to these countries that act as "growth poles" or "backwash" while penalizing those considered as "backwaters". Without negotiating to correct these anomalies, the FTA will tend to accentuate economic disparities among the countries within the grouping, and has the potential to undermine the proposed integration effort.

Indeed, the polarization effect which has emerged in the SADC goes to confirm that only low value added parts of the production chain will be located outside the Republic of South Africa, while high value added parts of production will be in South Africa – a type of regional division of labour in which most SADC countries will not be able to move up the industrial ladder (O'Brien 1997). Given that the GDP of COMESA is US $ 296.4 billion, and further given that South Africa accounts for almost 76% of the SADC GDP it is quite clear that South Africa, whose GDP is 1.3 times that of COMESA, would be the main partner - calling the shots in the region.

It would therefore be fair to conclude that negotiation in this respect will not be on the basis of equal partnership, but one in which South Africa will have an upper hand because its production concentration is in areas where the market is strongest, even if wages are higher and production costs unfavourable due to the existence of transport costs or tariffs which make it uneconomical to relocate to low cost peripheral areas. But when the stage of deeper integration is reached and transport and other costs become negligible, the low cost peripheral areas with comparative advantage come up on their own. It then becomes economical for the periphery to supply the centre and wages in the poor area can be expected to rise. Even in the absence of financial compensation mechanisms at this stage, the critical question that should be asked is how the subsidy rule and infant industry rules are to be applied to members which are at different stages of development and the free movement of labour in the case of the least developed countries in the group.

It is equally obvious that for the Tripartite FTA to be beneficial to all the members, attention will need to be given to a set of transitional arrangements by which, when there are losses, appropriate adjustments will have to be made. This is why other parts of the regional integration programme such are infrastructure become important and vital when taking into account the Tripartite FTA's distributional impact. And where government revenue is seriously affected by changes in customs revenue, longer term transitional arrangements are needed whilst alternative sources of taxation are to be worked out.

The theoretical justification of regional integration is that it will not only spur the process of industrialization and growth by creating pre-conditions for economies of scale, efficiency, specialization and coordinated industrial planning, but it will also promote exports of manufactured goods which are often subject to discrimination and escalating tariff charges in the developed markets. The regional FTA, by facilitating the elimination of barriers to exports on the part of partner countries, allows for increased trade in manufactures, which result in higher productivity, thus, raising the incentive to invest in research and development (R&D), and to implement the concept of cluster industrialization, which in our view may favour the less industrialized countries within the Tripartite FTA group.

Schmitz (1997) shows that being able to reap benefits of economies of scale do not necessarily mean increasing the size of the firm. A cluster is defined as the geographical and sectoral concentration of enterprises. He shows that such clustering opens up possibilities of efficiency gains. These gains are captured in the concept of collective efficiency, defined as the comparative advantage derived from local external economies and joint action. It is not the concentration of firms *per se* which may bring gains, but the subsequent development that might carry with it such producers, or the emergence of suppliers who provide raw materials or new components and second machinery and spare parts.

It is the subsequent development in terms of the division of labour and specialization amongst the small scale producers that become beneficial to the process of industrialization. Clustering may induce technological spillover by facilitating the rapid diffusion of know-how and ideas. It is therefore an important institutional arrangement for small firms to overcome growth constraints and be able to trade with distant nationality and abroad. Maybe, African countries, and in particular members of the Tripartite FTA can borrow a leaf from the positive effects of the clustering from Asia and Latin America.

Within the Tripartite FTA, clustering has become an active part of South Africa's industrial policy. There is therefore much to be gained from such a policy and should become part of negotiations within the COMESA-EAC-SADC Tripartite FTA Agreement. This will permit firms to spread fixed cost of innovation over a larger market, and contribute to accelerated innovation and technical progress.

Rodrik (1992), on the other hand argues that the most appealing of these theories is the one referring to economies of scale. He underscores this point by explaining that the presence of economies of scale and of free/entry in markets provides a very good case for trade liberalization on the grounds of productivity. With increasing return to scale, average costs are a decreasing function of firm level of output. Therefore, any measure which results in the increase of domestic price, such as protection measures, will also end in increasing the average cost of the industry. Higher prices will entice new firms to enter the market, and at the same force incumbents up their average cost curves. But, trade liberalization has the opposite effect by bringing the domestic prices down. This forces the firms that have remained in the market in spite of falling prices to increase production in order to achieve equality between their average cost and the lower domestic price.

While most explanations of the link between total factor productivity (TFP) growth and export put emphasis on such static factors as economies of scale and capacity utilization, and while these may account for an initial surge of productivity soon after the measures increase exports, they are insufficient to explain the continuing high TFP rates. But rather, the relationship between exports and productivity growth may arise from the role of exports in helping countries adopt best technologies.

It is the skilled labour force which allows the mastering of such technologies, following rapid increase in productivity. But the World Bank (1993) observes that even if exports grow on the basis of productivity change due to domestic efforts, the cumulative magnitude of productivity growth over many years is unlikely to be the sole result of such domestic efforts.

1.5 Conclusion and Way Forward

Most of the African countries are still trapped in the production and exportation of primary raw materials. This has closed off economic development possibilities. The failure to move to the next level of adding value and transforming primary products has meant that many African countries still export a very limited

number of primary commodities despite the abundance of natural resources. This has also meant that in spite of the commendable efforts of establishing a large number of regional trading arrangements; intra-Africa trade has not broken the 10% ceiling. Another reason for this is that the countries export primary products to their former trading partners and import manufactured products from them. The similarities of products or non-complementarity, in our preferred economic jargon, is also due to lack of product differentiation through value addition.

It has been argued that, prior to regional integration, there should be high levels of trade between the member countries, as well as complementarity in goods and factors among the regional partners. However, this review has shown that regional partners are trapped in low per capita income and a pattern of production and consumption where they consume what they do not produce and produce what they do not consume. This can neither translate into the potential for product differentiation, nor facilitate trade.

The review has further indicated that the enlarged regional markets are still not large enough to serve as a basis for achieving higher levels of industrial growth, and that the African countries lack the income and the structural complementarities that could be relied upon to generate appreciable gains from specialization based on regional integration arrangements. Furthermore given the large differences in the level of economic development, regional integration is likely to generate polarization effect.

However, based on the preliminary data, it has been found that the formation FTAs had increased intra-African trade, but that a number of challenges still need to be addressed. The main one of which is the paucity of skilled human capacity and the supply side constraints in each of the three RECs. These underscore the need to create the human resource capacity and capabilities as well as the industrial manufacturing capacities.

It is in this context that we must make reference to the Communiqué of the Second COMESA-EAC-SADC Tripartite Summit, which called for the deepening of the COMESA-EAC-SADC integration process towards a single market and which directed that a programme of work and roadmap be developed on the industrial pillar. This in other words, gave the Tripartite Negotiating Principles, Processes and Institutional Framework team, a clear mandate to define what measures are needed to push the industrialization agenda forward. Since other measures have been undertaken in terms of liberalization of trade issues, the focus should now shift to the issues of industrial development. We propose that some of these issues should include:

- The preparation of Tripartite FTA Industrial Master Plan;
- Rehabilitation and expansion of existing manufacturing industries such as Zisco steel industry in Zimbabwe; and
- Establishment of New Production Manufacturing Units at a multinational level in the high priority sectors which the IDDA-I set out and which are the same as the ones in the LPA, and include:
    - Food and agro-industries
    - Building material industries
    - Metallurgical industries
    - Mechanical industries
    - Electrical and electronic industries
    - Chemical Industries

- Forest industries
- Energy industries

In order to make the industrial sector operational, other supporting areas such as building capabilities and capacities in human resources, institutional infrastructure, technology, industrial financing, information and management, including the establishment of multinational industries especially in sectors with high investment costs. We are convinced that the TFTA region can successfully transform itself into a knowledge-based economy in the shortest time possible, and move to the next level of innovation-driven economy within the next 15 years.

What this requires is to build human capabilities in the identified priority sectors by upgrading and expanding some of the existing institutions of higher learning in the region, and by retraining some of the graduates, including new ones within the given timeframe. Above all, we should learn from the past failures and borrow lessons from the best practices. History should indeed, not be allowed to repeat itself.

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Chapter 2: Foreign Direct Investment and Export Performance of Kenyan Manufacturing Firms

Daniel O. Abala

2. Introduction

Foreign direct investment (FDI) in Kenya is defined as investment in foreign assets, such as foreign currency, credits, rights, benefits or property, undertaken by a foreign national (for example, a person who is not a Kenyan citizen) for the purposes of production of goods and services which are to be sold either domestically or exported overseas (Investment Promotion Centre Act, Chapter 518). FDI generally refers to an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise in a country other than that of the investor defined according to residency (World Bank, 1996). Ownership of less than 10% is regarded as portfolio investment.

Foreign Direct Investment (FDI) has been identified to contribute significantly to the economic growth of many countries. Governments of many host countries (recipients of FDI) are using financial incentives such as tax allowances and grants in aid among other policies to attract inward FDI into their countries due to the perceived benefits associated with FDI inflows. It has been suggested in numerous papers that foreign firms are capable of affecting the levels of productivity and growth rates in the industries they enter, as well as promoting skill upgrading, increased employment and increased innovation (Blomström, 1986; Blomström and Persson, 1983; Görg and Strobl, 2001; UNCTAD, 2005). Growth in export activities in recipient countries has also been said to be an important contribution of FDI (Aitken *et al,* 1997; Greenaway *et al,* 2001; de Mello, 1997)

Indeed, there is a widely held view that FDI promotes exports of host countries by augmenting domestic capital for exports, helping transfer in technology and new products for exports, facilitating access to new and large foreign markets, training of the local workforce and upgrading technical and management skills. On the other hand, it has also been argued that FDI may lower or replace domestic savings and investments, transfer low level or inappropriate technologies for the host country's factor proportions, target primarily the host country's domestic market and hence not increase exports, inhibit the expansion of indigenous firms that might become exporters and not be helpful in developing the host country's dynamic comparative advantages by focusing solely on local cheap labour and raw materials (UNCTAD, 2005).

Earlier studies examining the impact of FDI on export activities of multinational firms (MNCs) have typically focused on the developed economies (O'Sullivan, 1993; Blake and Pain, 1994; Cabral, 1995; Barry and Bradley, 1997; Greenaway *et al,* 2001). There is need to understand the role of FDI in the export behaviour of firms in developing countries. This paper raises two main questions, namely:

(1) How does FDI impact the export decisions of Kenyan firms?
(2) How does FDI affect the export performance of Kenyan firms?

The study specifically investigates the export decisions and export performance within Kenya's manufacturing sector on a panel of firms from 1993 to 2003. The ability of FDI to influence export activities of Kenyan firms would be a vital stimulant for the government to eradicate bottlenecks and encourage more FDI inflows into the country. This study uses a relatively big sample with a longer panel

data and should be able to avoid the problems of small sample size and panel data covering short periods.

In Kenya, there have been a number of policy initiatives with the objective of promoting both FDI and export activities. The government sees foreign investment as an integral component of Kenya's economic policy. In the period under observation, the government began seriously focusing on export promotion, introducing a range of different reforms. Export processing zones (EPZs) were set up where firms could produce for export with good facilities and several tax incentives. These included import duty, value added tax (VAT) exemptions on imported equipment and raw materials, a 10-year tax holiday followed by a rate of 25% for the next 10 years when the exemptions from withholding taxes on dividends and payments to non-residents for the first 10 years expire and no foreign exchange controls are in place (see Gerdin, 1997). From 1994, the EPZ firms were also allowed to sell in the domestic market upon paying the relevant import duties, VAT and a low duty. By 1997, no fewer than 15 zones had been established though employment in the firms was still low. A scheme referred to as Manufacturing Under Bond (MUB) was also introduced, aimed at making it easier for exporters to obtain inputs and to sell to the export market. The scheme allowed imports free of duty and local purchases free of sales tax and Green channel procedures in import licensing. These latter procedures were set up in the 1980's to cut down on delays in obtaining foreign exchange for imports and became redundant when the foreign exchange market was liberalized in 1993.

Investment is one of the most important factors that drive manufacturing and the economy, and the Kenya government has attempted to put up a policy of investment promotion. Fixed investment in Kenya has since independence averaged around 20% of the GDP. The capital output ratio has been around 4%, suggesting that given the current economic structures this investment could generate a 5% growth rate. Though the country has hitherto depended heavily on foreign funding, foreign direct investment had averaged only some US $30 million during the 1980s. Foreign investment has been held back by restrictions on dividend transfers as well as lack of a stable macroeconomic framework and a credible government. Attempts have been made to simplify the investment process particularly from 2003. In 1982, for example, the government set up an investment promotion centre as a department within the Ministry of Finance. This was later converted into an autonomous parastatal, acting as an advisory agency to the government. Its duty is to help investors through the labyrinth of Kenya's bureaucracy. As part of regional harmonization (COMESA), the government has been making efforts to devise an investment code to guide investments in the country since the year 2003.

The rest of the paper is organized as follows: section 2 provides an overview of FDI and Kenya's manufactured exports; section 3 reviews the literature on how FDI may impact on exporting activities of firms; section 4 sets out the model to be estimated and also describes the data to be used; section 5 provides a discussion of the empirical results; and section 6 concludes with implications of the study.

2.1. Evolution of FDI and Kenya's Manufactured Exports

Kenya has had a long history with foreign firms. From the time of independence through the 1970s and part of the 1980s it was one of the most favoured destinations for FDI in East Africa. FDI grew steadily through the 1970s as Kenya was the prime choice for foreign investors seeking to establish a presence in Eastern and Southern Africa. The then relatively high level of development, good infrastructure, market size, growth and openness to FDI at a time when other countries in the region had relatively closed regimes

all contributed to the MNCs choosing Kenya as their regional hub. There was also relative political stability and security during that period.

FDI started at a low of around US $10 million a year in the early 1970s before peaking at US $60 million in 1979-1980. However, after the 1980s Kenya's economy was characterized by deterioration in economic performance, corruption and bad governance. Inconsistency in the implementation of economic policies and structural reform measures as well as the deterioration of public service and infrastructure ensured decades of low levels of FDI inflows. FDI inflows in the period 1981-1999 averaged only US $22 million per annum. It should also be noted that although Kenya was the leading destination of FDI in the East African region in the 1970s and 1980s, the relative level of flows was never high even by developing countries' standards. This can be seen by looking at the stock of FDI, which was only 7.5% of the GDP in 2003, compared to 25.3% for Africa as a whole and 31.5% from developing countries (UNCTAD, 2005). Kenya's regional leadership in attracting FDI also disappeared as soon as Tanzania and Uganda started reforming their economies and opening up to foreign investors in the early 1990s. FDI inflows in the 1996 - 2003 period averaged some US $29 million annually while inflows to Tanzania and Uganda surged to US $280 million and US $220 million respectively, from negligible levels in the 1980s (see UNCTAD, 2005).

In relative terms, Kenya's case was even worse since its economy was about 30% larger than Tanzania's and twice as big as Uganda's in 2002. It is notable that developing countries as a whole attracted an annual average of US $41 of FDI per capita in 1996 - 2003 when Kenya only managed inflows of US $1.3 per capita. Kenya's share of FDI inward stock was 55% among the East African countries in the mid 1990s but this declined to 18% by the end of 2003. The biggest beneficiary of this loss was Tanzania, which in the mid 1990s had a 24% share, rising to 46% by the year 2003. The same scenario was repeated in the period 2003 to 2009 where the average FDI flows into Kenya were US $106 million per annum compared to US $456 and US $521 million for Tanzania and Uganda respectively (World Bank, 2010).

Kenya now attracts about one third of what each of her neighbours attracts in terms of FDI inflows. This situation has persisted despite the Kenyan government's attempts to implement a series of measures aimed at attracting foreign investors into Kenya since 1988, especially with respect to export platforms such as Manufacturing Under Bond (MUB) and Export Processing Zones (EPZs). Nevertheless, these export platforms have themselves been disappointing in performance, with exports from EPZs accounting for about 3.5% of total manufacturing exports while employment in these firms accounted for barely 1% of total manufacturing employment by 1997 (see Glenday and Ndii, 1997). This rose somewhat due to the effects of the African Growth and opportunities Act (AGOA) after 2001.

Kenya also missed out in the global surge in FDI that experienced in most parts of the world in the 1990s and beyond. While the average FDI inflows to Kenya doubled in the 1981-85 and 1996 - 2003 periods, the average inflow into African countries increased sixfold and the average inflows into developing countries as a whole increased almost tenfold. It seems clear that the factors behind Kenya's poor performance in attracting FDI at a time of global surge of inflows and particularly to its immediate neighbours with similar economic structures must be found mainly within the country.

Studies on Kenya's inability to attract FDI despite it having been the prime destination of FDI in the 1970s and 1980s have identified such factors as macroeconomic instability, corruption and governance, inconsistencies in economic policies, deteriorating public services and poor infrastructure as some of the factors responsible for the low FDI inflows. These studies also highlight market size, low economic growth,

lack of policy transparency and rising cost of electricity and labour. The studies include Kinaro, 2006; Opolot *et al,* 2008 and UNCTAD, 2005 among others. The deterioration of Kenya's infrastructure, particularly at a time of major improvements in infrastructure in other parts of the developing world have induced many foreign investors already established in the manufacturing sector to divest or consolidate their operations out of Kenya in recent years.

The trend of FDI in Kenya has shown that foreign investors are moving out of Kenya with few new investors coming in or even existing investors planning significant expansion. Johnson (2006) suggests that exports have a potential of stimulating economic growth strategies. Kenya's Vision 2030 asserts that the country intends to attract at least 10 large strategic investors in key agro-processing industries and raise its market share in the regional market from 7% to 15% by the year 2012. Exports can affect the economy as a whole through productivity enhancing externalities such as technology spillovers and therefore if FDI is found to promote exports, FDI can indirectly enhance economic growth. Numerous studies have concluded that exporting is crucial to growth and foreign direct investments can play a role in enhancing the exporting capability of a country (see Bernard *et al,* 2000; Bernard and Jensen, 2001; Bigsten *et al,* 1999; Bigsten *et al,* 2002, Girma *et al,* 2005; and Kneller *et al,* 2004).

2.2. Related Literature

This section provides a review of the existing literature on the relationship between FDI and manufactured exports. We initially discuss theoretical issues followed by a review of the empirical studies.

2.2.1. Theoretical literature

The classical trade theories argue that economic growth is a function of the factors of production, mainly labour and capital. However, in the last two decades there has been an impressive array of economic growth literature triggered by the endogenous growth theory, which has led to an extensive inventory of models that stress the importance of trade in promoting sustainable economic development. The classical trade theories of David Ricardo and Hecksher-Ohlin were based on the assumption of immobility of production factors internationally and did not allow for any conclusions about the relationship between FDI and trade. Mundell (1957) relaxed the assumption of immobility of factors of production as well as the assumption of identical production function and developed a standard two-good, two-factor and two-country Hecksher-Ohlin trade model. In this model capital mobility is introduced as a perfect substitute for trade. Markusen (1983) presents various models advancing conditions such as external economies of scale and differences in factor proportions, creating an added drive for trade. Markusen (ibid.) comes to the conclusion that the result of substitutability between FDI and trade as argued by Mundell (1957) is a special case present only in factor proportions models. Schmitz and Helmberger (1970) relaxed the assumptions of the Hecksher-Ohlin framework, moving away from a situation of factor immobility to a situation where capital is mobile internationally. They concluded that trade increased in both products and factors, thereby establishing a complementary relationship between FDI and trade. Vernon (1966) suggests a substitutional relationship between exports and FDI. He describes a model in which a change in the location of production generates an outflow of FDI (to reduce production costs from the host country to low income countries thus replacing export flows). Horst (1976) argues that foreign investment is not limited to local production of the final goods in the host country. The multinational enterprise engages in non-manufacturing activities not directly related to production with the host country but results in augmenting demand for other kinds of goods which possibly could generate an increase in exports. The ownership, location and internalization (OLI) paradigm developed by Dunning (1977) has had a major impact on FDI

theories. The importance of the OLI paradigm is seem in terms of its ability to function as a framework on whether MNEs serve a foreign market through exports or local production. The MNE's decision on exporting, licensing or investing is determined by the combination of ownership, location and internalization advantages. Relatively recent trade theories emerging in the early 1980s have generated more realistic general equilibrium trade models. The more recent models have been able to incorporate the relationship between vertical and horizontal FDI. Vertical FDI being taken to mean that the MNE decomposes the production process into stages according to factor intensity whereas horizontal FDI means the MNE locates production close to the final market, duplicating the production process and hence serving foreign markets by local production.

The main difference between horizontal and vertical FDI and export relationship as modelled by Helpman (1984) and Markusen (1984) is a case of substitutionality and complementarity respectively. Helpman (1984) presents a model of vertical MNEs based on differences in factor endowments whereas Markusen (1984) presents a model incorporating horizontal FDI based on firm-level economies of scale. In this case the firm possesses a technical advantage which can be used in several production facilities simultaneously without reducing its marginal productivity. The MNE therefore has an incentive to duplicate the production process resulting in horizontal FDI. This has implications for FDI and trade. The horizontal FDI implies a substitution relationship while a complementary one is expected for the vertical FDI. Another distinction extending from vertical and horizontal FDI is the knowledge-capital model. Carr *et al* (2001) and Markusen and Maskus (2002) present models for this situation that allow for combinations of horizontal MNEs, vertical MNEs and national firms to arise endogenously. Knowledge-capital models incorporate both a complementary and substitutional relationship between FDI and trade.

Modelling the export decision has developed along two lines; the export-platform FDI and complementarity. The export -platform FDI is typically defined as the establishment of production facilities in a foreign country and the use of part or all of the output from those facilities to serve a third country. It refers to the export of a single product line, where these exports are not exported to the parent country. Export-platform FDI is determined by the interaction of shipping costs and cost advantages between countries. Ekholm *et al* (2004) model a form of FDI where foreign direct investment is performed in order to create an export-platform in the host country. Complementarity between exports and FDI refers instead to the export and FDI flows from the home country to foreign countries: exports and FDI become positively correlated if there are horizontal or vertical complementarities across product lines (Kneller and Pisu, 2004). An export platform model consequently predicts a complementary relationship between inward FDI and host country exports.

The theoretical literature suggests that the form of FDI should have a strong influence on the relationship between FDI and trade. The next issue is to establish the exact nature of the link between FDI and exports by examining existing empirical literature.

2.2.2. Empirical literature

The issue of what causes firms to export has been extensively studied. There is a large and growing body of empirical work that has documented the superior characteristics of exporting firms relative to those producing purely for the domestic market. These studies include Bernard and Jensen (1995, 1997), Richardson and Rindal (1995), Bernard and Wagner (1997), Bernard, Wagner and Jensen (1995), Aw and Hwang (1995), Clerides *et al* (1998), Delgado *et al* (2002), Kraay (1999), Aw *et al* (2000), Bigsten *et al* (2004), Van Biesebroek (2005) among others. The desired characteristics for exporting firms are

reported by these studies to be firm size, higher productivity, being more capital-intensive, being more technology-intensive and being able to pay higher wages.

Generally, foreign-owned firms are more likely to export than locally owned ones, and when they do, they tend to export a large share of their output (higher export intensity) (see Helpman *et al,* 2004; Kneller and Pisu, 2004; Bernard and Jensen, 1997). On the relationship between FDI and exports, the literature is so far mixed. Several empirical studies document evidence of strong positive spillover effects that domestic firms become more export oriented in response to the activities of MNEs in the host country (Aitken *et al,* 1997; Greenaway *et al,* 2004; Kneller and Pisu, 2005, Kokko *et al*, 1997; Sjöholm, Sjöholm and Takii, 2003). Other studies have either found no or even negative impacts and still others found no clear link between the two (Barrios *et al,* 2003; Kneller and Pisu, 2005; Ruane and Sutherland, 2005). Kokko *et al* (1997) found for Uruguay that foreign firms established after 1973 (corresponding to the outward-oriented period of Uruguay) positively affect the probability of exporting of domestic firms. Bigsten *et al* (1999) suggest that firms with foreign ownership that already have some links with foreign countries face lower costs of exporting. FDI can therefore be a strategy to acquire foreign markets. Zhang and Song (2000), investigating the role of inward FDI in China, found that FDI provides China with competitive assets for export-oriented production in technology-intensive products in the world trade, and so more firms (including domestic ones) can develop their exports. Using the GMM model, Sjöholm and Takii (2003) found that manufacturing firms in Indonesia with any foreign ownership are substantially more likely to enter the export market than wholly domestically owned firms. Ancharaz (2003) studying Mauritius export performance and export competitiveness showed that FDIO flows in Mauritius had contributed to export growth. Using time series regressions as well as panel data for some East Asia economies, Johnson (2006) indicates that FDI inflows have a significant and positive effect on host country exports.

Greenaway *et al* (2004), using a panel of UK firms from 1992 to 1996 confirm positive spillover effects from MNEs on the decision to export as well as on their export intensity. In their study foreign presence is measured as the sum of employment or output in the industry and in an attempt to separate competition from information effects they add exports from foreign multinationals as a proportion of total exports in the industry. They found that even when they controlled firm and industry level characteristics, both the likelihood of exporting and export intensity increased in the industry-level foreign presence index. In a similar study, Kneller and Pisu (2004) using firm level dataset for the UK manufacturing sector between 1988 and 1999, found that foreign firms were more likely to export than indigenous ones and when they do they are more export intensive and disproportionately contribute to the total manufacturing exports from the UK. Girma *et al* (2005) focused on the direct impact of FD on exports by considering the export dynamics of foreign acquired firms in the UK manufacturing sector and found that US acquired firms increase their exporting intensity on average by 3:1 percentage points.

In another study Kneller and Pisu (2005) using firm-level data for the UK manufacturing firms found mixed results. Their results indicate that except for backward spillovers (which are positive and significant) they do not find any evidence of forward and horizontal spillovers. They also find that the export decisions of domestic firms do not seem to be affected by contacts with multinational enterprises. On the contrary, the decision concerning how much to export appears to be influenced by the presence of foreign multinationals in the same upstream and downstream industries. In addition, intra-industry (i.e. horizontal) spillovers seem to depend on the export orientation of foreign firms. Both export-oriented and domestic market-oriented multinationals appear to generate positive and significant export spillovers, but those from the former are stronger. This suggests that, of the likely sources of export spillovers, leakage of specific information about foreign market from established foreign exporters appears to be a more important source. Similarly,

Ruane and Sutherland (2005) for Ireland using a Heckman selection model to account for inter-dependence between export participation and export intensity decisions find contrasting results. They find positive effects from the presence of foreign multinationals and negative effects from their export intensity on both the export propensity and export intensity.

In contrast, Barrios *et al* (2003) for Spain found no evidence of an effect on the export decision from MNEs or their export intensity. Using a firm-level dataset for Spanish manufacturing firms for the period 1990-98, their results show that a firm's own R&D activity is an important determinant of whether or not the firm becomes an exporter and how much a firm exports. R&D spillovers, either from MNEs or domestic firms do not appear to affect the likelihood of whether domestic firms become exporters. Abala (2009) found that firms with foreign ownership seem to be positively associated with both export propensity and export intensity using firm level panel data on Kenyan manufacturing firms covering the period 1993 - 2003.

In a recent study of Ghanaian firms using RPED data, Abor *et al* (2008) examines the effects of foreign direct investment on export propensity and intensity in Ghana. They find that FDI has a positive and significant effect on export propensity. Their random effects results also reveal a positive relationship between FDI and export intensity. This leads them to conclude that policies which encourage more FDI inflows into the country should be put in place in Ghana. These findings support those of Ancharaz (2003) for Mauritius, Johnson (2006) for several East Asian economies, Greenaway *et al* (2004) for the United Kingdom as well as the findings of Kneller and Pisu (2004) also for the United Kingdom. Similar findings were obtained by Girma *et al* (2005) focusing on the direct impact of FDI on the export dynamics of foreign acquired firms in the United Kingdom manufacturing sector. Abor *et al* (2008) have argued that the exports of host countries are promoted through FDIs by augmenting domestic capital for exports, facilitating access to new and large foreign markets, providing training for the local workforce and upgrading technical and management skills. The authors also find that productivity shows a significantly positive relationship with export intensity. This, they argue, shows that only the most productive firms find it profitable to pay the high cost associated with exporting.

The authors similarly find that firms with high degrees of foreign ownership exhibit high intensity. They argue that this result is driven by the fact that these firms have access to highly efficient technology and managerial skills leading to increased productivity and subsequently to increased export intensity. In relating firm size to export propensity and intensity, the authors find that large firms exhibit higher export propensity and intensity compared to smaller firms, a finding quite common in most studies in this literature. They argue that their finding is suggestive of the fact that large firms may be enjoying economies of scale, resulting in increased productivity, and that large firms may also be associated with lower average and marginal costs as in Bernard *et al* (2000). They suggest, for example, that in the operations of firms, large size may reduce capital costs and increase access to banking services, which is very essential for exports than for domestic sales. The authors find that spillover effects such as location and sectoral affiliation of firms have no statistically significant effect on both the export propensity and intensity in their model.

We note that in the Abor *et al* (2008) study of Ghanaian firms, the authors did not control for possible endogeneity of productivity nor did they control for unobserved heterogeneity arising from such factors as differences in managerial ability of firm managers. These could bias their estimates for export propensity. Similarly, their analysis of export intensity did not take into account the possibility that firms self-select into the export market in a process which may be non-random. They do not seem to have controlled for the sample selection bias which is likely to arise from such a situation.

Empirical literature indicates mixed results in terms of the relationship between FDI and exports. However, most studies point to a positive relationship between FDI and exports. It is therefore possible to hypothesize on the basis of this literature review that FDI positively influences a firm's decision to export as well as its export intensity.

2.3. Data and Econometric Methodology

The data for this study come from the Regional Programme on Enterprise Development (RPED) and from the Kenya Manufacturing Enterprise Survey (KMES) as well as from the 2002/2003 Firm Survey conducted through the partnership between Kenya Institute of Public Policy Research and Analysis (KIPPRA) and the World Bank. The data are for the period 1993 - 2002.

The data indicate that the average firm size was 167 workers while the largest firm reported 5064 employees, with the smallest firm having 5 employees. The medium firm size is 50 workers. For this study firms have been categorized according to size, in four categories viz small firms: those with 1-10 workers, medium-sized firms: 11- 99 workers, large firms: 100 – 499 workers, and mega firms (very large): 500 or more workers. The data indicate that 33% of firms are under the category of small firms, 41% are in the category of medium-sized firms, about 20% are in the large-sized firms category, and about 6% are mega firms.

The sectoral distribution of the firms in the full sample indicates that on average, the food and wood working sectors each accounted for about 19% of all the firms in the sample, while the textile/garments and metalworking sectors represented 23% and 25% respectively. The data further indicated that in terms of locational distribution, firms located in Nairobi represented 58% of the sampled firms while Mombasa accounted for 21% as Nakuru and Eldoret accounted for 10% and 9% respectively.

The Kenyan data indicate that the mean foreign ownership of Kenyan firms is about 18%. It has been argued that the higher the proportion of foreign ownership, the more firms tend to participate in the export market. Table 3 below shows the sample statistics of some of the variables used in the analysis.

TABLE 3: DESCRIPTIVE STATISTICS

Variables	Observations	Mean	Std. Deviation
Export intensity (ratio of exports to total sales)	1293	.1807682	.3389313
Export propensity (=1 if firm exports, 0 otherwise)	2343	.2471191	.4314287
Firm age in years at time of interview	2343	21.23773	15.89462
Firm size (employees)	2343	163.0352	291.3816
Foreign ownership dummy (=1 if there is any foreign ownership, 0 otherwise)	2343	.1754161	.3804038
Total factor productivity index	2343	3.306066	2.501502
Location: Nairobi = 1, if firm located in Nairobi, 0 otherwise	2337	.580659	.4935569
Mombasa = 1, if firm located in Mombasa, 0 otherwise	2337	.2062473	.4046967
Nakuru = 1, if firm located in Nakuru, 0 otherwise	2337	.1026958	.3036261
Eldoret = 1, if firm located in Eldoret, 0 otherwise	2337	.0967052	.2956191
Sectors: Food = 1 if firm is in food industry, 0 otherwise	2343	.1895006	.3919894
Textile =1 if firm is in textile industry, 0 otherwise	2343	.2338882	.4233923
Wood = 1 if firm is in wood industry, 0 otherwise	2343	.1895006	.3919894
Metal = 1 if firm is in metal industry, 0 otherwise	2343	.2505335	.4334128

Most of the firms in the sample are medium-sized firms (41%), with employees ranging between 11- 99 workers. This is followed by small-sized firms (1-10 workers) representing 33% of the sampled firms. Large firms employing between 100 - 500 workers represent 20% of the sample while very large firms with 500 employees and above represent only 6% of the sample.

In terms of sectoral classification, the metalworking sector represents the highest percentage with 25% of the firms, followed by textiles sector with 23%, while the food sector and the woodworking sector represent 19% each. The rest are distributed in other sectors. Most of the firms are located in Nairobi, the capital city, accounting for 58% of the sample. Mombasa, Nakuru and Eldoret account for 21%, 11% and 10% respectively. Approximately 25% of the firms sampled export their products and sell about 18% of their output in the foreign market on average. The mean foreign ownership is given as 18%. This means that on average foreign capital represents approximately 18% of the sampled firms. The average age is given as approximately 21 years at the time of the sampling and the average level of firm productivity is 3.3. The mean number of years of worker's education is approximately 6 years.

2.3.1. Empirical methodology

The empirical methodology employed to analyse the effect of FDI flows on exports follows that of Bernard and Jensen (2001) where the determinants of export decision and export intensity are motivated by the literature. We first test for the effect of FDI on the decision to export based on the probit model and subsequently test for the effect of FDI on export intensity. This allows us to determine if FDI flows encourage firms to enter into the export market and if exporting increases with FDI flows. The model can be stated as follows:

The export decision model is a probit because of the discrete choice nature of the dependent variable

$$\text{Probability}\ (\text{exporting} = 1) = \Phi(X\beta)\ldots\ldots\ldots\ldots\ldots\ldots.(1)$$

Where β is the set of estimated coefficients

X is a vector of explanatory variables (FDI, age, tfp, firm size, education, sector location)

$X\beta$ is the probit index and export dummy = 1 if export, otherwise 0.

The export intensity model is a panel data regression and is stated as:

$$\text{Export Intensity}_{it} = \alpha_t + \alpha_2 X_{it} + u_i + V_{it}\ldots\ldots\ldots\ldots\ldots\ldots(2)$$

Where X_{it} is a vector of explanatory variables as in equation (1)

V_{it} and u_{it} are the error terms

The vector explanatory variables include:

Export intensity = export sales/total sales

FDI = percentage of foreign ownership

Firm age = firm age in years

tfp = total factor productivity

Firm = firm size

Education = education of workers in the firm (years)

Sector = Food sector is the reference

Location = Nairobi is the reference

Theoretically we expect a significantly positive effect of FDI on firms' decision to export. This indicates that firms with high foreign ownership are more likely to export compared to domestically owned firms, a positive and significant relationship between firm age and export decision suggests that older firms through accumulated experience and economies of scale would be better placed to export, a significantly positive relationship between productivity and export decision suggest that firms that exhibit higher productivity levels are more likely to export. The case of education, sector and location may depend on the nature of the data.

2.3.2. Regression results

We report the probit regression results on the effect of FDI on export propensity of firms in Table 4.

TABLE 4: PROBIT REGRESSION: EFFECT OF FDI ON EXPORT PROPENSITY

Variable	Coefficient	Standard error	Z	Significance
Foreign ownership	0.8511	0.185	4.61	0.000
Firm size:				
Medium	1.923	0.266	7.19	0.000
Large	2.715	0.284	9.56	0.000
Very large	2.770	0.365	7.56	0.000
Firm age	-0.004	0.006	-0.67	0.505
Location:				
Mombasa	0.147	0.196	0.75	0.453
Nakuru	-0.026	0.280	-0.09	0.927
Eldoret	-0.152	0.221	-0.69	0.492
Sub-sector:				
Wood	0.067	0.246	0.28	0.780
Metal	0.602	0.200	3.02	0.003
Textile	0.399	0.201	1.99	0.047
Tfp	0.144	0.055	2.59	0.010
Education	0.032	0.029	-1.09	0.274
Constant	-2.623	0.335	-7.82	0.000
LR Chi^2 (13)	254.95			
Prob > Chi^2	0.0000			
Pseudo R^2	0.3834			
Log likelihood	-204.9802			
Observations	611			

The results of the study show a significantly positive effect of FDI on firms' propensity to export, with a coefficient 0.8511 and a z-value of 4.61. This indicates that firms with high foreign ownership are more likely to export compared to wholly domestic owned ones. The reason could be that these firms may bring along superior technology and management skills that could lead to higher efficiency and productivity so that the decision to export would follow from this. It may also be that firms with foreign capital may be in a better position to finance the sunk cost of entering the export market. Firms with FDI finance from FDI inflows would more likely export. They may also have links with foreign markets and would be motivated to export. These results confirm findings of previous studies, e.g. Kneller and Pisu (2004) among others.

Contrary to apriori expectations, firm age does not seem to influence exporting and the coefficient is negative. The results are however not statistically significant. It is also possible that younger firms have a greater incentive to export compared to the older ones since they could be more proactive, flexible and aggressive in foreign markets. The younger firms also tend to have smaller market share domestically and may be more interested in exporting to increase their market share.

These results, in line with earlier studies, indicate that there is a significantly positive relationship between firm productivity and a firm's export decision, suggesting that firms exhibiting higher productivity levels (tfp) are more likely to export. Productive firms generally would seek to sell their products beyond the

domestic market, if it is not large enough. It is therefore expected that productive firms would be very much interested in exporting abroad.

These results show that firm size is significantly positively related to a firm propensity to export. Compared to small firms, medium size, large and very large firms are more likely to enter the export sector. In terms of the sub-sector effect, the results of this study indicate that firms in metal and textile sectors are more likely to export compared to the reference subsector (i.e. food sector) whereas firms in the wood sector are less likely to export. The results further show firm location has no significant effect on a firm's likelihood to export, since no significant effects were found for all the location variables in the model. One reason could be that exporting agents and facilities are concentrated and more accessible to firms located in Nairobi (the reference location) so that the other locations exert no significant effect on exporting.

Table 5 shows the regression results on the effect of FDI on export intensity. In this regression we have controlled for sample selection bias, using the Heckit method so that we have a generated regressor, the inverse of Mills ratio.

TABLE 5: RANDOM EFFECTS REGRESSION: EFFECT OF FDI ON EXPORT INTENSITY

Variable	Coefficient	Standard error	Z	Significance
Tfp	0.0144	0.0078	1.85	0.064
Firm age	-0.0015	0.012	-1.28	0.202
Foreign ownership	-0.0059	0.0453	-0.13	0.896
Sub-sector:				
Wood	0.01910	0.0460	0.42	0.677
Metal	-0.0911	0.0541	-0.35	0.724
Textile	-0.0444	0.0459	-0.97	0.333
Location:				
Mombasa	0.0513	0.0403	1.27	0.203
Nakuru	0.0611	0.0590	1.04	0.301
Eldoret	-0.0162	0.0516	-0.31	0.753
Firm size:				
Medium	0.0386	0.0291	1.33	0.185
Large	0.0690	0.0323	2.14	0.033
Very large	0.02250	0.0540	4.17	0.000
Inverse Mills ratio	-0.0412	0.0118	-3.51	0.000
Constant	0.1210	0.0558	2.17	0.030
R-squared:				
Within	0.1429			
Between	0.1629			
overall	0.1976			
Wald Chi^2 (14)	63.87			
Prob > Chi^2	0.0000			
Observations	371			

In this regression, foreign ownership of firms exerts no significant effect on export intensity. However, firms with high productivity will export more compared to firms with lower productivity (tfp). We expect that highly productive firms would demonstrate increased export intensity. This is because high productivity firms may be capable of financing export activities so that increased productivity may translate into increased export intensity. The results also indicate that firm age may not significantly influence the

proportion of a firm's output that is exported. This may be as mentioned earlier, younger firms are more aggressive in the foreign market since the domestic market is already dominated by the older firms.

In terms of firm size, large firms and very large firms exhibit a significantly positive impact on export intensity than small and medium firms. This may suggest that a certain minimal size of a firm is required to break into the foreign market. Similarly, medium, large and very large firm sizes may also be associated with lower average or marginal costs. These sizes may reduce capital costs and increase access to lower priced banking services which are critical for exporting than for domestic sales. All the subsectors show insignificant effects on export intensity in relation to the reference subsector, the food sector. Firm location similarly has no influence on the share of a firm's output that it exports.

The Inverse of Mills ratio is statistically significant, signalling the fact that the firms may self-select into exporting in a non-random manner. The significance of the Inverse of the Mills ratio indicates that there is indeed a sample selection bias.

2.4. Conclusions and Policy Implications

FDI has been identified as a major contributor to the economic growth of host countries. It has been noted for promoting exports of host countries by augmenting domestic capital for exports, transferring technology and new products for exports, facilitating access to new and large foreign markets and providing training for the local workforce as well as upgrading technical and management skills. However, it has also been argued that FDI may lower or even replace domestic savings and investment (crowding out), transfer low level or inappropriate ones for the host country's factor proportions, primarily target the host country's domestic market and hence not increase exports and inhibit the growth of indigenous firms that might have become exporters and hence not help develop the potential of the host country.

This study sought to examine the effect of FDI on firms' export propensity and intensity using the Kenyan manufacturing sector. Overall, the results demonstrate that FDI has a positive effect on firms' export propensity but has no significant effect on their export intensity. This is explained by the fact that FDI improves technologies and management skills that translate into efficiency and improved productivity (tfp) and hence the export propensity would depend on the ex-ante productivity. Another aspect is that firms with foreign capital injection may be in a better position to finance the sunk cost involved in entering the export market and may also have links with foreign markets and are therefore motivated to export. These results confirm the findings of prior studies.

The study showed that FDI impact on export propensity but not necessarily on intensity of exports. The increase in FDI inflows would translate into firms increasing their export propensity and thus would grow their exports in total even though it shows no significant impact or how much of the output a firm exports. Given this finding, economic policies should target enhancing the Kenyan environment to attract and support FDI inflows to propel economic growth. The environment should be enhanced to encourage FDI inflows by maintaining macroeconomic stability, and improving the quality of labour through efficient educational and training systems.

One of the main contributions of multinational firms is that they can access modern technology and larger markets. These can help boost Kenya's export base in manufacturing. Given the potentials that foreign-owned firms have in exporting over their domestic counterparts, policies could be designed to encourage FDI with exporting as a target. This could mean expanding the existing export processing zones to allow

such FDI inflows to enjoy some privileges that are not export processing zone specific. These may include exemptions from duties and levies on inputs, exemptions from income tax on profits for a period, and a "one-stop-shop" business registration facility extended to non-export processing zones on condition that they target exporting. This policy could promote complementarity between inward FDI and Kenya's manufacturing exports and give Kenya's exports a further boost. The results have established that increased productivity positively influences firms' propensity to export. The policy initiatives could also be directed at increasing the level of productivity in Kenyan manufacturing firms.

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Chapter 3: Global Financial Crises and Remittances: The Case of Kenya

Dr. Tabitha Kiriti- Nganga

3. Introduction

The global financial crisis originated from the sub-prime mortgage market in the USA and can be traced to a decade of low interest rates in the US which spurred liberal lending practices by commercial banks to the sub-prime market such that investors would essentially borrow money against such appreciating securities. Commercial banks and morgage financial institutions created products referred to as mortgage-backed securities, which were enhanced through underwriting guarantees by insurance companies. Investment banks repackaged and transformed these high-risk assets from the financial institutions into tradeable instruments that could be bought and sold in capital markets worldwide, thereby spreading the risk across the global financial system.

- Major channels of transmission of the impact of the global economic and financial crisis on African economies include:
- Decreased exports due to fall in commodity prices and reduced demand for exports, thus leading to lower export revenues.
- Increased stock market volatility, which has significant negative effects on the financial sector and a decline in the stock market indices.
- Depreciation in foreign exchange rates, which, especially against the US dollar, negatively impacts on debt-service burdens for countries that have high external debts, and furthermore, results in increased costs of imported intermediate inputs, with consequences for production, output and employment.
- Decreased Foreign Direct Investment (FDI) flows due to tightening of liquidity in global financial markets which could constrain economic growth.
- Potential decrease in Official Development Assistance (ODA) for the financing of government programs.
- Decrease in revenue from tourism, which would negatively affect economies that are dependent on tourism such as Cape Verde, Mauritius, Kenya, Uganda and Morocco.
- Reduced workers' remittances due to loss of jobs or reduced earnings of African migrant workers in Europe, North America and the Gulf States.

The objective of this paper is to investigate the impact of the global financial crisis on remittances in Kenya. We first look at the theories of remittances and then the flow of remittance to less developed countries (LDCs). We then look at the issue of Kenya: its flow of remittances before, during and after the global financial crisis. We then discuss the uses of remittances in general and then zero in on their use in Kenya and discuss how these uses could have been affected by the global financial crisis.

3.1. Remittances

3.1.1. Theories of reasons for remittances

Migrants, whether local or international, send remittances back to their families for different reasons. Some may remit for selfish reasons (in favour of themselves) while others will remit in favour of their family and friends they left behind. This leads to the two main approaches for analysing remittances. The first is the "portfolio" approach while the second is the altruism approach (IMF, 2005). The portfolio approach sees remittances as a self interest controlled capital transfer to diversify the migrant's savings. Portfolio motives come out of investment opportunities and saving differentiation while the altruistic approach sees remittances as a transaction that benefits the receivers who were left behind by the migrant without any demand on the receiver from the remitter.

In the pure altruistic framework, advanced by Becker (1974), an individual cares about the well being of others and derives satisfaction from giving. Husbands, for example, might send remittances to their wives because they care about them and derive satisfaction from giving. In this model, the migrant enjoys remitting and derives utility from the utility of those left at home, and the latter utility is presumed to depend on per capita consumption. The migrant therefore maximizes his or her utility with respect to the amount that he/she remits. These remittances are assumed to increase with the migrant's income or wages and to decrease with a rise in the income at home before receipt of remittances. The longer the duration of the migrant's stay away, the greater the associated decline in the number of dependents at home, the weaker the migrant's motivations to remit are believed to become.

Alternative or reinforcing reason for remittances could be social obligation on the migrant to care for dependents. This may be combined with self-interest especially when the long-term plan of the migrant is to return to his or her place of origin (Rempel and Lobdell, 1978).

In Stark's (1991) exchange (pure self-interested) model, a migrant remits cash or resources to relatives in return for services received from them. Stark suggests that aspiration to inherit, maintenance of home investments, and the intentions to return make the migrant retain interest in their original home beyond altruism.

Stark (1991) and Lucas and Stark (1985) view remittances as part of an inter-temporal, mutually beneficial contractual arrangement between the migrant and their family, which they call the eclectic (tempered altruism or enlightened self-interest). This views the migrant and family as having an implicit understanding that is of mutual benefit. The household allocates certain members as migrants with the aim of risk spreading. Remittances, as claims, would then flow to the family at times of crop failure or drought and to the migrant during spells of unemployment. A husband and wife can make such an arrangement where the husband moves to the urban area or abroad and the wife is left in behind to look after both their interests. The household also gains from investing in the education of youngsters who then migrate to urban areas or abroad to reap returns and remit to repay the family's outlay. Lucas and Stark (1985) argue the remittances should rise with the education of the migrant. Arrangements between a migrant and family are voluntary and thus must be self-enforcing and motives of altruism and self-interest mean that the migrant retains a vested interest in his or her origins beyond altruistic concerns.

According to Poirine (1985), remittances mainly also consist of the repayment of an informal and implicit loan taken out by the migrants during their youth, in order to secure a better education that later makes them more productive and competitive in the modern sector or internationally.

Another theory of remittances has to do with compensation capital for economic growth. The idea that remittances work as compensation capital for poor economic performance was supported by Chami, et al (2005) who found negative correlation between the size of remittances and the home country's GDP for the period 1970-1998. According to the authors, the negative relationship between remittances and economic growth is due to two main factors: moral hazard coupled with information asymmetry. The model assumes that recipients received remittances as an altruistic gesture. The recipient maximizes utility by selecting an optimal mix of his or her labor -leisure choice. Since remittances will accrue regardless of the recipients' labour efforts, they may choose more leisure and less work in order to maximize their utility. This decision could be a source of dependency syndrome associated with social transfer programs. Recipients may not desire to work hard since they have remittances as a source of income to depend on. The model also assumes the presence of asymmetric information; the remitter cannot observe the receivers' work effort. As such the remitter continues to supply more and more income regardless of whether the recipients are putting more effort to work or not. As such there may be decreased productivity, and as such remittances may not necessarily spur development and economic growth. This argument could be generalized to other social transfer programs which may induce perverse incentives by the recipients. The model however does not condemn remittances and social transfer programs rather it cautions that these types of programs are good for cushioning vulnerable households; who may or may not become more productive.

3.2. Flow of Remittance to Less Developed Countries (LDCS)

Workers' remittances have become an important supplement to basic incomes in LDCs, where they generally support consumption rather than investment. According to World Bank estimates, remittances to developing countries as a whole have been increasing at a slower pace in recent years, with the annual increase down from 18 per cent in 2006 to 9 per cent in 2008 (World Bank, 2011).

According to the Factbook 2011, *r*emittances to developing countries were a resilient source of external financing during the 2008/2009 global financial crisis, with recorded flows expected to reach $325 billion by the end of 2011, up from $307 billion in 2009. Worldwide, remittance flows are expected to reach $440 billion by the end of 2011.

Remittances, which represent a major source of foreign exchange for developing countries[1] ($63 billion a year for Latin America, nearly $20 billion for sub-Saharan Africa in 2008), and is an important source of income for households, were expected to contract globally by between five and eight percent in 2009 after years of double-digit growth (World Bank, 2009). The situation is particularly problematic for those countries for which remittances are a large percentage of GDP. This includes small economies such as Lesotho whose remittances are 29 percent of GDP (World Bank, 2009).

The manager of the migration and remittance unit at the World Bank, Dilip Ratha, on 'Migration and Remittances Factbook 2011' from World Bank http://vimeo.com/worldbankvideo says that:

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[1] Remittances fell only 5.4% in 2009 compared to a 36 percent decline in foreign direct investment (FDI) between 2008 and 2009 and a 73 percent decline in private debt and portfolio equity flows from their peak in 2007.

Remittances in 2008 and 2009 became even more of a lifeline to poor countries, given the massive decline in private capital flows sparked by the crisis. However, high unemployment is prompting many migrant-receiving countries to tighten immigration quotas, which would probably slow the growth of remittance flows. Also uncertain currency movements can have unpredictable effects on remittance flows.

Table 6 gives the outlook for remittance flows to the developing countries between 2011 and 2012.

Table 6: Outlook for Remittance Flows ($ billions) to Developing Countries, 2011-12

Region	2007	2008	2009	2010e	2011f	2012f
Developing countries	278	325	307	325	346	374
East Asia and Pacific	71	85	86	91	98	106
Europe and Central Asia	39	46	35	37	39	43
Latin America and Caribbean	63	65	57	58	62	69
Middle-East and North Africa	32	36	34	35	37	40
South Asia	54	72	75	83	87	92
Sub-Saharan Africa	19	21	21	21	22	24
Low-income countries	**17**	**22**	**22**	**24**	**26**	**29**
Middle-income countries	**262**	**303**	**285**	**301**	**319**	**345**
World	385	443	416	440	464	499
Growth rate (%)						
Developing countries	22.8%	16.7%	-5.5%	6.0%	6.2%	8.1%
East Asia and Pacific	23.7%	20.2%	0.3%	6.4%	7.2%	8.5%
Europe and Central Asia	38.5%	16.5%	-22.7%	3.7%	6.5%	10.4%
Latin America and Caribbean	6.9%	2.2%	-12.0%	2.0%	7.6%	10.0%
Middle-East and North Africa	21.5%	11.8%	-6.3%	5.3%	4.5%	6.7%
South Asia	27.1%	32.5%	4.5%	10.3%	5.1%	6.3%
Sub-Saharan Africa	46.7%	14.9%	-3.7%	4.4%	4.5%	6.7%
Low-income countries	27.6%	32.5%	2.4%	8.2%	8.7%	9.0%
Middle-income countries	22.5%	15.7%	-6.0%	5.8%	6.0%	8.0%
World	21.1%	15.1%	-6.1%	5.8%	5.4%	7.5%

e= estimate; f=forecast

Source: Massimilano Calì with Salvatore Dell'Erba (2009), The global financial crisis and remittances: What past evidence suggests ODI Working Paper No. 303.

As Table 6 shows, remittances to sub-Saharan Africa declined by 3.7% in 2009 while in other developing countries, there was positive growth during the same period. This is expected to grow to 6.7% in 2012. However, this will depend on the way the financial crises facing the euro zone are sorted out.

Officially recorded remittance flows to developing countries recovered quickly to $325 billion in 2010 after the global financial crisis. But they have not kept pace with rising prices in recipient countries. Remittance flows are expected to grow at lower but more sustainable rates of 7-8 percent annually during 2011-13 to reach $404 billion by 2013 (Mohapatra, Ratha and Silwal, 2011).

With a global economic recovery in 2010, remittance flows to all six developing regions registered positive growth in 2010. In part because of increase in oil prices and expansion of economic activity in the Gulf Cooperation Council countries, remittance flows to South Asia and East Asia increased at a faster pace of 8.2 percent and 7.4 percent respectively in 2010. However, remittance flows to Latin America and the Caribbean and Eastern Europe and Central Asia regions remained almost flat in 2010 because of economic weakness in the United States and Western Europe. In line with a recovering but still fragile global economy, remittance flows to developing countries are expected to increase in 2011-13, but at lower and more sustainable rates compared to the period prior to the global financial crisis.

Recorded remittance flows to developing countries are expected to grow annually by about 7.4 in 2012 and 7.9 percent in 2013 to reach $375 billion in 2012 and $404 billion by 2013. Worldwide recorded remittance flows, including to high-income countries, are expected to reach nearly $500 billion in 2012 and $536 billion in 2013 (Mohapatra, Ratha and Silwal, 2011).

3.3. Use of Remittances

The World Bank estimates that, after recovering by the end of 2011, recorded remittances to developing countries will rise further in 2011 and 2012, possibly exceeding $370 billion in two years' time. Director of development prospects at the World Bank, Hans Timmer said:

> Remittances are a vital source of financial support that directly increases the income of migrants' families.... Remittances lead to more investments in health, education, and small business. With better tracking of migration and remittance trends, policy makers can make informed decisions to protect and leverage this massive capital inflow which is triple the size of official aid flows.

Remittances are likely to affect the economy regardless of whether they are sent with the intentions of a portfolio investment or altruistic helpfulness. Capital for portfolio investment may increase the economic activity since investments are done with the intentions of generating profits and productivity, in the same manner as foreign direct investment does. Capital sent with the idea of altruism does not bring any demand for profits or productivity. Households are free to use the remittances as they deem fit. If altruism dominates remittances, the remittance inflows will have a smaller effect on the economic activity. The effect could even become negative depending on whether the capital makes the receiver less productive than the productivity the capital generates from being used.

World Bank (2011) argues that after foreign direct investment (FDI), remittances are the Africa's largest source of foreign inflows. Migrant remittances contribute to international reserves, help finance imports, and improve the current account position of recipient countries. They are associated with reductions in poverty, improved health and education outcomes, and increased business investments.

Remittances can affect economic growth directly, by raising consumption and investment expenditures; by increasing expenditures on health, education, and nutrition that contribute to long-term productivity; and by improving the stability of consumption and output at both the household and macroeconomic levels.

At the macro level, remittances are a large and stable source of external finance for African countries that improves their creditworthiness and access to capital. In many African countries, these flows exceed FDI, portfolio equity, and debt flows; in some countries they are equal in size to official aid. Remittances tend

to be more stable than other sources of foreign exchange, and they are often countercyclical, helping sustain consumption and investment during downturns and performing the role of a shock absorber. These beneficial effects of remittances improve sovereign creditworthiness and the external debt sustainability of African countries. Securitization of future remittance flows can increase the access of African banks and firms to international capital markets; it can also be used to fund longer-term development projects, such as infrastructure and low-income housing. Using remittances for such purposes should be accompanied by prudential debt management and efforts to ensure medium-term sustainability of external debt.

Remittance receipts are associated with reductions in poverty; increased household resources devoted to investment, and improved health and education outcomes. Migrant remittances help smooth household consumption and act as a form of insurance for households facing shocks to their income and livelihood caused by drought, famine, and other natural disasters. Household surveys in Africa show that remittance-receiving households have greater access to secondary and tertiary education, health services, information and communication technology, and banking than households that do not receive remittances. The surveys also reveal that the average amount of remittances received by households from outside Africa is larger than that of intraregional and domestic remittances. A significant part of all remittances is spent on human and physical capital investments, such as education, health, land, and housing, starting a business, improving farms, and purchasing agricultural equipment (World Bank, 2011).

At the micro level, remittances can have great potential to generate a positive impact on recipients' welfare. This is mainly because they go directly to family members without any intermediaries and they are available to the recipients to use them according to their own priorities. For example, households may decide to use them to finance basic consumption, education, health, improvement of dwellings, purchase of real estate and investment in business. They may be especially important in supporting micro-enterprises. Thus remittances can potentially play a significant role in relief of destitution and stimulation of economic activities at local levels. In addition they can help households maintain their consumption levels (consumption smoothening) through economic shocks and adversity. For developing countries, international remittances are seen to be a more constant source of income.

Sanders (2003) contends that up to 80 per cent of remittances are used for basic household consumption and 5-10 per cent is used to invest in human capital such as education, health, and better nutrition. Other important uses of remittances include land, housing and livestock. These are often seen as (future) assets of the emigrants themselves hence a sort of investment. Smaller portions of remittances are spent on socio-cultural events, for loan repayments, savings and generally only little is invested in employment and income generating activities other than agriculture and livestock (Sanders 2003; Kiriti, 2003). In rural areas remittances are spent on productive assets such as land, cattle and equipment which allow rural households to continue the agricultural activities and to strengthen their livelihoods. Orozco (2003), in a study on micro-enterprises in Mexico found that remittances were responsible for 27 per cent of the capital invested in micro enterprises. Sander (2003) in a survey in Albania found that 17 per cent of the capital to establish enterprises came from remittances (Sander, 2003).

3.4. The Case of Kenya

In Kenya, the global financial crisis made a bad situation worse. The country was already experiencing the effects of the post-election violence and drought. The initial effect of the financial crisis was a depreciation of the exchange rate due to non-resident outflows from the domestic equity and bond markets. This was followed by a slump in the stock market. Foreign exchange reserves of the Central

Bank also fell below the statutory level of four months of imports as they were used to cushion the market from extreme exchange rate volatility. The second round effects of the financial crisis were economic in nature. These comprised of slowdown in exports (mainly horticulture and tourism) occasioned by reduced international demand. These effects also affected domestic economic activity and hence the economic slow-down.

Although it was expected that migrant remittances would decline, in the Kenyan case, it actually increased in 2008 compared to 2007 mainly as the Diaspora responded to cushion relatives against adverse effects of multiple shocks, including the aftermath of the post-election violence and drought. However, remittances declined by 15 percent in the first four months of 2009, compared to the same trimester in 2008 (Central Bank of Kenya, 2009). Remittances to Kenya, a key source of foreign exchange for Kenya, rose 6 percent in February to $53.3 million compared with the same month in 2008 (Central Bank of Kenya, 2009). Kenyans overseas sent $50.3 million home in February 2008. The total amount in the first two months of 2009 fell 11 percent to $92.9 million from $104.3 million in the same period of 2008. Total remittances in 2008 were $611.2 million, making the receipts the third largest source of hard currency after horticultural and tea exports.

Table 7 shows an improvement in the monthly flows of remittances since January 2004. It also shows that remittances increased by 17.2 percent (from USD 39.5 million to USD 46.3million) in the period January to June 2009 compared with an 8.2 percent fall in a similar period in 2008. Also, remittances are pro-cyclical. The largest inflow in 2008, amounting to USD 67.9 million was recorded in April 2008. The funds were partly for investment in the Safaricom IPO and cumulatively, remittances were 11.4 percent lower in the January-June 2009 period over the comparable period in 2008. The larger inflow in 2008 reflected the need for consumption smoothening especially for families affected by the post election violence and for investment in the Safaricom IPO.

TABLE 7: REMITTANCES TO KENYA 2004-2009

Year	2004	2005	2006	2007	2008	2009	2010	2011
January	25,154	28,564	31,506	40,930	53,925	39,535	45,117	64,139
February	27,676	26,056	30,283	39,533	50,382	53,353	46,423	60,759
March	29,944	31,219	36,354	48,562	59,344	55,361	52,309	71,577
April	27,773	29,216	35,369	38,251	67,872	48,117	52,679	70,071
May	26,931	32,358	42,427	41,163	48,538	49,180	51,172	68,124
June	30,047	34,360	35,667	48,643	49,490	46,347	52,541	71,888
July	33,187	29,133	41,065	53,350	44,137	50,372	50,652	72,797
August	28,894	31,759	30,587	58,803	43,388	55,947	51,993	79,563
September	28,894	31,616	28,841	60,575	48,953	53,347	58,557	-
October	25,223	33,037	29,633	46,848	61,113	53,037	58, 503	-
November	25,473	34,282	31,403	55,564	43,970	48,231	56,380	-
December	29,130	40,557	34,459	41,421	40,129	56,329	65,617	-
Annual Total	338,326	382,153	407,593	573,643	611,241	609,156	641,943	558,898

Source: www.centralbank.go.ke

According to the Central Bank of Kenya, Kenya received US$611.2 million in 2008, from $573.6 million in 2007, about 2.7 per cent of GDP. The reduction of incomes and the loss of jobs by Kenyans in the Diaspora were expected to reduce remittances. Table 2 shows that remittances have increased significantly over time and actually increased in 2008, by 6.6 per cent compared with 2007. Remittances also increased substantially in August 2011 to US$79,563 billion compared with US$51,993 during the same month in 2010. As shown in the table, while remittances were quite volatile in 2008, there was a general downward decline from May 2008, even though they increased in September and October. In the second part of 2008, monthly remittances declined relative to 2007, except in October. Remittances declined by 27 per cent in January 2009 when compared with January 2008. From March 2009, remittances took a downward trend from a high of 55.4 to a low of 46.3 in June 2009. Figure 8 shows the annual total remittances to Kenya from 2004 to 2011.

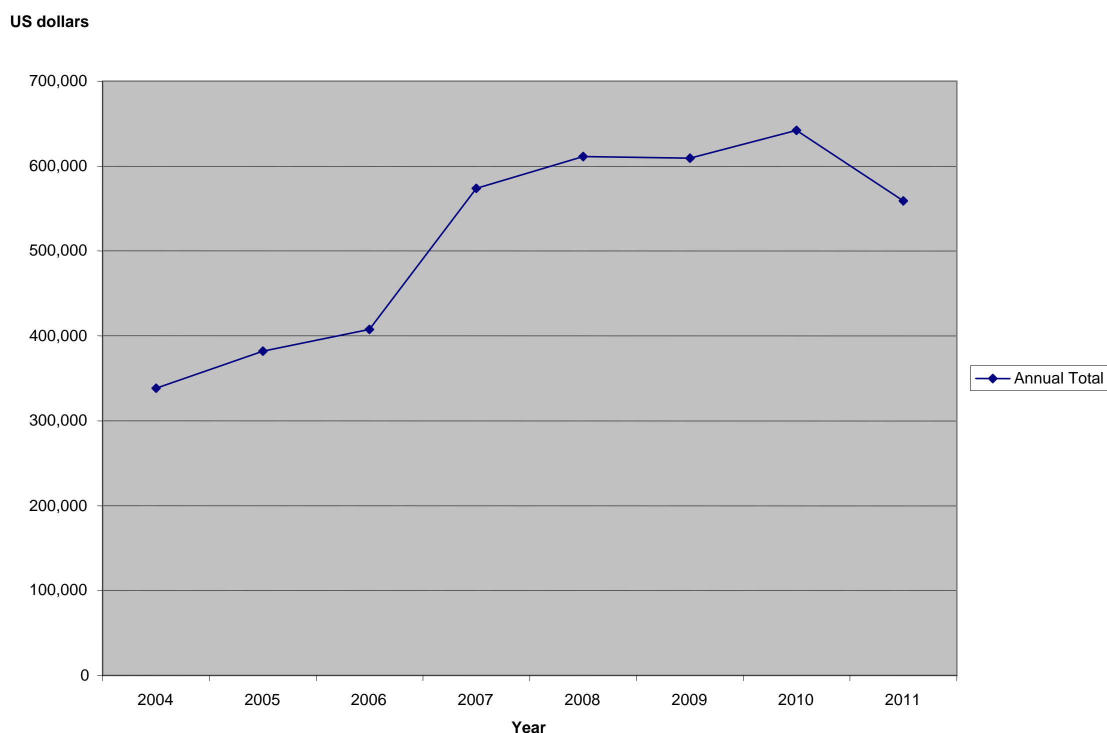

FIGURE 4: ANNUAL TOTAL REMITTANCES TO KENYA FROM 2004 TO 2011

Figure 4 shows that remittances actually decline in 2009 showing that they were quite sensitive to the global financial crisis in the Western world.

A significant portion of remittances sent to Kenyan households is spent on housing investment and purchase of land. A household survey by the World Bank (2011) shows Kenyan households invest 55.3 per cent of remittances received from outside Africa and 47 per cent of remittances from other African countries in land purchases, building houses, businesses, improving the farm, agricultural equipment and other investments.

It shows that households receiving remittances in Kenya use 11.2 per cent of the remittances from outside Africa, 27.5 per cent of remittances from within Africa and 1.3 per cent of domestic remittances in

construction of new houses. Kiriti (2003) found that the biggest percentage of remittances is used on food followed by education as shown in Table 8.

TABLE 8: USE OF REMITTANCES IN KENYA

Component	Proportion (%) of Remittances used
Food	19
Education	17.7
Health	6.7
Rent (house/land)	4.6
Vehicles	0.9
Marriage/funeral	1.5
Construction of new house	13.3
Rebuilding of house	3.2
Purchase of land	5.6
Improvement of land	2.4
Business	8.4
Investment	9.8
Other	6.9
Total	100

Source: World Bank (2011)

Although Kenya is dependent on agriculture, only 2.4 per cent of the remittances is used in the improvement of the land which corroborates Kiriti (2003) findings that remittances are mainly for consumption purposes. Uses of remittances for investment and entrepreneurship in Kenya are somewhat limited. Only 9.8 per cent of the remittances are used for investment purposes. However, remittances take care of consumption smoothing although it has been found that this consumption is mainly on imported products which may worsen the Balance of Payment position. However, a significant portion of international remittances are spent on land purchases, building a house, business, improving the land, and other investments (as a share of total remittances. Investment in these items represented 34.3 percent in Kenya.

As such reduction in the remittances in the first six months of 2009 could have affected the welfare of many households that depend on remittances since as can be seen in Table 3, consumption and education have the lion's share of the remittances. It could also have affected the education of quite a number of those households that depend on remittances.

3.5. Future Outlook

Just when it looked like the world was recovering from the effects of the global financial crises of 2008-2009, the global growth prospects for 2012 are bleak. Advanced economies are projected to grow at a slow pace in 2012; and China, a key driver of the global recovery after the 2008-2009 financial crises, is not faring well either.

Fears of a double-dip recession are haunting markets around the world. Global stock markets have tumbled repeatedly on worries over Europe's debt crisis, while the euro continues to lose ground against the US dollar. Investor confidence has reached panic levels, with the Credit Suisse's Global Risk Appetite Indicator at a 30-year low.

In addition, a series of sovereign credit downgrades has hit many developed countries: the US lost its triple-A credit rating for the first time in its history, Italy and Spain experienced several downgrades, and France's triple-A rating is under threat. What's more, unemployment is on the rise throughout advanced economies, with the United Kingdom (UK) reaching its highest unemployment level for 17 years.

The epicenter of this financial and economic turmoil is once again the developed world, and in particular the euro zone. Greece's inability to repay its debt is pushing the European Union (EU) towards the biggest crisis in its history, with possible significant spill-over effects within the euro area and beyond. If no decisive action is taken, a Greek sovereign debt default is likely to trigger a domino effect, which could affect major European economies such as Italy and Spain, with a severe impact on France, as well as the UK and Germany.

In a context of increased global interdependence, developing countries are unlikely to remain immune to the debt crisis in the developed world. Sooner or later, they will feel the effects along three possible channels:

Balance sheet problems of European banks, volatile stock markets and reduced investor confidence may prompt credit lines cuts and delayed or cancelled investments in the developing world

In addition to the above, the euro zone crisis could impact on developing countries through China's hard-landing. The Chinese economy is slowing down: exports are falling, and its overheated property market is weakening. This, in turn, could affect least developed countries for which China represented the biggest trading partner in 2010.

Austerity packages introduced by European governments are likely to weaken demand for developing country exports and might lead to cuts in aid spending. Moreover, high unemployment rates associated to weak economic activity in developed countries may translate into fewer remittances directed to developing economies which will have the same impact as outlined above in regard to the impact of the global financial crisis.

It is expected that the Euro will experience depreciation against the dollar. A weak euro may put further pressure on developing countries' dollar-based exports and diminish remittances purchasing power.

Some developing countries are more at risk than others. Countries most at risk include those heavily dependent on European economies and with a limited fiscal policy room. Kenya, for example, is particularly vulnerable given its strong trade and financial links with Europe, as well as its narrow fiscal space. However, the magnitude of the impact of the euro zone crisis on Kenya will depend on the speed and type of policy solutions implemented by European countries.

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Chapter 4: Informal Cross-Border Trade in Agricultural Commodities: Examples from Kenya and Her Neighbours

Seth Omondi Gor

4. Introduction

Kenya shares territorial boundaries, close trade ties and common membership in fledging regional economic blocks such as Common Market for Eastern and Southern Africa (COMESA) and/or East African Community (EAC) with a number of countries, including Tanzania, Uganda, Ethiopia, Somalia and South Sudan. A common feature of these regional groupings is that they are in their infancy and they therefore face a host of trade-related challenges.

Given Kenya's unique position as an industrial power-house and a communication hub for her neighbours, it is widely acknowledged that the volume of informal trade between Kenya and these countries is bound to have a significant impact on regional trade. This notwithstanding, several informal trans-border-related questions remain unanswered, including:

- What agricultural commodities are traded and in what quantities and values?
- What are the profiles of the traders involved?
- What leads them (the traders) to informal trade?
- How is the trade financed?
- What is the traders' source of market information?
- What options do the respective governments have with regard to this trade?

The present study attempts to address itself to some of these questions.

4.1. Informal Sector, Informal Trade and ICBT

The informal sector in Kenya is defined to cover all semi-organized and unregulated activities that are small scale in terms of employment. The activities are largely undertaken by self-employed persons or employers of a few workers in the open markets, in market stalls, in both developed and undeveloped premises, in residential houses, or on street pavements.

The main legal feature of the informal sector enterprises in Kenya is that they are not registered or legally bound to register with the Registrar of Companies. Nevertheless, these enterprises may or may not have operating or occupational licenses (mostly from local authorities) for carrying out businesses. The Agricultural sector in Kenya is however excluded in the coverage of informal sector activities.

Traditionally, the informal sector activities consisted of urban artisans. Today, the sector has expanded to encompass fishing, the manufacturing, building and construction, distributive trades, transport and communications, hotels and restaurants and community, and personal services industries. The main activities include tailoring, carpentry, blacksmith, retailing shops, groceries, kiosks, meat and maize roasting, sale of clothing and shoes, open-air restaurants, general repair and maintenance of fixed assets and other

durables, repair and assembling of motor vehicles, street vending and hawking, newspaper vending, shoe shining, and hair dressing, among others.

Efforts aimed at linking informal trade to the existing informal sector are generally quite recent. This is most evident for Kenya, where agriculture is not classified in the informal sector despite the fact that agricultural commodities constitute the bulk of the informal-cross border trade merchandise.

One aspect of the activities of the informal sector that is not adequately documented is the international trade activity of the informal sector, variously referred to as informal trade or Informal Cross Border Trade (ICBT). Informal trade takes different forms and is known by different names such as: unrecorded trade, illegal trade, unofficial trade, underground trade, black market, and parallel economy, among others. It is however best characterized by its non-inclusion in the national accounting system of a country.

From a conceptual point of view therefore, informal trade relates to activities that in form and structure operate outside the bureaucratic controls of the government. More specifically, ICBT refers to unrecorded business transactions undertaken across the borders based mainly on popular economy. The traders involved do not submit tax returns at the end of each financial year, hence are not entered in national accounts statistics.

Dongala (1993) observes that informal trade is said to occur within the informal sector if the following features obtain; there is unregulated and large-scale trade involving many participants, scale of operation is smaller than in the formal sector, requirements in the formal sectors such as registration are minimal or at times nonexistent and whenever they exist, are avoided with relative ease, there is ease of entry and exit, rampant evasion of trade related licenses and/or taxes such as import license or export tax, use of parallel foreign exchange markets, participants evade paying international trade related taxes, but pay local taxes and licenses to sell in local market places, traded goods originate from both formal and informal sector sources and all goods are traded at market prices.

Data based evidence shows that ICBT represents a significant proportion of regional cross-border trade in Sub-Saharan Africa (Ackello-Ogutu, 1996; Peberdy, 2002; Mwaniki, 2004; Soko, 2006 and Uganda Bureau of Statistics, 2006 and 2007). Lesser and Leeman (2009) estimate that indeed in some countries, informal flows exceed formal trade flows for certain commodities. This position is also corroborated by USAID (1996; 1997; 1998a and 1998b) who estimate that informal trade may be similar in value to official regional trade between Sub-Saharan countries.

4.1.1. Size of the informal sector

The informal economy has not only persisted, it has also expanded tremendously over time especially in the developing countries. The sector has had the highest rate of growth in Africa and Central and South America, where it has continued to expand and to gain recognition and where it has expanded to almost the same size as the formal sector. Table 9 reports the average size of the informal sector across different regions. It is evident from the table that the average size of the informal sector as a percentage of GDP was in excess of 40% in Africa and Central and South America over the period 1999 to 2003.

TABLE 9: AVERAGE SIZE OF THE INFORMAL SECTOR AS A PERCENTAGE OF GDP

Period	Africa	Central and South America	Asia	Central and Eastern Europe and Former Soviet Union	OECD
1999/2000	41.3%	41.1%	28.5%	38.1%	16.8%
2001/2002	42.3%	42.2%	29.5%	39.1%	16.7%
2002/2003	43.2%	43.4%	30.4%	40.1%	16.3%

Source: Lesser and Leeman (2009)

Table 9 shows the informal sector expanding in all the other regions as well except for the OECD where the sector not only shrunk, but was also much smaller at an average of 16% of the GDP over the period 1999 to 2003. Aryeetey (2009) attributes this expansion to globalization and increased openness of economies whose casualties increasingly find refuge in this sector.

4.1.2. Motivation of the study

ICBT has several short and medium term benefits. It can enhance food security for food deficient countries; it can alleviate poverty and even provide employment. In the long-run however, it is likely to lead to negative economic and developmental effects. ICBT reduces incentive to invest in the formal economy, lowers efficiency of measures put in place to ensure health, safety and environmental protection, erodes government revenues and creates unfair competition against formal trade.

Despite this, there is a dearth of accurate and systematic country specific analyses and or data on ICBT. This makes it difficult to assess more precisely the magnitude of this phenomenon, the motivation behind it and its implications for the domestic, regional and international economy. This study attempts to shed some light on the nature and extent of the largest segment of ICBT in Africa-trade in agricultural commodities, with a view to providing information that could help in the formulation of appropriate macroeconomic policies and strategies to exploit its potential impact.

4.1.3. Trade in agricultural commodities

Given the small industrial base of most African countries coupled with major distortions induced by government policies, the bulk of informal trade across borders is in agricultural and particularly food commodities and products. Trade in agricultural commodities affects the largest number of developing countries because agriculture is the economic sector that provides livelihood to majority of the people in such countries. Producers of agricultural commodities therefore find in the informal channels, an alternative for maximizing their revenues whenever prices are biased against exporters in the formal sector.

Agricultural commodities, especially those produced by small-scale farmers, dominate the ICBT involving countries in the Eastern and Southern African region. In Sub-Saharan Africa, agricultural exports account for about 25-50% of total trade in some 13 countries, more than 51%-75% in some 10 countries, Kenya, Tanzania and Somali included and over 75% of total exports in some 6 countries, Uganda and Sudan included.

Minde and Nakhumwa (1997) estimate that substantial volumes of food commodities are traded between Malawi and her neighbours. Tchale (2001) concurs with Ackello-Ogutu and Echessah (1997), that informal

trade statistics for most agricultural commodities far outweigh the formal trade figures. Uganda Bureau of Statistics (2011) show that agricultural products accounted for over 23% and 35% of total exports and imports respectively.

Informal agricultural export flows have been particularly important between Uganda and her five neighbours, Kenya included. Uganda Bureau of Statistics (2006) estimate that Uganda informally exported to these countries, agricultural products valued at USD 113 million, corresponding to an estimated 75% of official agricultural export flows, or 43% of total agricultural exports to the same countries. The bulk of such informal exports were mainly destined for Kenyan and Congolese markets with the top five exported products being maize, beans, groundnuts and bananas.

Uganda Bureau of Statistics (2011) puts Uganda's informal trade share of exports to Kenya at 31.9% in 2008, 33.75% in 2009 and 24.61% in 2010. For the same period the informal trade share of Uganda's imports from Kenya is estimated at 1.7%, 1.89% and 1.41% respectively.

Lesser and Leeman (2009) report that in ICBT between Kenya, Uganda, Tanzania and Rwanda over the period 2004-2006, maize was the most traded good, accounting for over 68% of all informal flows, followed by beans and rice. Over the same period, Uganda's informal maize exports to Kenya represented almost five times the volume of formal maize export flows, or an average of 83% of the total volume of maize exported from Uganda to Kenya over the same period.

In the Horn of Africa (Sudan, Ethiopia, Eritrea, Djibouti and North Eastern Kenya), Little (2005) notes that for some agricultural commodities such as livestock and grains, unofficial exports to neighbouring countries, did exceed at times, the official trade by a factor of 30 or more, thereby constituting over 95% of total trade in these commodities.

4.1.4. Significance of ICBT in agricultural commodities

Cross-border trade in agricultural commodities has special significance in many African countries for three reasons. First, it is linked with domestic trading with major implications for rural development. Second, food crops are often involved, with major implications for national and regional food security. Finally, small-scale farmers are involved either directly in marketing and/or sales as suppliers of produce with significant implications for livelihoods.

4.2. Nature of Informal Cross Border Trade in Kenya

4.2.1. Participants in informal cross border trade

Kenya shares territorial boundaries with a number of countries, all of which are her trade partners both formally and informally. These include Uganda, Tanzania, Sudan, Ethiopia, and Somalia. Due to shared cross-border trade characteristics, and for ease of analysis, Sudan, Ethiopia and Somali are grouped together in their ICBT with Kenya, under the Horn of Africa.

Most participants in ICBT are individual traders, a large proportion of which are women and micro, small and medium sized enterprises. They include locals, migrants and even refugees particularly from Ethiopia, Somali and Sudan a number of who are based in Kakuma and other refugee camps close to their countries of origin. The migrants and the refugees tend to carry out trade between Kenya and their home countries by taking advantage of their knowledge of local customs, products and networks.

A number of such traders are not registered at all, and therefore operate entirely outside the formal economy. Others are registered in Kenya but avoid trade regulations and duties either fully or partially. This is actualized in two ways. In the first instance traders simply avoid the official border posts and use unofficial routes, locally referred to as 'panya routes'. This is the preferred option of small scale, small volume traders. This is made easy by the porous nature of Kenya's borders. The other option which is preferred by large volume traders is to pass through the posts but resort to such illegal practices as under-invoicing, misclassification of goods or even mis-declaration of country of origin, with a view to paying lower tariffs, of course with the connivance of the customs officials.

On the whole, ICBT transactions across the Kenya/Uganda and Kenya/Tanzania borders involve buyers, sellers, brokers and middlemen, transporters, loaders, couriers, store owners, security personnel, money changers, informal money lenders. A significant number of these roles are performed by women and the youth. In the Kenya/Uganda border, People with Disability (PWD) play an important transportation role using their wheel chairs.

ICBT in the northern frontier is based on long distance movement of livestock and other agricultural commodities across vast, hostile territory and so is largely the preserve of men. Trade here involves an intricate network of traders, financiers and transporters. Mahmoud (2003) estimates that more than 20 actors are involved in any one transaction along the approximately 800km route from Southern Ethiopia to Nairobi. Market participants include herders, brokers, middlemen, trekkers, loaders, truckers, security personnel, veterinary officers, money lenders, wholesale traders, hay merchants among many others.

4.2.2. Types of agricultural commodities traded

Goods traded informally across Kenya's borders originate from Kenya or even from the neighbouring countries such as bananas from Uganda, beans from Tanzania and livestock from Somalia and Ethiopia. Such goods are sourced from both formal and informal sectors.

The types of goods traded vary from one border post to another. They include both small volumes transported by individuals crossing the border carrying goods on their head, backs or hand, walking on foot, pushing a cart or wheelbarrow, or riding a bicycle or motorcycle or a wheelchair as well as large volumes transported in trucks and containers by land, in dhows, canoes and steamship across lake Victoria to Uganda and Tanzania, in container ships across the Indian Ocean to Tanzania, Somali and far away destinations or by air. Surveys indicate that the largest share of informally traded goods is traded in small volumes.

A number of cross-border monitoring survey initiatives have been mounted by various institutions over the years, notably Uganda Bureau of Statistics (2006, 2007, 2008); The Regional Agricultural Trade Intelligence Network (2007); The Famine Early Warning Systems Network (2007), Ackello-Ogutu and Echessah (1997, 1998) among many others, to monitor informal trade between Kenya and her neighbours by observing different border points. The findings are unanimous that a substantial proportion of cross-border trade in Kenya is in staple food commodities, including maize, rice and beans.

The surveys show that maize is the most traded good, accounting for 68% of all informal flows. The volumes informally traded at times exceed many times over, the volumes formally traded. It's followed by beans and then rice (Lesser and Leeman, 2009). In the period 2004-2006, instance, informal maize imports from Uganda was valued at USD 73 million. Over the same period, formal imports of maize from

Uganda to Kenya were valued at USD 16.5 million. More specifically, in 2004, 92% of the total maize imports from Uganda were traded informally. In 2005, this figure was 81% and in 2006, it was 78%.

Quite a number of agricultural commodities traded informally between Kenya and her neighbours are actually re-exports, i.e. imports that are exported by Kenya or her neighbours without any value addition. They include vegetable products, tea, coffee, sugar, non-alcoholic beverages, tobacco, and agricultural raw materials like cotton, bananas, and groundnuts among others.

4.2.2.1. KENYA'S INFORMAL TRADE WITH TANZANIA

Kenya's informal imports from Tanzania are mainly agricultural food commodities. Maize is the leading import item followed by beans, and rice in that order. Other imports include yams, carrots, tomatoes, cassava, cabbages, cow peas, sugar, rice, bananas, millet, maize meal and groundnuts. Kenya's agricultural food exports to Tanzania include wheat flour, bread, root crops, sugar, rice, bananas, maize meal, milk and coffee. Most of the agricultural commodities traded are largely influenced by the food items grown around the border and the neighbouring districts. Trade in most of these items is caused by low cost prices in countries of origin and high profit margins in the neighbouring countries.

4.2.2.2. KENYA'S INFORMAL TRADE WITH UGANDA

Uganda is Kenya's largest trading partner in the region. ICBT between the countries therefore involve an exchange of substantial quantities of agricultural commodities. Over the period 1994-1995 for instance, Ackello-Ogutu (1997), estimates the total annual value of informal trade between the two countries at USD 146 million, compared to the total annual value of formal imports, which stood at USD 96 million over the same period. This suggests that the volume of trade between the two countries is grossly under estimated in official documents.

The items of trade are more or less the same as those between Kenya and Tanzania. Maize is a key import item from Uganda. Others include beans, sorghum, simsim, choroko, millet, groundnuts, rice, cassava, yams. Leading informal exports to Uganda include wheat flour, bread, milk, maize flour, confectionaries, and sugar.

4.2.2.3. KENYA'S INFORMAL TRADE WITH THE HORN OF AFRICA

Sudan, Ethiopia, Eritrea, Djibouti and Somalia are important informal trading partners to Kenya. Trade with this group of countries is unique because they border the northern frontier, a vast, hostile and insecure part of Kenya, which is also home to the largest refugee camp in the country. Given the political instability and incessant conflicts in countries in the Horn, the border posts along this frontier are quite porous and, the bulk of refugees hosted in the said camps are therefore mainly citizens of the same countries. A natural offshoot of this is a thriving ICBT involving livestock, foodstuffs, and other agricultural commodities.

Cross-border trade in livestock is the most significant form of trade in this region. Dalleo (1975) observes that this practice pre-dates colonial period. As a commodity, livestock has features that make it particularly amenable to ICBT even in the poor security conditions typical of northern frontier. It is a living and mobile commodity that can be transported overland rather than on roads, and can easily be moved across borders. A high proportion of trade in livestock is therefore done informally, unlike trade in other products which can be trucked across borders.

Little (2007), contends that 95% of the trade in livestock is actually informal. The usual practice is to move livestock across the borders on foot. For every 100 cattle moved on foot, there are normally three trekkers and an armed security person. In most cases, trade is done through middlemen and brokers, who identify potential buyers and sellers.

ICBT in livestock in the Horn has another important dimension. In most cases it complements and even finances cross border trade in grains and other food products. This has been widely documented along almost all the ICBT routes in the region including; Southern Sudan/Northern Kenya (Gurele and Lautze, 2000), Southern Ethiopia/Northern Kenya (Teka et al 1999; Mahmoud, 2003) and Southern Somali/Northern Kenya (Little, 2000; 2006).

A common practice for many livestock traders is that once they sell their animals, they use the proceeds to purchase grains and other food products to bring back across the border to sell in the deficit areas. Other popular products in this region include pasta, biscuits, and food aid. In many cases they backhaul their purchases using the same trucks. Umar (2007) estimates that about 25% of livestock traders in Kenya/Ethiopia/Somali ICBT are involved in the sale of staple foods, most of which are informally imported from Somali and purchased from the revenues from livestock trade.

4.2.3. Financing ICBT in Kenya

Participants in ICBT rely on a range of informal institutions to set up and support their businesses. In the Kenya/Uganda border, Ackello-Ogutu (1997), estimates that only 4% of traders have access to formal sources of finance. In the Horn, less than 10% of traders have access to such sources. According to little (2007), more than 95% of credit used in ICBT in the Horn is obtained informally from kinsmen, friends and associates.

In Kenya/Uganda ICBT, 32% of traders obtain start-up capital from relatives, friends and kinsmen, 53% from personal savings and 11% from savings societies (Ackello-Ogutu, 1997). A popular source of short term funding in Kenya/Uganda ICBT are the informal money changers, who also double up as money lenders. They advance loans with a maturity of one day, at interest rates that are above 10% per day.

In Kenya/Tanzania ICBT, Ackello-Ogutu (1998) estimate that only about 5% of traders have access to formal sources of finance. The rest obtain their start up or even business expansion capital from informal sources. 69.5% of traders obtain finance from personal savings, 21% from Savings and Credit Societies, 21.1% from friends, relatives and kinsmen and 2.1% obtain supplier credits.

Informal financing of ICBT in the Horn is particularly critical, because it is about the only option available to traders. In the Kenya/Somalia and Kenya Ethiopia borders in particular, informal financing arrangements help minimize the risks associated with carrying large sums of money in an unstable environment. The usual practice is for the traders to convert their earnings into dollars in informal money house in Nairobi, then 'wire' back the money to informal money houses situated at the border, where upon the money is picked up by their business associates. The informal money houses charge a commission of 3%-6% to wire the money to different locations, as opposed to 10%-12% charged by formal financial institutions (Little, 2007). This is the '*Hawala System*'. In some cases, traders convert all, or part of their earnings into tradable goods which are then picked by a designated wholesaler at the border.

Mahmoud (2003) records a practice where a trader who sells animals in Nairobi, transfers their cash earnings to a designated wholesaler at the border. The wholesaler uses the same to purchase commodities

in Nairobi which are then hauled back to the border. The wholesaler instructs a business associate at the border to repay the livestock trader or his associate. The associate receives the money then re-initiates the process of procuring livestock movement back to Nairobi. This informal practice then allows both traders to conduct business without having to transfer cash across vast, insecure territory.

4.2.4. Market information in ICBT

Effective flow of information is critical to any market system. ICBT buying participants need to know the variety and quality of goods available in the market, where they are and what price they command. The sellers too need to know what is in demand and at what price. In a sense an effective market mechanism is dependent on how well informed the market participants are. An important part of the structure of informal markets is therefore their sources of market information.

In Kenya/Uganda ICBT, Ackello-Ogutu (1997), reports that 70% of market participants obtained market information by word of mouth, through friends, relatives and business colleagues, 18% obtained information from market signals, 4% from the media and 7% from other sources. UBOS (2008) report that 51% of traders accessed market information mainly through friends, relatives and neighbours, 48% visited the markets physically with another 48% accessing information through their contacts with fellow business colleagues and associates. Other sources of such information include middlemen and brokers. In Kenya/Tanzania ICBT, Ackello-Ogutu (1998) reports that 65.8% of the traders obtained market information from inter-personal communication, 14.1% through market signals, 11.8% obtained information through orders from buyers, 7.2% from the media, and 1.2% from market visits.

Kenya's informal trans-border trade with countries along the Northern frontier is largely based on traders, brokers, middlemen and financiers all of whom work together in tightly woven and intricate networks bound together by common kinship, religion and/or ethnicity. Market information is to a great extent obtained only informally through word of mouth, and the flow of information is largely dependent on brokers and middlemen and their social networks. In Kenya/Somali border for instance actors on either sides of the border are from the same ethnic group. More often, they draw on a common language and identity to pass on market information and facilitate transactions. This reduces substantially the cost of monitoring and enforcement.

Conflicts are regular happenings in this region. In such times, these networks assume even more significance. Flow of market information is curtailed, as actors turn inwards to transact only with those they trust, know well or can converse with in a common language. This can have devastating consequences for the market, as some groups are excluded from participating in the market. Little (2003) and Green et al (2006), document the emergence of specific clan-controlled market networks in Southern Somali/Northern Kenya border, and ethnic-based markets in Marsabit town in Kenya.

4.3. Incentive for Informal Cross Border Trade

Several factors have conspired to promote informal trade between Kenya and her neighbours. Key among them is the significant disparities between formally and informally traded goods in the region, owing to generally high levels of import and export duties on selected commodities. Levin and Widell (2007) contend that the extent of informal trade is directly correlated with the average applied tax rate (e.g. tariffs and VAT) in the importing country. They estimate that in 2004 for instance, a 1% point increase in

the overall tax rate imposed on imported goods from Kenya, led to a 3.8% increase in tax evasion on those goods.

Another key incentive to informal trade is the existence all around the countries, particularly at the border points, of communities that transcend borders. Such communities share a lot in common both culturally and socially. They speak the same or similar language, inter-marry and own land on either side of the border. This constitutes particularly strong social networks that lead to cross border trade because they have long standing knowledge of customs, products and networks of each other. Examples include the Somalis on either side of Kenya/Somali border at Mandera and Moyale, the Luos on either side of Kenya/Tanzania border at Sirari, the Banyala and Basamia on either side of Kenya/Uganda border at Busia, the Saboat on either side of Kenya/Uganda border at Malaba, the Maasai on either side of the Kenya/Tanzania border at Namanga and Loitokitok, among many others.

Long standing wars and conflicts in the neighbouring Sudan and Somalia and earlier on Uganda, ensured that citizens of these countries living near the borders relied more on Kenya than on their own countries for supplies. This provides/d an incentive for people from either side of the divide to secure goods from where they are available and sell to areas of deficit. This encouraged a steady stream of back and forth flow of goods and services.

Informal trade is not illegal in entirety. But corruption that thrives at the border points has ensured that such illegal aspects as under invoicing or misspecification of ports of origin continue. There seems too to be some aspect of tolerance of informal trade activities by the government. At the Busia border point for instance, People with Disability (PWD) cross the border with abandon on wheelchairs that are openly stuffed with goods (Uganda Bureau of Statistics, 2009).

Poor road infrastructure which hinders access to some domestic markets, has led traders, particularly farmers to take their produce to external markets that are within reach. This has been particularly observed along the Kenya/Tanzania border at Tarakea and Holili.

ICBT is a major source of livelihood for communities living near the borders. These people therefore engage to earn an income with which to support oneself and family. Another incentive is the allure of lucrative markets in neghbouring countries which lead to high profit margins for traders. The informal trade between Kenya and Uganda for instance is sustained because the relative prices are higher in Kenya. This provides traders with the incentive to cross over with their goods. These activities are aided by the relative ease of convertibility between the regional currencies, especially through the informal foreign exchange markets that thrive at the border posts.

Kenya, like the rest of East Africa, has long and cumbersome customs procedures that lead to delays in clearing goods. On average, such delays can last anywhere between 30 and 40 days, thereby occasioning huge losses on traders. This coupled with complex regulatory requirements that are in most cases, unclear or even unknown to traders act to compel many traders to engage in unrecorded trade.

Differing ecological conditions in the neighbouring countries do also act to create opportunities for trade in agricultural commodities. Uganda for instance is blessed with relatively good soils and climatic conditions than her neighbours. This explains the massive flow of agricultural commodities from Uganda. Closely associated with this is the differing seasonal pattern of crop production between Kenya and her neighbours. Uganda for instance, has two harvesting seasons while Kenya has one.

The landlocked nature of some neighbouring countries such as Uganda and Sudan, seasonal climatic conditions such as drought, episodes of pests and disease outbreaks leading to crop failure and one-off policy interventions such as the 2011 ban on maize exports to Kenya by Tanzania all act to promote ICBT.

4.3.1. Measuring the informal incentive

The decision by a trader to participate in either the formal or informal trade channel is determined by several factors but the bottom line is the expected returns from either channels. Dongala (2007) calls this the 'informal incentive'. The 'informal incentive' so defined therefore accrues from avoiding taxes and fees from international trade. It also accrues from using free or black market foreign exchange.

Following on McDonald (1985), the 'informal incentive' can be estimated by deriving the incentive to export and the incentive to import of a country.

The incentive to import can be defined as:

$$I_x = \frac{\mathbf{e}}{\mathbf{s}(\mathbf{1} - \mathbf{t_x})} \quad \text{---} \ (1)$$

Where I_x is the incentive to informally export, e is the free or black market rate in foreign exchange, *s* is the effective official exchange rate and t_x the export tax rate.

The incentive to import on the other hand can be defined as;

$$I_m = \frac{s(1 - t_m)}{e} \quad \text{---} \ (2)$$

Where e and *s* have the same meaning as in equation (1) and t_m is the import tax. A positive value for I_x or I_m indicates that it is profitable to trade in informal markets.

Using aggregated WDI and GDF online databases, we estimated the informal incentive to trade (import and export) for selected Eastern African countries. Due to lack of suitable data the black market foreign exchange rate was estimated by assuming that it is lower than the official exchange rate reported for a particular period by 5 per cent.

The WDI/GDF database gives taxes on exports for a particular year and taxes on international trade. For purposes of this study, we assumed that taxes on international trade comprise taxes on exports and taxes on imports only, hence taxes on imports is calculated as the excess of international trade on taxes on exports. The import tax and export tax is therefore estimated as the ratio of taxes on imports and those on exports as a proportion of taxes on international trade. The results are reported in Tables 10 and 11.

Table 10 reports the informal incentive to import for Burundi, Kenya, Uganda, Rwanda, Ethiopia and Sudan for the period 1990 to 2009 while Table 11 reports the informal incentive to export.

Both tables show that the incentives to informal import and export exist in all the investigated countries.

TABLE 10: INFORMAL IMPORT INCENTIVE, 1990-2009

	N	Mean	Min	Max	Var	Std
Burundi	9	0.1997	0.0021	0.5248	0.0284	0.1683
Kenya	5	0.0007	0.0002	0.0022	0.0000	0.0009
Uganda	7	0.0067	0.0027	0.0117	0.0000	0.0030
Rwanda	3	0.1866	0.1408	0.2667	0.0048	0.0696
Ethiopia	13	0.0634	0.0003	0.1424	0.0019	0.0436
Sudan	2	0.0396	0.0221	0.0570	0.0006	0.0246

Source: Calculated from WDI and GDF online database, *World Bank*.

Burundi, Rwanda, Ethiopia and Sudan are shown to have the highest informal trade incentives as shown by the maximum informal import incentives. Kenya is reported to have the lowest incentive to import. It is also evident from the two tables that the amplitude of standard deviation coincides with the informal incentives for imports; hence countries with high incentives to informally import also have high standard deviations in that order. This suggests that there exists a relationship between macroeconomic instability and the expansion of informal activities. Macroeconomic instability is, in this case, reflected in the exchange rate overvaluation relative to free market rates.

TABLE 11: INFORMAL EXPORT INCENTIVE, 1990-2009

	N	Mean	Min	Max	Var	Std
Burundi	9	0.7698	0.4763	0.9481	0.0231	0.1519
Kenya	5	0.9494	0.9480	0.9498	0.0000	0.0008
Uganda	7	0.9440	0.9395	0.9476	0.0000	0.0027
Rwanda	3	0.7816	0.7093	0.8230	0.0039	0.0627
Ethiopia	13	0.8928	0.8215	0.9497	0.0015	0.0393
Sudan	2	0.9143	0.8986	0.9300	0.0005	0.0222

Source: Calculated from WDI and GDF online database, *World Bank*.

The incentive to informally export is particularly high for all the countries investigated. Kenya is shown to have the highest incentive to export informally at 0.9440 and Burundi the lowest at 0.7698; a reversal of positions with respect to incentive to informally import. This implies that compared to formal export markets, for Kenya, informal trade reaps 94.94% differential gain in informal markets, for Uganda 94.40%, for Sudan 91.43% and for Ethiopia, 89.28%.

4.4. Conclusion

The average share of informal sector trade in Africa is estimated at 43% of the official GDP (Lesser and Leeman, 2009). This makes the sector almost equivalent to the formal sector. Its existence is therefore a source of serious policy dilemma, as countries grapple with what to do with it. Opinion is divided on whether the informal sector should be streamlined into the formal sector or whether it should be facilitated to play a complementary role.

In Kenya's national trade policy (Republic of Kenya, 2009) for example, the overall policy for the informal sub-sector is to focus on mainstreaming informal trade into the overall economy by focusing on its growth and graduation into formal trade status through the provision of business development services. The overall policy framework is however, silent on ICBT.

The Republic of Uganda (2008) recognizes the contribution of ICBT to the overall growth of the economy and recommends that the sector benefits from initiatives like provision of infrastructure, access to easy credit, development of business and marketing skills, and harmonization of trading policies across neighbouring countries, among other measures. A number of authors have also suggested putting in place appropriate trade facilitating measures such as reduction of trade transaction costs arising from import-export trade procedures with a view to curtailing informal trade (Lesser and Leeman, 2009).

Member countries of WTO launched negotiations on Trade Facilitation in July 2004 (the 'July Package') under which members were required to give proposals on how to improve the existing GATT Article V (Freedom of Transit), Article VIII (Fees and Formalities Connected with Importation and Exportation) and Article X (Publication and Administration of Trade Regulations). The latter two Articles addressed themselves largely to the requisite trade facilitation measures aimed at curbing ICBT.

Key proposals under these Articles can be grouped into three broad categories. The first category relates to simplified and reduced documentation requirements and formalities for importation/exportation including, among others: transparent and lower fees and charges, simplified and expedited release and clearance of goods from customs, border agency co-operation, automated customs management systems and enhanced transparency and predictability of trade-related laws and regulations.

The second category relates to instituting a simplified trade regime for low value transactions - the motivation here being to encourage small traders to formalize low-value cross border transactions, thereby reducing the incidence of informal trade.

The third and final category relates to a raft of measures intended to complement the first two categories, including: helping traders to understand and comply with existing trade related regulations, provision of adequate support services formal importing/exporting, awareness creation regarding the benefits of formalization, improved interaction between border agencies and the private sector, and enhancing integrity of customs administration.

This disharmony is the result of, one: the limited appreciation of the contribution of ICBT to the economy owing to its very nature and, two: the misconception that formal and informal trade are two very different trade practices that can be dealt with by different sets of policy measures. Our position is that the two are so intricately intertwined, that it is very difficult to distinguish between what is formal and what is informal. Evidence of this interconnectedness arises whenever policies directed at formal market channels start to affect informal channels and vice-versa.

This is evidenced by, among other factors, the fact that maize that is informally sourced from trans-border markets may eventually be sold through a licensed retail outlet or find its way to a licensed miller's factory, from where it may be processed, packaged and exported formally. Similarly, livestock that is trekked informally will be sold to Kenyan traders from the Northern frontiers, who will transport and sell the same to a state corporation, the Kenya Meat Commission (KMC), which will proceed to process, package and formally export some of its products, and release the rest to the formal economy for domestic consumption. In this process, livestock will be officially taxed at the various markets it passes

through, thereby generating a significant amount of taxes, licenses and permit revenues for the formal sector, as well as unofficial payments in the form of bribes to government personnel and offices.

All in all, we suggest that formal and informal trade be viewed as complementary activities, taking into consideration the fact that it is almost impossible to eliminate the latter. In fact in some border points, informal trade is the only trade option available. Efforts must therefore be made to conceive policy suggestions that would optimize both forms of trade from the viewpoint of the national economy.

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Chapter 5: Non-Tariff Measures in Kenya: A Case Study

Dr. Tabitha Kiriti-Nganga

5. Introduction

The term non-tariff measures (NTMs) is defined to include export restraints and production and export subsidies, or measures with similar effect, not just import restraints. This is the term most widely used in GATT and UNCTAD, although textbooks generally prefer the terms barriers or distortions. Perhaps the most theoretically satisfying definition is that of Baldwin (1970), who defines non tariff distortion as any measure (public or private) that causes internationally traded goods and services, or resources devoted to the production of these goods and services, to be allocated in such a way as to reduce potential real world income.

According to UNCTAD (2010) NTMs are policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing quantities traded or their prices or both. As import tariffs have been reduced worldwide and locked in under the twin pressures of multilateral rounds and preferential agreements, NTMs have risen in prominence and have become a source of concern. Streamlining cost-raising NTMs is now recognized in many countries as a key component of national competitiveness agendas. While many of those NTMs such as product standards or labelling requirements are imposed for legitimate purposes, such as protecting public health or the environment, they can become an obstacle for firms.

When poorly designed and adopted with little consultation with the private sector, NTMs hurt competitiveness by constraining the ability of companies to outsource key inputs, putting them at a competitive disadvantage on international markets. NTMs also often complicate day-to-day business and distract managerial attention. Firm surveys highlight private-sector demands for more transparency in the adoption and application of NTMs across countries.

Transparency starts with clear and shared knowledge of what measures are in place. Yet, there is currently little visibility on their use worldwide, and most studies still rely on TRAINS' obsolete and fragmented data. Part of the reason for this lack of visibility is that collecting data on NTMs is a difficult endeavour.

Article 49 of the COMESA Treaty states that:

Except as may be provided for or permitted by the treaty, each of the member states undertakes to remove immediately upon the entry into force of this treaty, all the then existing non tariff barriers to the import into that member state of goods originating in the other member states and thereafter refrain from imposing any further restrictions or prohibitions.

Article 75 of the EAC Treaty specifies that:

…except as may be provided for or permitted by the treaty, the partner states agree to remove all the existing non-tariff barriers on the import into their territory of goods originating from the other partner states and thereafter refrain from imposing any further non tariff barriers.

In Kenya many internal processes by trade facilitation agencies have been reported to be inefficient, adding to cost of doing business and eroding Kenyan firms competitiveness in the domestic, regional and international markets. The regulations, processes, procedures and operations of the trade regulatory agencies sometimes act as trade hindrance to domestic and intra-EAC trade. There are challenges because of many duplicative roles played by these agencies, all of which add to the cost of doing business and restrict the expansion of the domestic trade as well as EAC intra-trade.

The objectives of this paper are to:

- Classify NTMs according to the UNCTADs new classification method;
- Document the NTMs in Kenya;
- Use the survey method to analyse how these NTMs restrain trade; and
- Recommend policies that will lead to better-informed policy and foster dialogue on harmonization, streamlining, and reform, both at national and regional levels.

5.1. New NTM Classification

There are a wide variety of NTMs. UNCTAD (1994) uses a classification of over 100 trade measures, including tariffs with a discretionary or variable component. The old UNCTAD NTMs classification had six core categories according to the nature of the measure: (a) price control measures; (b) finance measures; (c) automatic licensing measures; (d) quantity control measures; (e) monopolistic measure; and (f) technical measures (Figure 5). These were further subcategorized in accordance with the types of measures under consideration. Measures were listed in accordance to the Harmonized Coding classification. In general, only "sensitive product categories" and "technical regulations" were further subcategorized according to the objectives of the measure (for example, protection of safety, human health, animal health and life, plant health, environment and wildlife). NTMs classification was divided into *Core-Measures* and *Non- Core Measures*, where core measures included measures intended to protect local producers; and non-core measures included measures intended to protect local consumers.

The new classification of NTMs follows a hierarchical "tree" structure where NTMs are differentiated according to 16 "branches" or chapters denoted by alphabetical letters (see Figure 5), each comprising "sub-branches" (1-digit), "twigs" (2- digits) and "leafs" (3 digits). This classification drew upon the existing, but outdated, UNCTAD Coding System of Trade Control Measures (TCMCS) classification on NTMs, and has been modified and expanded by adding various categories of measures to reflect the current trading conditions.

The updated classification includes a substantial number of new sub-categories on sanitary and phyto-sanitary (SPS) measures and technical barriers to trade (TBT), and introduced a few new categories of NTMs such as “export measures”, “trade-related investment measures”, “distribution restrictions”, “restrictions on post-sales services”, “subsidies”, “measures related to intellectual property rights” and “rules of origin”. The classification also introduces the concept of “procedural obstacles”, which refers to issues related to the process of application of an NTM, rather than the measure itself (collected through survey data).

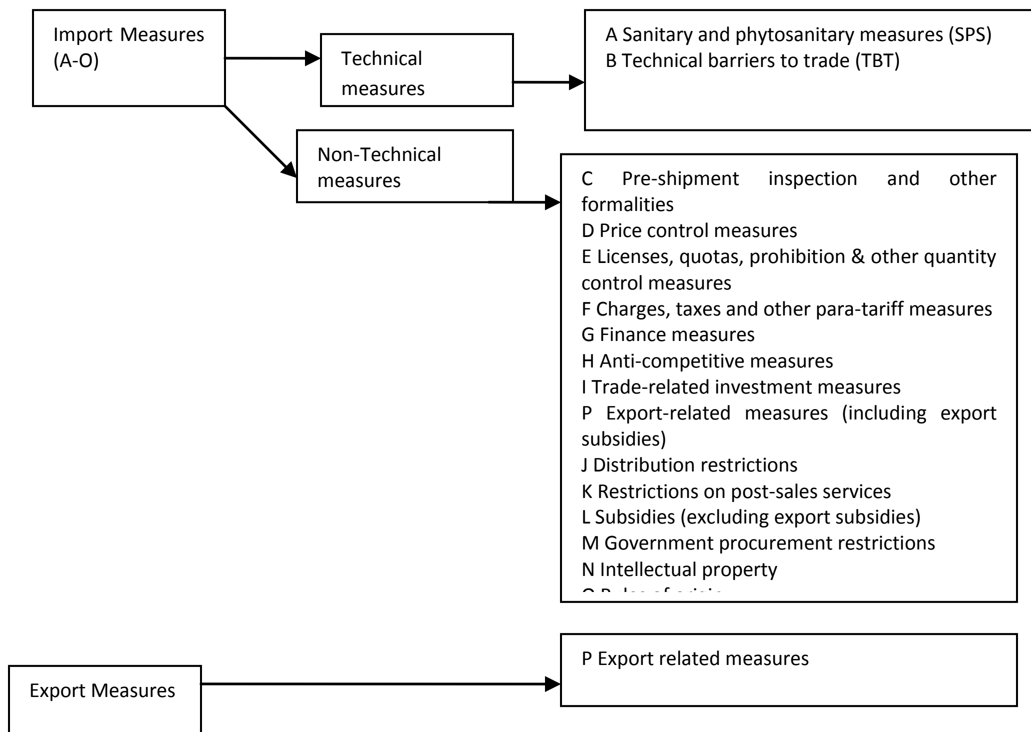

FIGURE 5: NEW CLASSIFICATION OF NTMS

To gather information on NTMs in Kenya various documents were reviewed and Table 12 shows this information.

TABLE 12: RULES AND REGULATIONS, THEIR SOURCES AND AGENCIES THAT CAN BE CLASSIFIED AS NTMS

RULES AND REGULATIONS	NTM SOURCE	MINISTRY/ DEPARTMENT/ AGENCY
Certificate of origin	East African Customs Union Protocol 2007	Kenya Revenue Authority, Kenya Bureau of Standards, Ministry of Finance
Prohibition of trade practices to repress competition	Restrictive trade practices, monopolies and price control act (cap 504)	Ministry of Finance
Plant import permit (PIPs) Phytosanitary certificate requirements	Plant Protection Act (cap 324), Agricultural Produce Act (Export Import – Cap 319 and Cap 320)	KEPHIS/KEBS Ministry of Agriculture
Fish Movement Permit	Fisheries Act (cap 378)	Ministry of Fisheries
Ban on Beef and Beef Products from Uganda and USA	Food Safety Department of Veterinary Services (DVS),	
Vehicle importation Age limit Left hand drive vehicles Road Worthiness	KS 1515:2000 quality standard Traffic Act Cap 403	Kenya Bureau of Standards Ministry of Transport
Intellectual Property Rights	The Industrial Property Act Cap. 509	Kenya Industrial Property Institute, Ministry of Trade
Anti Piracy Security Device	Copyright Act 2003	State Law Office

Metrology	Trade descriptions Act 2004	Department of Weights and Measures, Ministry of Trade
Trademark and brand registration	Trademarks Act Cap. 506	Ministry of Trade
Import Permits on meat, dairy, poultry and their products	Dairy Industry Act Cap. 336, Meat Control Act Cap. 356, Animal diseases Act Cap. 364,	Kenya Dairy Board, KEBS, DVS, Kenya Port Authority Health officials
Import ban on Ugandan day old chicks	Animal diseases Act Cap. 364	DVS, Ministry of Livestock Development, Ministry of Agriculture
Varying Inspection Requirements and Testing	Public Health Act Cap.242, Radiation Protection Act Cap.243 (In the case of irradiated foods) Food, Drugs and Chemical Substances Act Cap. 254	Ministry of Health, Ministry of Health, KEBS
Pesticide contaminant regulations	Pest Control and Products Act Cap. 346	PCPB, Ministry of Agriculture, KEBS, KEPHIS
Seed certification	Seed and Plant Varieties Act (Cap 326) Bio-safety Act 2009	KEPHIS, Ministry of Agriculture
Orange certificate of the international Seed Testing Association	Plant Protection Act (Cap 324)	KEPHIS, Ministry of Agriculture
Food additives regulations	Food, Drugs and Chemical Substances Act Cap. 254, http://www.kenyalaw.org/kenyalaw/klr_home/ KS 660 (Guidelines to the safe use of food additives)	Ministry of Health, KEBS
Import Standardization Mark (ISM)	Standards Act Cap 496 Section 10, Certificate of Conformity	KEBS, Ministry of Industrialization
Best before date regulation	Food, Drugs and Chemical Substances Act Cap. 254,	KEBS, Ministry of Industrialization
Medicine Import Permits and certificate of registration	Kenya National Drug Policy of 2006, Pharmacy and Poisons Act, Cap 244, The Industrial Property Act Cap. 509	Ministry of Health, Ministry of Trade
Import permits Certificate of Analysis of GMOs	Bio-safety Act 2009	KEPHIS, Ministry of Agriculture
Import License	The Customs and Excise Act Cap 472	Ministry of Trade, Kenya Revenue Authority
Axle load specifications	Legal Notice No. 118 of the Traffic Act Cap 403	Ministry of Transport
Weighbridges	Traffic Act Cap 403	Ministry of Transport Ministry of Road Kenya Revenue Authority
Gross Vehicle Mass	Traffic Act Cap 403	Ministry of Transport Ministry of Road Kenya Revenue Authority
Transit Licenses/bonds/fees for	Traffic Act Cap 403	Kenya Ports Authority, Kenya

goods		Revenue Authority, Ministry of Transport
Police road blocks	Traffic Act Cap 403	Ministry of Transport Ministry of Internal Security,
Truck entrance fees and short grace periods	Traffic Act Cap 403	Kenya Ports Authority, Kenya Revenue Authority, Ministry of Transport
Permits for refuelling	Immigration Act Cap 172	Kenya Revenue Authority, Ministry of Finance
Multiple police road blocks and mobile control along the transit routes	Traffic Act Cap 403	Ministry of Transport Ministry of Internal Security
Horticulture Export Permit	Horticulture Produce Export Act Cap 319	Horticultural Crops Development Authority (HCDA)
Horticulture Phytosanitary Certificate for exports	Horticulture Produce Export Act Cap 319	KEPHIS, HCDA
Horticulture Certificate of Conformity to traceability of produce, hygiene, Maximum Residual Levels, good agricultural practices and proper post harvest handling procedures	Pest Control and Products Act Cap. 346, Food, Drugs and Chemical Substances Act Cap. 254, http://www.kenyalaw.org/kenyalaw/klr_home/ KS 660 (Guidelines to the safe use of food additives)	Ministry of Agriculture, HCDA, PCPB, KEBS, KEPHIS, Ministry of Health
Export permit for mineral based products	Mining Act Cap 306	Commissioner of Mines and Geology
Administrative complexity of formalities in release and clearance of goods	The Customs and Excise Act Cap 472 Kenya Ports Authority Act, Cap 391	Kenya Ports Authority, Ministry of Roads, Ministry of Transport, Kenya Revenue Authority
Work permits	Immigration Act Cap 172	Ministry of Immigration and Registration of Persons, Ministry of Labour
Port charges	The Customs and Excise Act Cap 472 Kenya Ports Authority Act, Cap 391	Kenya Revenue Authority Kenya Port Authority
Labelling requirements	Food Drugs and Substance Act Cap 254, Pharmacy and Poisons Act Cap 244, Standards Act Cap 496	KEBS, Ministry of Health, KEBS
Translation of documents	The Registration of Documents Act Cap 285	Ministry of Education (Commission for Higher Education), KRA, Ministry of Finance, Ministry of Trade,
Preference given to Kenyans in the tendering process up to Ksh. 50 million in respect of goods or services and up to Ksh.200 million for works	Public Procurements and Disposal Act 2005	Ministry of Finance

5.2. Survey Data Collection

To achieve the third objective, data was collected from official documents and interviews with public officials and private agencies and representatives to indicate why these rules and regulations could be considered as NTMs. This was through perception based firm level survey for exporters/importers and truckers on what they think are the rules and regulations that they consider as NTMs that could be hindering the free flow of trade in Kenya. A questionnaire was administered on the interviewees.

The public and private agencies interviewed were as shown in Table 13.

TABLE 13: PUBLIC AND PRIVATE AGENCIES INTERVIEWED

No.	Public Agencies	Private Agencies
1	Ministry of Finance	Kenya Association of Manufacturers (KAM)
2	National Environment Management Authority	Kenya Private Sector Alliance
3	Kenya Bureau of Standards	Vehicle Importers (big and small)
4	Kenya Plant Health Inspectorate Services (KEPHIS)	Truck drivers
5	Ministry of Fisheries Development	Clearing agents
6	Ministry of Internal Security	Fish exporters
7	Ministry of Public Health and Sanitation	Flower exporters
8	Ministry of Immigration and Registration of Persons	Safaricom
9	Pharmacy and Poisons Board	Airtel
10	Kenya Investment Authority	Oil importers (Kobil)
11	Department of Veterinary Services	Textile manufacturers (EPZs) Mombasa road/Kitengela
12	Ministry of Industrialisation	Supermarkets/Nakumatt/Tuskeys
13	East African Community	Kenya Meat Commission (Athi River)
14	Ministry of Trade (Department of External Trade)	
15	Kenya Revenue Authority	
16	Public Procurement Authority	
17	Kenya National Highway Authority	
18	Export Promotion Council	

5.3. Analysis of Findings

5.3.1. Public agencies

The public agencies are mainly in coordinating of the various activities that fall under their mandate. Over 65 per cent of the public agencies interviewed said that the regulatory authorities had not harmonized test certificates and procedures because different regulatory authorities are responsible for different procedures. According to them, there were no arbitrary documentation requirements when the certificate of conformity had been obtained. The agencies contended that the documentation required for the various imported products is clarified in various websites. They also denied the claim that there were non-official payments to police and customs officials.

Slightly over 50 per cent of those public agencies interviewed agreed that the aim of the rigorous regulations enforced by customs officials was mainly for revenue generation while over 70 per cent said

that the pre-shipment verification of conformity (PVOC) program was not a hindrance to trade. All public agencies interviewed were in agreement that the pre-shipment verification of conformity facilitates trade by ensuring that all products which meet the quality requirements are cleared first. They also said that the PVOC program is aimed at protecting domestic industry/production.

For them, the restrictions on imports of certain food products such as ultra-high temperature (UHT) milk, poultry, beef and beef products from certain countries is not aimed at protecting the local industries but can be interpreted as a trade barrier.

Approximately, 70 per cent of those interviewed contended that there were discriminatory applications of SPS measures such as bans issued on certain products from some countries and not others. For example, the imposition of private standards on horticultural products is discriminatory. 80 per cent of those public agencies interviewed said that the arbitrary documentation requirements, high transit fees, road blocks, axle-load requirements gross vehicle mass, weighbridges and so on are as a result of both multiple overlapping laws and structures and the need to raise revenue.

About 60 per cent of those interviewed said that the delays in clearance of goods at customs are not as a result of customs departments' staff having poor understanding of the rules of origin but rather due to lack of institutional capacity such as ICT infrastructure and insufficient human resources. However, 70 per cent of the public agencies interviewed said that delays in exporting are due to inadequate staffing levels and poor infrastructure.

There was general consensus that multiple documentation requirements by different administrative structures is as a result of lack of harmonization and that there is need for port efficiencies and infrastructures to improve operations of the ports in handling both imports and exports.

However, they argued that the cumbersome inspection procedures and non-acceptance of certificates of origins was not aimed at protecting local industry. 20 per cent said that there is need to engage in mutual recognition agreements and accreditation processes so that different regulators can accept each other's conformity assessments procedures. Approximately 10 per cent of the public agencies said the SPS certificates accompanying goods from the exporter's country are often not mutually recognized resulting in arbitrary documentation requirement because the regulators involved have not signed the mutual recognition agreements.

About 60 per cent of public agencies said that the roadblocks and weighbridges are necessary but that there is need for a single window and automation of customs procedures as this would reduce the delays in clearing trucks at customs.

5.3.2. Private firms

The private firms that were interviewed classified NTMs as:

- Delays in clearance of goods at the port due to lengthy clearance processes;
- Non-recognition of certificates of origin;
- Lack of harmonized import/export documentation procedures;
- Requirement of transit fees and bonds;
- Verification and classification of goods;

- Varying procedures for issuance of certification marks, inspection and testing used by the KEBS and other countries bureaus of standards;
- The existence of many institutions involved in approving imports, and varied certification and testing procedures and inspection of certificates of conformity to international standards;
- Varying application of axle loads specifications for trucks transiting through Kenya;
- The existence of several weighbridges between the port of Mombasa and Malaba/Namanga/Busia;
- Restriction/bans of imports/exports to and from certain countries;
- Imposition of import quotas;
- Testing requirements of certain products from some countries and not others;
- Cumbersome testing procedures for certain exports and imports;
- Administrative levies;
- Corrupt practices;
- Numerous police road blocks;
- Road toll charges;
- Lengthy classification and valuation of import processes;
- Different boarder opening times; and
- Lengthy procedures for issuing work permits.

Table 14 shows the restrictive trade practices and their impact on businesses.

TABLE 14: RESTRICTIVE TRADE PRACTICES AND THEIR IMPACT ON BUSINESSES

Restrictive Trade Practice	Rate of impact	Percentage
Import and export permits and licenses	Severe impact	33.3
	No impact	33.3
	Very severe impact	16.7
	Moderate impact	16.7
Non-automatic licensing	Moderate impact	16.7
	No impact	66.6
	Very severe impact	16.7
Product export/import bans	Moderate impact	16.7
	Very severe impact	33.3
	Severe impact	50.0
Trade Monopolies	Severe impact	33.3
	No impact	33.3
	Very severe impact	16.7
	Minor impact	16.7
Discriminatory sourcing	Very severe impact	50.0
	Moderate impact	16.7
	No impact	16.7
	Minor impact	16.7
Corrupt practices	Moderate impact	16.7
	Very severe impact	33.3
	Severe impact	33.3
	Minor impact	16.7
Distribution constraints	Moderate impact	33.3
	No impact	16.7
	Severe impact	16.7
	Minor impact	33.3
Technical quality standards	Minor impact	16.7
	Moderate impact	16.7
	Very severe impact	16.7
	No impact	16.7
	Severe impact	16.7
	Moderate impact	16.7
Sanitary and phyto-sanitary measures	No impact	16.7
	Severe impact	16.7
	Minor impact	50.0
	Moderate impact	16.7

As Table 14 above shows, product export/import bans and discriminatory sourcing had very severe impact on business in Kenya as reported by the respondents. This was followed by import and export permits and licenses which had severe impact on business.

Table 15 shows the impact of rules of origin on businesses in Kenya.

TABLE 15: RULES OF ORIGIN AND THEIR IMPACT ON BUSINESS

Application of Rule of Origin	Rate of impact	Percentage
Non-acceptance of certificate of origin	Severe impact	14.3
	No impact	42.8
	Moderate impact	14.3
	Very severe impact	28.3
Arbitrary product classification	Moderate impact	42.8
	No impact	28.3
	Minor impact	14.3
	Severe impact	14.3
Corrupt practices	Moderate impact	14.3
	Very severe impact	57.1
	Severe impact	28.6

In terms of rules of origin and their impact on business in Kenya, corrupt practices had very severe impact on business followed by arbitrary product classification. Table 16 shows the impact of clearance of export of goods documentation on private business.

TABLE 16: IMPACT OF CLEARANCE OF EXPORT GOODS DOCUMENTATION ON PRIVATE BUSINESSES

Restrictive Trade Practice	Rate of impact	Percentage
Administrative Levies	Severe impact	33.3
	Very severe impact	16.7
	Moderate impact	50.0
Arbitrary/multiple documentation	Severe impact	50
	Very severe impact	16.7
	Moderate impact	16.7
	Minor impact	16.7
Lengthy Classification and Valuation of Import Process	Severe impact	33.3
	Very severe impact	16.7
	Moderate impact	33.3
	Minor impact	16.7
Lengthy Clearance Processes	Severe impact	28.7
	Very severe impact	57.1
	Moderate impact	14.3
Corrupt practices	Severe impact	28.6
	Very severe impact	71.4

Looking at the impact of clearance of export good documentation on private businesses, the respondents reported that corrupt practices, lengthy clearance processes, arbitrary/multiple documentation had the most severe impact, followed closely by administrative levies and lengthy classification and valuation of import processes. Table 17 shows how NTMs affect the trucking business and especially transit traffic.

TABLE 17: TRANSIT TRAFFIC/TRUCKING AND IMPACT ON BUSINESS

Restrictive Trade Practice	Rate of impact	Percentage
Uncompetitive Port Entry taxes/charges	Severe impact	50
	Very severe impact	16.7
	Moderate impact	33.3
Arbitrary or high border taxes	Severe impact	33.3
	No impact	16.7
	Very severe impact	33.3
	Moderate impact	16.7
Inefficient port operations	Severe impact	16.7
	No impact	33.3
	Very severe impact	50.0
Variable weighbridges	Severe impact	33.3
	No impact	16.7
	Very severe impact	16.7
	Minor impact	33.3
Road toll charges	Severe impact	50.0
	Moderate impact	33.3
	Minor impact	16.7
Border opening times	Severe impact	33.3
	No impact	16.7
	Moderate impact	33.3
	Minor impact	16.7
Variable documentation requirements	Severe impact	33.3
	Moderate impact	50.0
	Minor impact	16.7
Corrupt practices	Very severe impact	66.7
	Severe impact	33.3
Numerous Police Roadblocks	Severe impact	50.0
	Very severe impact	16.7
	Moderate impact	16.7
	Minor impact	16.7

In terms of transit traffic/trucking and its impact on business, Table 6 shows that corrupt practices had the most severe impact on business followed closely by inefficient port operations, numerous police road blocks, variable documentation requirements, road toll charges and uncompetitive port entry taxes/charges.

When asked to rank which non-tariff measures has the most negative impact on their businesses, the respondents ranked restrictive trading practices first, followed by the application of rules of origin second, clearance of goods documentation third and transit traffic and trucking issues fourth.

The average non-official payment per shipment was Ksh.500,000. Of this, 50 per cent is usually given to customs officials, 30 per cent to port officials and 20 per cent is given to police officers. The annual waste due to breakage or spoilage in transit was Ksh.600,000. Of this, 45 per cent is due to delays in customs/issuance of permits, 40 per cents due to quarantine delays and 20 per cent due to border transit delays.

The average waiting time for business license for export/import business was 3 weeks while for foreigners looking for a work permit; it took them one week on average to get the work permit. The average number of road blocks between the port of Mombasa and the border towns of Malaba or Namanga was 12 and the truckers spent on average on hour at each of the road blocks. They also claimed to pay Ksh.1000 on average in non-official fees to the police officers at each road block. It takes 3 days on average to pass through customs at Mombasa-Malaba-Namanga. The truckers also claimed to pass though 7 weighbridges between Mombasa and the border town and spend 1 hour on average at each weighbridge.

In this study, some of the non-tariff measures mentioned by the private agencies seemed not to fit into any of UNCTAD's categories. For example, non tariff measures such as road blocks, government bureaucracy, corruption, weighbridges and so on did not fit into the UNCTAD's classification.

It is important to note that almost every commodity was subjected to more than one regulation in the HS categories. Some public officials seemed ignorant of the fact that the Act/laws/ regulations that they were implementing were tantamount to being NTMs. In correcting data, the authors encountered problems of bureaucracy and we had to plead with the officials to be given the information that we needed. Bureaucracy was a major problem as most officials insisted on letters going through their bosses for them to release any information.

There were also difficulties in reconciling private-sector claims with official texts as most of the claims by the private sector were disputed by the public officials. Also, there were inconsistent claims by various private-sector operators on impediments to trade. Some of the non tariff measures mentioned by some private sector operators as impediments to trade were not considered as impediments by others still in the private sector. There were also inconsistent accounts given by different government agencies on the same issue. For example, the issue of non-harmonization of import export documents was not seen as a problem by some public officials while others thought it was an impediment to trade.

In addition, there were some regulations that we were not sure whether they had the power to affect trade, that is, some regulations that seemed innocuous on paper but seemed to generate undue hassle to comply with. For example, some regulations such as police road blocks were seen as a major impediment to trade while ideally one would never have thought about them that way as in Kenya they are mainly for security reasons and also to reduce the diversion of transit goods into the local market.

5.4. Conclusion and Policy Recommendations

From the survey results, it is seen that there is a difference between what the private businesses see as non-tariff measures and what the public officials consider to be non-tariff measures. This is as expected because the public officials are more concerned with implementing Government policy while private businesses are out to make profits. However, it is important to take the concerns of private businesses seriously and implement policies that facilitate trade instead of hindering it.

The analysis has shown that product export/import bans and discriminatory sourcing, corrupt practices, road blocks, clearance of export goods, documentation regarding private businesses, lengthy clearance processes, arbitrary/multiple documentation, administrative levies, lengthy classification and valuation of import processes, inefficient port operations, numerous police road blocks, variable documentation requirements, road toll charges, and uncompetitive port entry taxes/charges have very severe impact on

business in Kenya. The respondents also reported losses of goods and money due to delays at ports, weighbridges and through non-official payments to port officials and police officers.

Such observations demonstrate that the mentioned NTMs are not transparent, that they are discriminative, not scientifically based and generally act as barriers to trade. To reduce delays and facilitate the movement of goods from Mombasa to their places of destination, there is need to remove the numerous weighbridges. Since the trucks can be weighed at the port of entry and exit, there is no need to weigh the sealed trucks in between the ports.

There is also need to improve efficiency at the ports of entry and exit by computerizing all operations and retraining the members of staff. Moreover, customs officials, police officers and other public agencies involved in goods clearance, issuance of certificates of confirmation, import/export permits, and so on that accept or solicit for bribes should be prosecuted and sacked from those positions.

There is also need to harmonize the documentation procedures with other trading partners and to reduce the lengthy clearance procedures that end up frustrating trade instead of facilitating it. EAC member states should consider harmonizing road transport policy and adopting a common regulatory regime for road transport aimed at raising quality standards and improving safety. Consideration should be given to the East African Road Transport and Traffic Act.

There is also need to speed up the waiting time for a business permits. However, this can only happen if the private businesses also adhere to the rules and regulations set up in terms of various products under the Kenyan Law.

Kenya could learn from the European Union experience in development and application of the principle of mutual recognition in standards that facilitate free intra-EU trade in goods. Furthermore, the Kenya Government should be weary of the emergence of new non-national measures that would act as a hindrance to intra- EAC trade.

Also, since WTO rules are for transparency and "non-discrimination" among the domestic goods flow, Kenya and other EAC members should consider eliminating NTMs that are not WTO compliant with immediate effect. Such NTMs include the operation of the weighbridges for intra-EAC goods transit, the use of only national clearing agents, the exclusive use of trucks registered and drivers who are citizens in the member states, and the imposition of entrance fees on traders from other member states entering with their products.

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Chapter 6: Regional Trade Agreements: A Case Study of Kenya

Dr. Tabitha Kiriti-Nganga & Jasper Okelo

6. Defining Regional Economic Communities

UNECA (2004) defines regional economic communities as intergovernmental organizations set up by groups of countries to foster stronger economic ties and cooperation.

Both as a concept and a phenomenon, integration is once again in vogue. Regional trade agreements have multiplied worldwide. Almost all countries are members of at least one agreement and many are party to multiple agreements. Existing agreements are re-invigorated and expanded while new ones are being negotiated and formed. Integration measures have extended their reach beyond traditional free trade in goods to a number of domestic regulatory spheres, including: services, investment and intellectual property rights to deepen the integration among partner countries.

For most countries, integration entails an agreement among a group of countries to remove various kinds of trade barriers. Developing countries such as Kenya are active participants in the regionalism movement. They see regional integration as an essential avenue towards economic growth, development and poverty alleviation. The overarching motive for these arrangements is the formation of a body with a common purpose, usually to increase human welfare.

6.1. Theory of Economic Integration

The theory of regional integration draws heavily from the standard trade theory, which states that free trade is superior to all other trade regimes. From this basic principle, it is assumed that integration among two or more countries will improve the welfare of the member countries provided the arrangement leads to trade creation, minimal trade diversion, and or trade creation that exceeds trade diversion (Ngeno, et al. 2003).

The term integration covers a wide variety of schemes. Lyakurwa (1997) classifies the schemes into five levels on the basis of the degree of integration, as proposed by Balasa (1961) and Jovanovic (1992). These are:

Preferential Trade Agreements (PTAs): Tariffs on trade among member countries are reduced relative to those on trade with non-member countries.

Free Trade Area (FTA): Member countries remove tariffs and quotas on trade between members in goods originating within the FTA, but retain control over their own restrictions on trade with non-members. The tariffs and other restrictions applying to external trade will vary from one country to another. For this reason, A FTA normally applies rules of origin to implement the preferential trade arrangement.

Customs Union: Members not only abolish restrictions on internal trade as in a FTA but they also impose a common external tariff (CET) on trade with non-member countries. Rules of origin are no longer required, which is a major advantage because implementation of rules of origin is very costly administratively.

Common Market: A customs union which, in addition to its usual characteristics, has free movement of factors of production. Common restrictions apply to movements of factors with non-member countries.

Economic Union: This goes further than a common market in that major economic policies, for example, fiscal, monetary, and industrial policies are coordinated and a monetary union may be introduced.

The above classification is hierarchical with each level embracing the one before it. For example, in the formation of the EAC, creation of a Customs Union was considered as the entry point followed by a Common Market, a Monetary Union, and ultimately a Political Federation of East African States.

The customs union theory is concerned with associated welfare gains and losses. The effects can be both static and dynamic (Lipsey, 1987; and Lyakurwa, et al, 1997) and they arise from:

- Reallocation of resources in response to changing relative prices;
- Specialisation;
- Economies of scale;
- Changes in efficiency owing to increased competition; and
- Levels of investment and growth.

Most of the theoretical literature relates to static effects (changes in the terms of trade) while the dynamic effects (specialisation, economies of scale and efficiency changes) are rarely dealt with as they are difficult to model.

Due to the shortcomings of the standard trade theories and observed lack of progress in the integration process, some authors for example, Fine and Yeo (1997) suggest that the focus of regional integration in Africa should re-orient itself to the enhancement of economic growth through stable and sound national macroeconomic policies and rapid accumulation of human and physical capital. Robinson (1996) argues in favour of focusing on cooperation in infrastructure and natural resources development. This is because the requirements for making reasonably complete forms of regional integration work are more demanding. For example, the distribution of gains has to be carefully enumerated and compensation mechanisms designed. In contrast, regional cooperation in infrastructure and natural resources is far less demanding and there are clear gains for all countries involved irrespective of their size of economic development.

The biggest challenge in understanding the successes and/or failures of regional integration in Africa perhaps is the analysis of benefits and costs. The empirical evidence is scanty and is based mostly on simple descriptive intra-regional trade statistics. Available evidence (World Bank, 1991; Lyakurwa et al. 1997; Yeats, 1999; and Longo and Sekkat, 2000) indicates that there have been no noticeable changes in the composition of trade that would suggest that integration has led to any significant structural changes in the economies of the countries involved.

Most studies on customs unions are based on the pioneering study by Viner (1950), which focused on production effects and resultant changes in trade structure. According to Viner, the formation of a customs union would lead to increased trade between union members. However, the desirability of this (from the point of view of union members or of the world as a whole) would depend on the balance between two effects:

Trade creation: The shifting of production of some goods from a less efficient member to a more efficient member; and

Trade diversion: The shifting of production from an efficient non-member to a less efficient member.

Both effects are likely to occur as a result of tariff changes associated with the formation of a customs union. Trade creation represents a move towards freer trade and greater efficiency in the union and so welfare improves. Trade diversion, on the other hand, leads to reduced efficiency and to an adverse effect on the welfare of the union members. The overall impact of the customs union therefore depends on the balance between trade creation and trade diversion, with prospective unions being assessed on whether or not total trade creation outweighs total trade diversion.

McMillan (1993) argues that it is possible for a regional integration arrangement, formed among an arbitrary group of countries, to structure itself in such a way as to make each member country better off without making any member worse off. This is possible by setting an optimal common external tariff. However, given the difficulty in calculating the optimal tariff, this proposition may seem to be only of theoretical interest.

In general, it is argued that integration schemes characterised by factors which are likely to enhance trade creation and those likely to minimise trade diversion are the most likely to be welfare improving. Following Hazelwood (1987), the factors that are welfare improving include the following:

(1) Factors enhancing trade creation, including:
   - Extensive overlap among union members in activities protected by the tariff; and
   - Large differences between member countries in the cost of producing commodities subject to protection.

(2) Factors tending to minimise trade diversion, namely:
   - Many union members;
   - Pre-union trade being a small proportion of members' production;
   - A high pre-union trade being with members; and
   - A Low common external tariff compared with members' pre-union tariff.

Therefore, benefits and costs considered under static analysis deal with changes in relative prices as a result of the changing pattern of tariffs.

Regional Trade Agreements (RTAs) alter the prices from members (as tariffs are phased out) relative to imports from the rest of the world. Consequently, demand patterns will change, resulting in adjustments in trade and output flows. Viner (1950) found that the welfare impact of RTA is ambiguous. Gains will occur if higher cost domestic production is replaced by cheaper imports from a partner country (trade creation). But if a partner country replaces lower cost imports from the rest of the world (trade diversion) there will be losses. Therefore, membership in an RTA will have positive and negative effects on an economy, and it is the net impact that will determine whether a member experiences welfare gains or losses.

In assessing the static effects of forming an effective RTA, three important principles from the theory of integration must be considered. First, the allocative gains of economic integration depend on whether the products produced by members of the RTA are in direct competition with, or complimentary to each other. For there to be competitive economies or efficiency gains in an RTA, there must be a considerable overlap

in the range of commodities that members of the RTA produce. The creation of an RTA where there exists overlapping production with significant differences in production costs between members can lead to large gains from trade as resources are allocated more efficiently among member countries. Intra-industry trade characterizes most trade between industrial economies, and the formation of an RTA is likely to lead to competitive gains. For example, it can be argued that the members of the European Union (EU), the United States and Canada (members of a free trade agreement (FTA), and Australia and New Zealand (also members of a FTA) are competitive economies and that there were significant gains from trade. However, for many developing countries that belong to RTAs, it is questionable whether they are competitive economies. Generally, members of developing country RTAs have a narrow range of exports of goods and services, mostly primary commodities that are exported to industrial countries often under unilateral preferential arrangements. There is therefore very little scope for efficiency gains.

Economies whose structure of production is not competitive tend to be complementary and both benefit and lose from RTAs. Complementarity exists when members of RTAs produce commodities or products that do not compete much with the local production or other RTA members. Traditional integration theory contends that in the case of complementary economies, economic integration will have the usual trade diversion and trade creation effects; the higher the barriers to trade with non members, the higher the risk of trade diversion. Intuitively, one can argue that complementarity exists between developed and developing countries in an RTA (that is North/South RTAs). Trade between industrial economies and many developing countries is often characterized as trade in homogenous products, for example, wheat for textiles. In this case, each country will have a comparative advantage in the export of a different type of goods while all goods will be consumed by all member countries. The Economic Partnership Agreements (EPAs) that are part of the Cotonou Agreement between the EU and the member states of the Africa, Caribbean and Pacific (ACP) region can be characterized as RTAs between complementary economies.

In addition to these static effects, there are also a variety of potential dynamic effects. Dynamic effects are felt more gradually, but are longer lasting and in some cases continued. The effects include:

- Greater possibilities of economies of scale;
- Increased competition within the union, with consequent efficiency benefits;
- Capital formation through several channels such as reduction on trade barriers to diffusion, technology transfer, externalities form export growth and increased marginal product of capital; and
- Ability to influence terms of trade faced by union members through group actions.

When these effects exit, they have potential positive effects on growth. They provide stronger arguments for regional integration than the static arguments based on resource re-allocation. It should be noted that some of the dynamic effects could result from preferential as well as non-preferential tariff reduction.

One of the straightforward tests of the welfare effects of regional trade agreements proposed by McMillan (1993) is to examine what happens to exports and imports for countries in the union. If in each commodity category the volume of imports and exports increases after entry into the integration scheme, then the scheme is welfare improving relative to the pre-integration situation. Although this is a straightforward test, it is subject to objection because changes in trade volumes may have other causes besides the entry into an integration arrangement. In other words, there remains a problem of counterfactuals (Bhagwati, 1993).

Regarding terms of trade, if regional trade integration leaves all prices unchanged when internal tariffs are eliminated, and if goods are sufficiently strong substitutes, the demand for goods imported from third parties will be reduced and regional trade will increase. However, empirical evidence is not categorical about this. An analysis by Sloaga and Winters (1999) of nine regional blocs (NAFTA, Latin America and European regional trade areas) for instance, does not offer evidence of a positive effect on intra-regional trade after the signing of regional agreements. As a matter of fact, empirical evidence shows that trade diversion occurs to some extent, with intra-regional integration agreements imports as a ration of extra-regional integration agreements imports increasing after implementation of regional integration agreements in many regional integration agreements (World Bank, 2000). In fact, regional integration might lead to negative growth if trade diversion occurs with respect to intermediate goods (World Bank, 2000). However, Chang and Winters (1999) found a positive effect on terms of trade in the case of Brazilian membership in MERCUSOR. There was a substantial fall in the price of US goods in the Brazilian market relative to the prices of the Argentinean ones.

De Rosa (1997) reviews literature which seeks to assess the effects of regional integration on welfare of member countries using general equilibrium models (CGE). The approach, containing a great deal of microeconomic details is used to predict income gains associated with the regional integration.

Lewis, et al (1999) in assessing the impact of free trade areas in the South Africa area found that trade creation dominates trade diversion under all areas concerned.

In the EU, static gains from competition and scale effects have been estimated at up to 5 per cent of GDP (World Bank, 2000). Flores (1997) in the study on MERCUSOR found that the potential gains that might be expected from competition and scale effects are 1.8 per cent, 1.1 per cent and 2.3 per cent for Argentina, Brazil and Uruguay respectively. The larger economies gain less because they are already larger and and reaping economies of scale.

This model would be the most appropriate to use for analysing the impact of the EAC regional integration but its complexity, the detailed requirements, and the constraints do not allow for its use in this study.

Overall, evidence from CGE studies show that there are gains from regional integration even though the gains are small (World Bank, 2000). The net gains or losses from integration is a major issue in developing countries because in a customs union, internal tariffs are removed from member states and a common external tariff for non member states is established. Both these have a direct effect on reduction in government revenues because these countries rely substantially on trade taxes. In most cases, custom duties and other forms of import taxes and excise and sales taxes generate the bulk of the revenue. Therefore, if members of a regional integration differ in respect of the importance they attach to trade taxes as a source of revenue, loss of revenue becomes one of the thorniest issues to deal with. Rajaram, et al (1999) indicate that the EAC members depend on import and excise duties as a major source of revenue in varying degrees (Kenya, 32 per cent; Uganda, 51 per cent and Tanzania, 30 per cent). The removal of internal tariffs and establishment of a common external tariff will affect this. However, if regional integration leads to trade creation, consumer welfare improvement and industrial development, then the spill over effects can compensate for the loss in direct revenue. Loss of revenue from integration for COMESA member states, for instance, is insignificant and may be compensated for by dynamic gains from growth (Alemayehu and Kibret, 2000). This may be true also for the EAC since al the three member countries were in COMESA until Tanzania's recent withdrawal.

It is also argued that revenue losses arising from regional integration schemes in developing countries can be compensated for by growth of manufacturing encouraged by integration. Unlike Latin American integration during the 1950s and 1960s and the Lagos Plan of Action for regional integration in Africa, modern integration initiatives aim at using integration as an instrument for export-oriented development rather than import substitution. This stimulates importation of capital goods, which in turn induce increases in domestic investment (Rodrick, 1995). However, growth in manufacturing may not occur in all the countries involved in the regional integration agreement, especially in the case of developing low income countries where regional integration is more likely to lead to divergence (of income levels) rather than convergence (World Bank, 2000; Venables, 1999).

Although access to markets is a major consideration under export oriented growth, it is argued that protection is a major pre-requisite for it to occur. For example, Shafaeddin (1998) indicates that all countries and the newly industrialising countries, first laid their foundation of industrial capability before venturing into foreign markets. This can justify protection as a strategy for targeted industrialisation but cannot justify continuous protection (McCarthy, 2001). Therefore, in the world of non-reciprocal trade liberalisation that the EAC states face as developing countries, modest protection and unrestricted access to markets of developed countries can create favourable circumstances for industrial growth. This will allow the benefits from industrial growth to compensate for the costs that the consumer must bear because of protection arising from a common external tariff. Trade diversion that may arise will also be compensated for by industrial growth. The challenge that arises however is determination of an appropriate common external tariff to allow for the benefits of modest protection that can favour industrial growth to compensate for the loss in revenue.

Economies of scale from a regional integration scheme are expected to arise from enlargement of the market. The gains from economies of scale are based on the argument that the domestic market of a small country may not support a large number of firms, especially industries in which scale economies are important. This can cause problems since small numbers of firms tend to collude and exploit consumers by raising prices. Competition from imports is an important means of restraining monopoly power of domestic firms. Therefore, since regional integration facilitates a larger market, it provides the incentive for investment in the region. This means that creating trade barriers within a region can make it considerably less attractive for foreign investment and therefore deprive it of the dynamic advantages accruing from the flow of foreign direct investment.

Baldwin (1997) argues that creation of a regional integration scheme removes the barriers and the risks of marginalising the region. This argument was put forward in favour of integration between Eastern European countries as a compliment to their free trade with the European Union. Further, Elbadawi (1997) argues that economic integration could generate the threshold scales necessary to trigger the much needed strategic complementarity, and to attract adequate levels of investment necessary for the development of modern manufacturing cores and the transfer of technology within the region. We can therefore argue that integration of the East African countries can act as a catalyst for foreign direct investments flows into the region as a result of the economies of scale that may arise to investors.

The gains from economies of scale can be analysed building on the theoretical works of Krugman (1991). The theory states that factors determining location are production costs, the size of the market and access costs (insurance, customs, tariffs, and so on). The decision to locate a firm in a particular area is the result of a trade off between the advantages in terms of production costs in that area, the size of the market accessible from the location and the cost of getting access to that market. Krugman (1991) further argues

that concentration of manufacturing, for example, in one region which is better suited to this activity than the other has the following advantages:

- The ability to exploit economies of scale;
- Existence of demand externalities from other firms (e.g. suppliers of inputs); and
- Concentration of production which constitute increased local demand.

There is a disadvantage, however, in that there will be increased transport costs involved in serving the markets in the periphery. Therefore, the concentration of manufacturing forms will depend on the balance of the different factors. For example, manufacturing activities, which are not tied to a particular locality for reasons of natural resources that necessitate concentration for extraction purposes, and have low transport costs, are more likely to concentrate in a single or smaller number of localities. Manufacturing activities, and activities with large economies of scale, are more likely to concentrate, other things being equal.

Lyakurwa et al (1997) indicate that many manufacturing activities involve significant fixed costs, and consequently have significant economies of scale. However, many developing countries are too small in terms of population and effective demand to be able to exploit fully the economies of scale. Regional integration may allow this to be achieved through increased concentration of manufacturing activities. Therefore, a group of countries may benefit from concentrating their manufacturing activities if economies of scale are large enough relative to intra-regional transport costs. The location in which the concentration takes place might not necessarily be the same for each sector, though the extent to which tie would be desirable to have different centres of concentration for different sectors would depend on the extent of the demand externalities between the sectors.

The argument above raises the problem with integration for member states with respect to economies of scale. Regional integration enlarges the unprotected market but to exploit the benefits of economies of scale, it will be necessary to allow increased concentration between countries to exploit the possibilities offered by regional integration. This means, however, that the benefits of regional integration are unlikely to accrue equally to participating countries although the union as a whole may gain. The likelihood that some members will lose calls for an appropriate compensation mechanism within the union to allow all members to benefit from the integration scheme.

Regional integration has both political costs and benefits. In fact, the main arguments for membership in regional integration arrangements are political although socio-economic benefits offer the façade. World Bank (2000) discusses the politics of regional integration. There are a number of political benefits associated with regional integration, namely:

- Enhancement of security against non-members and reduction of the work of intra-regional conflicts. The arguments are that since countries interlock their economies through regional integration, conflict between them becomes more expensive and that, through regular political contact, the regional integration facilitates building of trust and initiation of other forms of cross-border cooperation. Polachek (1992; 1997) found that doubling of trade between two countries reduces the risk of conflict by 17 per cent. At times, the impetus for regional integration is moreover provided by the need to face a common external threat as a unified entity. For example, SADC emerged from SADCC that was formed in 1980 to provide a unified front against the apartheid

regime of South Africa. In ECOWAS, economic cooperation served as a precursor to military cooperation.

- Strengthening of bargaining power as a regional bloc can be fore effective than individual countries in negotiations. This benefit, however, depends upon the ability of regional integration agreement members to strike common positions on relevant issues, which is often an elusive goal. There is evidence that one factor that stimulated the formation of the European Economic Commission (EEC) in 1957 was the desire to increase bargaining power relative to the United States (World Bank, 2000).
- Facilitation of project cooperation (such as sharing of such resources as rivers, lakes, fishing grounds, hydro-electric power, rail connections) and cooperation to deal with trans-border problems such as pollution and transport bottlenecks. Such cooperation saves money and is facilitated by regional integration arrangements through collaborative ties and frequent policy level contact that builds trust.
- Provision of a commitment mechanism for trade and other policy reforms, which helps governments to implement domestic political agendas. By raising the cost and therefore reducing the likelihood of domestic policy reversal, regional integration is associated with political benefit of policy reform lock in. World Bank (2000) cites examples where regional integration arrangements have reinforced democracy in member states. MERCUSOR, for instance has additional membership to democracy.
- Greater political feasibility in relation to unilateral or multilateral trade liberalisation. Allowing reciprocal-free internal trade, regional trade integration arrangements are more acceptable to lobbies (mainly producer lobbies) than the two alternative forms of trade liberalisation.

There are also political costs associated with regional integration. The most important is that the deeper regional integration is the greater the loss of sovereignty. Another political cost, especially with respect to regional integration arrangements driven by economic rather than political motivations, is that regional integration arrangements create internal tensions and resentment (economic insecurity) if unfair distribution of regional integration benefits and costs is perceived and industries are concentrated in a single location (World Bank, 2000). Therefore, whether regional integration improves or worsens intra-regional security is a function of the economic characteristics of the member countries and the design and style of the integration scheme (World Bank, 2000).

Successful regional integration is based on trade creation and effective trade promotion. It is argued that a regional integration should lead to a win-win situation for the participating members. However, the theory of and experience with regional integration demonstrate that the outcome of integration will be influenced by the nature of the participating economies. McCarthy (2001) argues that many regional integration arrangements, including the former East African Community, which was dissolved in 1977, can trace their failure to the skewed distribution of benefits associated with integration. The skewness can be ascribed to the substantial differences in the economic size and levels of development of the participating states. Size differences lead to agglomeration and polarised development with the largest and most developed members being perceived to gain more than the others.

For the new EAC integration, compensation is a thorny issue since Kenya dominates intra-regional trade because of its larger and more diversified manufacturing sector (Rajaram et al, 1999). However, Ndungu

(20000 argues that the fears for Kenya's dominance in the new EAC are historical and not real and that the other members, particularly Tanzania, face a similar problem within SADC where South Africa dominates intra-regional trade. Despite this, the issue of compensation is of major concern and it is argued that EAC integration cannot work without appropriate safeguards to address trade imbalances.

Mechanisms for compensation pose a challenge. The options include:

- Payment of compensation by the advantaged member country;
- Establishment of a development fund;
- Investment in common services such as infrastructure; and
- Build in safeguard measures such as rules of origin and support of infant industries to protect the disadvantaged members.

These measures are used differently by various regional integrations schemes. For example, SACU uses a compensatory factor in revenue distribution in favour of the smaller members. EU uses the principles of common investment and a development fund while COMESA countries use safeguard measures. Use of particular measures depends on the unique circumstances applicable to members in each regional integration scheme. A compensation mechanism for the EAC would have to consider the unique economic circumstances prevailing in each of the members to avoid the past pitfalls that led to the collapse of the original EAC.

6.2. Economic Integration in Africa

Regional integration efforts in Africa have a long history dating back to the colonial period and an equally long history of failure due to lack of political commitment and disagreements over compensation and distribution of benefits. Despite the evidence of failure, African countries are once again calling for enhanced regional integration in relevant areas of economic activity such as trade, tourism, immigration, cross border investments and infrastructure.

The world's oldest customs union is the South African Customs Union (SACU) having been formed in 1910 (Alemaycha and Kibret, 2000; Jenkins, 2000). Moreover, a regional grouping for the three East African countries was formed in 1919. It developed into a customs union in 1967 under East African Community (EAC). However, the majority of the regional economic schemes in Africa started in the 1970s. There have also been attempts to establish continental integration schemes. The African Economic Community Treaty (Abuja Treaty) that came into force in 1994 in particular seels to strengthen existing regional integration schemes and to encourage the formation of new ones with the eventual aim of establishing a continental integration unit. The Sirte (1999) and Lome Declaration (2000) called for a speedy implementation of the Abuja Treaty.

Integration in Africa has been driven by two competing forces - one internal and the other external. Internal impetus to integration of African economies has been provided by the realization that the continent has over the centuries suffered wanton exploitation of its natural, material and financial resources at the hands of imperialist forces. Over the centuries, Africa has been confined to producing and exporting primary commodities in line with its perceived comparative advantage. Value adding by way of processing, manufacturing, packaging, and branding and so on is left to industrialized countries. In other words, Africa produces what it does not consume and consumes what it does not produce.

A country may have both internally or externally driven motivations for joining a regional trading block. What are the benefits that these countries that form regional trade agreements expect to derive from these integrations and especially when the motivation is internally driven?

Such countries may expect to derive the following benefits.

- More efficient use of the region's capital, labour and natural resources, which are often less than optimally utilized nationally and have generally been exploited extensively by the industrialized countries.
- Developing the market, so that instead of fighting and bending backward to be granted access to the markets of Europe and North America, Africa can begin producing first and foremost for its own markets.
- Reduced costs of transaction within the region, as a result of reductions in tariff and non-tariff barriers. This reduces monopolistic profits and leads to efficiency gains.
- Training effect, as national producers are gradually exposed to the regional market before the world market, since it is easier to compete in the regional market than in the global market. This could be a stepping stone to the outside world.

On the other hand, external interests may play a big role in pushing countries to form regional integrations and Africa has not been left behind. The overarching motivation for externally-induced regional integration is to maintain the historical division of labour that assigns Africa the source of raw materials for industries in the North. Below are some of the characteristics of externally-driven integration.

With the increasing demands for higher wages, improved working conditions and environmentally sound production methods, many trans-national corporations are increasingly looking at Africa as possible sites for the assembly of their high technology exports such as electronics, auto and engineering products.

In order to keep feeding the Northern industries with the necessary raw materials, it is in the interest of industrialized economies to secure the source of minerals, agricultural commodities and other natural resource-based inputs. It is cheaper doe these developed countries to deal with a bigger entity with uniform policies and procedures than individual states with differing policies and often changing political moods.

Regional trade agreements act as entry points for multilateral trade negotiations. As resistance to many issues fronted by industrialized countries in the multilateral forums like the WTO intensifies, the industrialized North finds it easier forcing the issues through regional forums.

A regional trading block can act as a captive markets. Trade and trade negotiations are about accessing markets. Expansion and securing of African markets rank very high in the scheme of corporate interests in industrialized countries. It is the essence of integration of Africa into the global economy.

Despite the early efforts of African Countries to form regional integration units, the record of sustaining regional integration schemes in Africa has been poor. The failure of most regional integration schemes in sub-Saharan Africa is attributable to a number of factors including restrictions on factor mobility; ineffectiveness of industrial planning and especially failure to agree on the distribution of industries; ineffectiveness of common external tariffs arising from requests for exemption to avoid revenue losses;

general failure of import substitution policies; lack of strong and sustainable political commitment; and macroeconomic instability (Lyakurwa, et al; 1997).

In spite of the unsatisfactory performance of regional integration schemes in Africa, there seems to be a new momentum to invigorate the process. The revival of the EAC, which started in 1992 and culminated in the formal launch in 2001 is one of such efforts. The current motivation for regional integration schemes in African countries may be somewhat different from that of the past initiatives. A number of analysts (Alamaychu and Kibret, 2000 and Jenkins, 2000) cite the following as reasons for the new interest in regional integration schemes:

- Political will expressed in the Abuja Treaty of 1991;
- Formation and strengthening of various regional blocks outside Africa (in Europe, Asia and the Americas), thereby setting a global trend;
- Small national markets and fear of marginalisation in a world dominated by powerful trading blocs;
- Liberalisation initiatives which have created a conducive environment for outward looking economic policy which regional integration is seen as an alternative to unilateral trade liberalisation; and
- Donor concern for small markets and lack of progress in economic development and poverty reduction.

Most sub-Saharan African countries see regional cooperation as a means of promoting intra-regional trade and exploiting economies of scale by pooling small and fragmented domestic markets to support industrialisation strategies (Kasekende and Ngeno, 2000).

Africa is home to 30 regional trade agreements (RTAs), many of which are part of deeper regional integration schemes. African RTAs have largely been motivated by the continent's desire to promote growth through regional cooperation. Many African countries are landlocked small economies with inadequate infrastructure. Although Africa has 12 per cent of the world's population, it produces just 2 per cent of the world's output because its productivity is low. In 2003, sub-Saharan Africa's GDP was 17 per cent lower than Australia's when South Africa is excluded. RTAs, by creating larger markets, are thought to enable African countries to exploit economies of scale and enhance domestic competition as ell s to raise returns on investment and, hence, attract more foreign direct investment (FDI). On average, each African country belongs to four RTAs (World Bank, 2004) and on top of the list are many Eastern and Southern African countries. For example, Tanzania belongs to the East African Community (EAC), the Southern African Development Community (SADC) and to the Common Market for Eastern and Southern Africa (COMESA).

6.2.1. What are the consequences of overlapping memberships?

Multiplicity of regional economic communities has contributed to significant overlap in trade programs. Some of the trade programs of the different regional economic communities may not be compatible. Multiple memberships make it difficult for member states to meet financial obligations to the regional trade communities that they belong to. It also makes it difficult for them to focus on the numerous agenda of each regional economic community. This leads to low ratification and implementation of agreed treaties and programs. Multiple membership leads to duplication of effort among the member countries and also means little support for and understanding of regional trading agreements in member countries.

The main reasons cited for joining more than one regional economic community are strategic and political considerations. Economic benefits and geographic contiguity also count.

Among the regional trading blocks in Africa are:

- The Indian Ocean Commission (IOC) comprising countries such as Comoros, Madagascar, Mauritius, Seychelles and Reunion.
- The Economic Community of West Africa States (ECOWAS) comprising 15 countries such as Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, Gambia, Ghana, Guinea, Guinea Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo.
- The Communaute Economique de l'Afrique de l"Ouest (CEAO) has seven member countries comprising of Burkina Faso, Cote d'Ivoire, Mali, Mauritania, Niger, Senegal and Benin.
- The Southern Africa Customs Union (SACU) consists of five member states such as Botswana, Lesotho, Namibia, South Africa and Swaziland.
- The Southern African Development Community (SADC) has membership of countries such as Angola, Botswana, Democratic Republic of Congo (DRC), Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
- The Common market for Eastern and Southern Africa (COMESA) comprising of Angola, Burundi, Comoros, Djibouti, DRC, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe.
- The East African Community (EAC) comprising Kenya, Uganda and Tanzania. Rwanda and Burundi applied to join the economic community, which was re-launched in 1999 to boost regional trade. The two countries have now been accepted as members of the EAC, expanding the regional economic bloc to five nations. Rwanda and Burundi on 18 June 2007 signed the Treaties of Accession into the East African Community, formally joining Kenya, Uganda and Tanzania in the now enlarged regional economic community of a combined population of 115 million. The EAC previously grouped Kenya, Uganda and Tanzania, which hope to transform the region into a political federation. The EAC agreed a customs union last year and plans to launch a common market for its population of about 90 million by 2010. The countries also plan to have a monetary union in 2009 and a common president and parliament by 2010. The five countries would like to tackle issues of trade and negotiating as a bloc in the World Trade Organisation (WTO), and African Caribbean and Pacific/European Union (ACP/EU) arrangements and Economic Partnership Agreements (EPAs).

In numerous forums, African leaders have underscored the imperative of greater coordination and harmonization among the continents many regional economic communities. The most important of these efforts are the Abuja Treaty establishing the African Economic Community and the Constitutive Act of the African Union. Chapter XIX of the Abuja Treaty stresses the importance of establishing the African Economic Community through the coordination, harmonization, and progressive integration of the activities of regional economic communities. It further enjoins member countries to promote the coordination and harmonization of the integration activities of regional economic communities of which they are members with the activities of the Community.

Article 3 of the Constitutive Act of the African Union also underscores the need to coordinate and harmonize the policies between the existing and future Regional Economic Communities for the gradual attainment of the objectives of the Union.

Although rationalization is not specifically mentioned in these documents, African leaders and policy makers widely understand that the multiplicity of overlapping memberships in regional economic communities constrains the integration aspirations of the region.

Concerned about the slow pace of continental integration, the 1991 African Heads of State Summit in Abuja laid out a timetable for full economic integration of the continent. Under the Abuja Treaty the creation of the African Economic Community will be carried out over 34 years (1994-2027) in six stages, ending in an economic union with a common currency, full mobility of the factors of production, and free trade among the continent's 53 countries.

African leaders also recognize that economic integration cannot be successful without physical integration. Thus a key component of New Partnership for Africa's Development (NEPAD) is to strengthen Africa's weak infrastructure. NEPAD assigns a significant role to the regional economic communities, emphasizes regional and sub-regional approaches, and encourages African countries to pool resources to enhance growth prospects and to build and maintain international competitiveness. NEPAD also highlights the importance of providing regional public goods and rationalizing the institutional framework for regional integration in Africa.

Globalization has opened new opportunities for most countries in the world. Their response to these new opportunities has to some extent determined their share of the benefits. Africa's share has been relatively small. For example, in the early 1960s, Africa accounted for as much as 10 per cent of world exports but by 2000, its share had declined to about 2 per cent (African Development Bank, 2003). According to the Food and Agricultural Organization (FAO), every region of Africa has experienced significant declines in the share of world agricultural trade since 1961, with Southern Africa falling the most from 9 per cent in 1961 to 3 per cent in 1998. In 1998, Central Africa's share was 0.2 per cent, West Africa's 1 per cent and East Africa's 1.1 per cent (Stevens, 2003).

Hence globalization is increasingly marginalizing the African continent. However, several factors account for Africa's marginal role in world trade, including the changing nature and attributes of exports, restrictions in market access in the major economies, and supply side constraints. Limited intra-African trade, a result of weak regional integration, is also a factor because it constrains opportunities for learning by doing for African countries. The small domestic markets do not provide enough opportunities for firms to learn or enough cushion for the export sector during shocks in the international market. They also lessen the scope for exploiting economies of scale and scope. As a result, many firms limit their exposure to the risky and more competitive export market. A larger African market would provide opportunities for firms to learn by doing underscoring the need for deeper regional integration in Africa as a first step towards improved export competitiveness (AU, 2001).

The drawn out nature of WTO negotiations and their requirements that African countries negotiate as a group have promoted integration. Regional integration can provide space to grow and power to negotiate differential treatment with major trading partners.

A more recent development likely to have a significant impact on regional integration in Africa is the European Union's proposal to negotiate economic partnership agreements (EPAs) with regional integration

communities. Under the economic and trade cooperation pillar of the Cotonou Partnership Agreement, African, Caribbean, and Pacific (ACP) countries, except South Africa, would benefit from the application of Lome IV nonreciprocal trade preferences over 2001-2007. At the end of 2007, these unilateral preferences would be replaced by WTO compatible reciprocal economic partnership agreements between the European Union and individual ACP countries or groups of countries. The EPAs will progressively eliminate tariffs and non tariff barriers to trade on goods and services and address technical barriers to trade and other related matters. Proponents of EPAs argue that they will promote sustainable development and better integrate poor regions into the global economy by building on and reinforcing African regional integration processes and taking into account the level of development of each regional economic community.

The EPAs proposed by the European Union that envisage comprehensive reciprocal trading arrangements between Europe and Africa's regional integration groups are likely to have direct and indirect impacts on Africa's regional integration agenda for three reasons:

The European Union is Africa's largest trading partner and trading agreements between the two are likely to have far reaching results for each party and for world trade in general.

Economic partnerships agreements require that negotiations be conducted and agreements be entered into with Africa's regional economic communities.

Economic partnership agreements will be based on reciprocity which will create new challenges for African countries and the regional economic communities they belong to or elect to belong to for purposes of negotiating the economic partnership agreement. For many African countries successfully exploiting the gains from the European Union's proposed economic partnership agreements thus depends on the regional economic community they choose to belong to. This could strengthen some regional economic communities while weakening others.

Unilateral initiatives by the major economies have also led to the growth of regional economic communities. For example, the United States African Growth and Opportunity Act (AGOA), whose objective is to provide African exports improved access to the United States market on a nonreciprocal basis. Through this initiative, Kenya has more than 21000 more people employed in sectors that export t the United States.

6.3. Constraints to Regional Integration in Africa

Deep regional integration is limited by inadequate capabilities, insufficient and unpredictable funding, poor remuneration for staff members and weak capacity. The lack of a supranational authority to enforce commonly agreed decisions reinforces these weaknesses, with sanctions seldom imposed on member countries in breach of agreements. This has opened a substantial gap between the aspirations of member countries expressed in treaties and protocols creating the regional economic communities and the reality on the ground.

For strategic and political reasons many African countries belong to more than one regional economic community, especially in East and Southern Africa (UNECA, 2004). The structure of each regional economic community varies, but they all share a common objective; reducing trade barriers among member countries by creating a common, larger space. However, the complex patchwork resulting from the multiplicity and

membership in regional economic communities raises considerable problems for policy and program coordination and harmonization.

The multiplicity of regional economic communities has several drawbacks:

- Fragmented economic spaces and approaches to regional integration;
- Increased cost of membership in regional economic communities.;
- Unhealthy rivalry for donor funds;
- Contradictory obligations and loyalties for member countries;
- Inconsistent objectives and conflicting operational mandates;
- Duplicated efforts; and
- Reduced ability for regional economic communities to pursue coherent and effective integration programs.

Effective integration requires more than just reducing tariffs and quotas. The process of seeking agreements among so many regional economic communities could delay the creation of the African Economic Community.

The overall low level of effective demand in the African region has also hindered regional integration. Although the number of conflicts has been significantly reduced and growth has resumed across much of the continent, poverty levels remain very high and purchasing power remains very low in all regions except North and Southern Africa. There is very little manufacturing industry in Africa, reducing the degree of complementarity among and across economies. Except for Egypt and South Africa, existing industries are largely unsophisticated, limiting the degree of intra-firm trade in Africa. In addition, weak transport and communication infrastructure and lack of skilled workforce further constrain integration.

Most economic communities in Africa lack leadership and very few countries are willing to compromise on important treaties or to persuade others to agree. Another major challenge is the creation of a multi-stakeholder constituency for regional integration in member countries. African governments often remain the principal advocates of regional integration. Civil society organizations and other organized corporate groups are not involved in regional integration hence making regional integration lack ownership among private citizens. Very few private citizens in Africa are aware of the anchor institutions of regional integration. African civil society organizations have yet to show sufficient interest in regional integration as an arena for policy activism. And there is very little domestic corporate pressure on African countries to provide an integrated regional or continental economic space mainly because African indigenous capital remains weak and still cannot exploit regional economies of scale. Constituencies for regional integration in member countries' can be successfully created only through the advocacy and engagement of all stakeholders.

In addition to the constraints mentioned above, regional integration in Africa faces challenges in several areas including trade, macroeconomic policy convergence, free movement of factors of production, infrastructure, transport and communication, and peace and security.

The major problem with establishing free trade and customs unions is that African countries depend on foreign trade taxes as revenue to finance public expenditure. They have been reluctant to remove barriers to intra-community trade because they fear a significant revenue loss. But tariff and non tariff barriers,

lack of physical connectivity (only 38 per cent of the roads in Africa are paved roads in good and fair condition), and the heterogeneity of policies and trade limit trade and market integration.

Apart from high tariffs, structural deficiencies, limited product diversification, similarity of products and production structures, lack of market information on member countries and production and supply side constraints are also impediments to trade and market integration.

The reach of regional institutions depends on the willingness and ability of national institutions to serve as compliments to regional bodies and to enforce their decisions. Credible national institutions would lend legitimacy to regional institutions. Member countries must be willing to give up some of their sovereignty for progress in integration.

6.4. Regionalism in East Africa

6.4.1. History of integration in East Africa

The history of regionalism in East African would offer a glimpse at some of the economic and political difficulties and stumbling blocks to be anticipated in the new East African Community.

The history of regionalism dates back to the times of the British Protectorate. When the British government declared a protectorate over Uganda in 1894, it decided to cover the expenses of the Mombasa - Kisumu Railway which was constructed between 1896 and 1901. When railroad construction was finished, Uganda ceded its Eastern Province to Kenya in 1902 for the purpose of having the area crossed by the railway under a unified administration. In 1900, Uganda made her first form of customs arrangements with Mombasa (Kenya) as the customs collection centre. In 1905, the East African Currency Board was established to issue currency for Uganda and Kenya, as well as a Postal Union for the two countries. A customs union between Kenya and Uganda was introduced in 1917. Tanganyika (now Tanzania) joined the Postal Union in 1933. In 1940, a joint East African Income Tax Board was set up. In1948, the East African High Commission (EAHC) and the East African Legislative Council (LEGCO) were set up. In 1961, the East African Commission Services organization was established to succeed the East African High Commission after independence. In 1967, the three countries signed the Treaty for East African Co-operation, which established the East African Community (EAC).

In 1977, the EAC collapsed due to different political philosophies leading to different economic policies. This was exacerbated by the then East/West divide that was polarizing the world into capitalists and the socialists. This was worsened by the overthrow of President Obote by Idi Amin as president of Uganda in 1971. There were also differences on the sharing of benefits from sharing jointly owned common service organizations and lack of policy to redress the situation. Apart from that, there was low private sector and civil society input in the running of the community.

In 1986, the heads of state of Tanzania, Uganda and Kenya agreed to revive the cooperation. In 1993, the three heads of state signed an agreement establishing the Permanent Tripartite Commission composed of the Ministers responsible for regional cooperation. This commission is responsible for the initiation, planning and implementation of cooperation programs. In 1994, the heads of state signed the Protocol establishing the Secretariat of the Commission with the headquarters at Arusha. The Secretariat is the principal executive organ of the Commission. It was launched by the heads of state in 1996. In 1999, the treaty establishing the East African Community was signed and in 2000, the treaty was enforced and the

New East African Community came into being and in January 2001, the three heads of states formally launched the East African Community.

Rwanda and Burundi applied to join the economic community and the two countries have now been accepted as members of the EAC, expanding the regional economic bloc to five nations. Rwanda and Burundi on 18 June 2007 signed the Treaties of Accession into the East African Community, formally joining Kenya, Uganda and Tanzania in the now enlarged regional economic community of a combined population of 115 million. The EAC previously grouped Kenya, Uganda and Tanzania, which hope to transform the region into a political federation. The EAC agreed a customs union last year and plans to launch a common market for its population of about 90 million by 2010. The countries also plan to have a monetary union in 2009 and a common president and parliament by 2010. The five countries would like to tackle issues of trade and negotiating as a bloc in the World Trade Organisation (WTO), and African Caribbean and Pacific/European Union (ACP/EU) arrangements and Economic Partnership Agreements (EPAs).

The present EAC reaches beyond the earlier attempt at regional integration by aiming at even closer integration, first by establishing a customs union (CU), then a common market, a monetary union, and ultimately a political federation. The three EAC member states had a combined GDP of $US45 billion in 2006. Kenya is the largest of the three economics with a GDP of $US22.8 in 2006, a population of 36.6 million, a per capita GDP of $US1200 (PPP) and a GDP growth rate of 5.7 per cent. Tanzania's GDP is $US12.8, its population is 39.5, a GDP per capital of $US700 and a GDP per capita of 5.8 per cent. Uganda's GDP is $US9.4, its population is 29.9 million, a per capita GDP of $US1700 and a GDP per capita of 5.3 per cent.

All three countries share number of similarities, resulting from their common location, climate, and history. However, Uganda is landlocked and relies on access to seaports in Kenya (Mombasa) and Tanzania (Dar es Salaam). They are all members of the World Trade Organization (WTO), and belong to other Regional Trade Agreements. All of them are members of COMESA but Tanzania also belongs to SADC.

6.5. Objectives of East African Community

All three countries view regional integration as an essential plank of their development strategy and an important ingredient in simulating increased trade and investment.

The challenges facing the East African countries were instrumental in creating demand for the new EAC. Ndungu (2000) elaborates on these challenges which include the need for:

- High output growth;
- Industrialisation;
- Reduction of unemployment which has become politically threatening;
- Increase in export trade;
- Reduction of external and domestic indebtedness to sustainable levels;
- Raising of social and human capital development; and
- Reduction of poverty.

Indeed, the EAC Treaty (Article 5.1) emphasises that the broad goal of EAC is to widen and deepen cooperation among partner states in political, social and cultural fields, research and technology, defence,

security, and legal affairs for their mutual benefits. The vision is to create wealth in the region an enhance competitiveness through increased production, trade and investment. Increasing industrial production is advocated to address the economic challenges faced by the East African countries, partly because of pressure from economic globalisation and from relatively successful regional integration schemes such as the South African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA). Beside, economic reforms and liberalisation have shown that there are regional spill over effects beneficial to the neighbouring countries.

Therefore, a more coordinated regional group with competitive production structures and policies that support a competitive production process is required to increase domestic production of goods and services. Furthermore, harmonised policies within a regional integration scheme can maximise the benefits arising from regional trade and the comparative advantages of participating countries (Ngeno, et al. 2003).

The formation of the customs union is expected to facilitate higher trade and investment flows between member states and through increased competition to improve the efficiency and competitiveness of the exports sectors in the individual countries.

Trade integration is not the only reason for regional integration. According to McIntyre (2005) argues that from a Kenyan perspective, the establishment of the EAC customs union provides an impetus to the COMESA customs union. Although Tanzania is not a member of COMESA, it is felt that the EAC group led by Kenya could set the EAC common external tariff as the goal for the COMESA customs union and be the prime force in the negotiations. A wider COMESA customs would be attractive to Kenya because it would provide a larger market to encourage the expansion of its manufactured or non traditional exports to the region.

McIntyre (2005) contends that conceptually, adopting and implementing simple, transparent import and export regulations and efficient procedures for customs clearance will reduce transaction costs and enhance efficiency in EAC member countries and improve the environment for trade expansion. Behind the border reforms are increasingly an important part of international trade architecture and of growing importance in the multilateral trade negotiations in the World Trade Organisation (WTO). These reforms place great demands on a country's human resource and institutional capacity, and it seems intuitive that regional approaches will be beneficial for sub-Saharan countries with limited resources and weak administrative capacity.

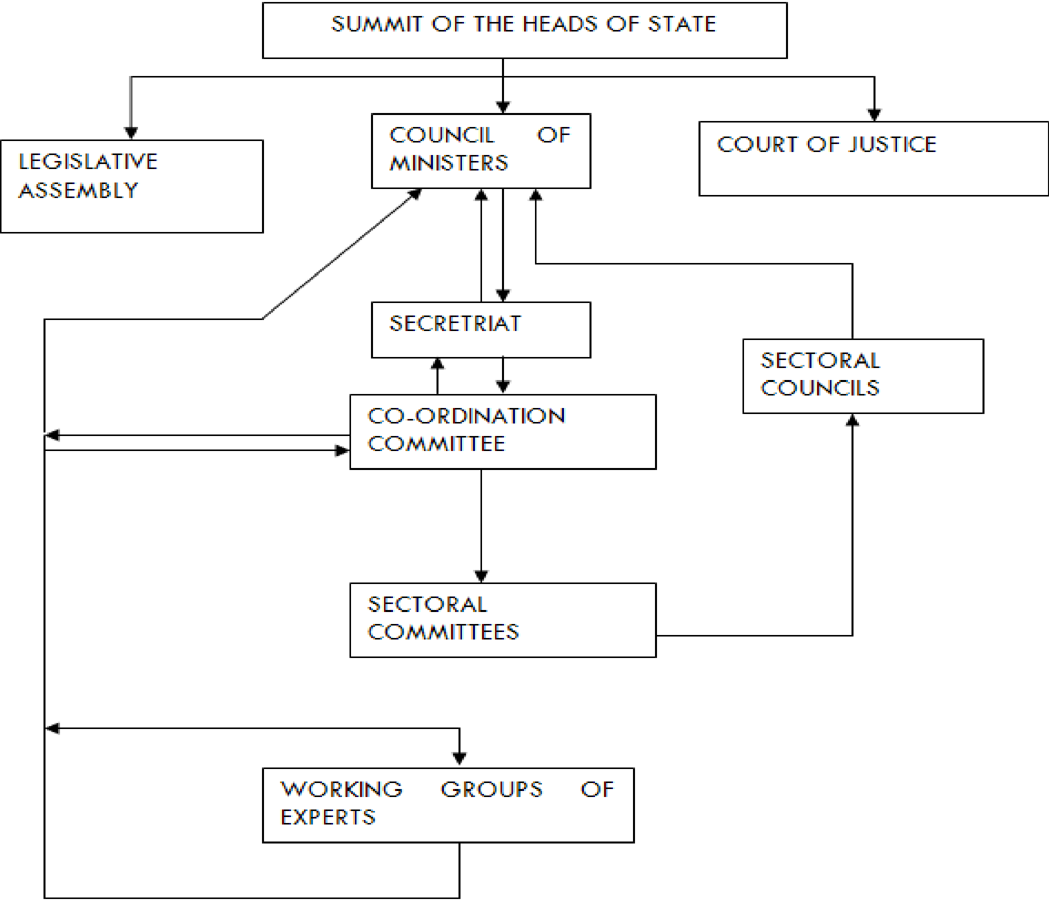
Schiff (2000) argues that regional cooperation on public goods such as water basins (rivers, lakes and so on), infrastructure (roads, railways and dams), the environment, hydroelectric and other sources of energy, and fisheries can generate benefits for member states. In the case of EAC member states, there is a lot of scope for cooperation in these areas and support can be received from the World Bank together with other multilateral, regional and bilateral agencies.

Hence, the objectives of the EAC can be summarised as deepening cooperation among partner states in among other areas in economic, political, defence, social, cultural, security and legal.

The fundamental principles of the EAC are mutual trust and political will, peaceful co-existence and good neighbourliness, peaceful settlement of disputes, good governance, and equitable distribution of benefits and cooperation for mutual benefits.

The operational principles of the community are people-centred and market-driven cooperation; provision of adequate and appropriate enabling environment such as conducive policies and basic infrastructure; establishment of an export oriented economy with free movement of goods, persons, labour services, capital, information and technology; the principle of subsidiarity with emphasis on multilevel participation; the principle of variable geometry which allows for progression in cooperation at different speeds; equitable, balanced development of partner states; the principle of complementarity and lastly, partner states undertake to abide by principles of good governance. The organisation of the EAC is shown in Figure 18.

TABLE 18: ORGANISATION OF THE EAC



6.6. The EAC Development Strategy

The first development strategy for the East African Community was launched in April 1997covering the period 1997-2000. It laid down the basic principles to govern the process of integration. The medium strategy was the establishment of a single market and an investment area in the region.

6.6.1. Key areas of cooperation

Harmonisation of policies to promote cross border trade and investment and to ease cross border movements of goods and persons;

Development of infrastructure; and

Enhancement of technological and human resources development.

6.6.2. The significant achievements of the first development strategy (1997-2000)

Confidence building measures by setting up a defence liaison office at the secretariat and the signing of a Memorandum of Understanding (MOU) for cooperation in defence and a MOU on foreign policy coordination.

Harmonisation of policies on convertibility of currencies; reading of budget statements on the same day and time; implementation of preferential tariff discount; harmonisation of standards of goods and services as East African standards; mutual recognition of health certificates issued by national bodies for goods traded in East Africa.

Easing of cross border movement of persons and goods through the use of the East African passport; a 7 days grace period for personal motor vehicles; immigration desks for East Africans at international airports; re-introduction of interstate passes and the withdrawal of visa charges for students.

Infrastructure development through implementation of projects in telecommunications, roads, civil aviation, posts, meteorology, energy and related areas. The key projects related to infrastructure development are the East African Road Network; the Postal Automation Project; the Civil Aviation Safety Project; the Five years Meteorological Development Plan; the lake Victoria Safety Navigation Project and the Power Master Plan.

Legal and Judicial Cooperation which involved the signing of the agreement for avoidance of double taxation; the signing of the road transport and inland waterways agreements; the signing of the treaty for the establishment of the East African Community; the signing of the MOU on cooperation in environment management; the signing of the protocol for the establishment of the Inter-University Council and the signing of he headquarters agreement between inter-university council and the government of Uganda.

Development of human resources and science and technology which involved the revitalisation of the inter-university council; setting up of the East African Science and Technology Coordination Committee; and operationalizing the activities of the advisory committee on education, research and training.

In health the strategy started with the formation of three working groups for the purpose of the control and prevention of sexually transmitted diseases and HIV/AIDS; control of communicable diseases and the development of heath research, policy and health system.

The process towards the establishment of the EAC Customs Union which meant the harmonisation of the exemption regimes; harmonisation and simplification of customs documentation; development of model harmonised investment code; harmonisation of commodity description and coding system; formulation of a private sector development strategy; continuing work on the establishment of a common external tariff; EAC rules of origin and program for the elimination of internal tariff.

Development of Lake Victoria and its basin which meant undertaking a study on an institutional and legal framework for the development of the lake and its basin; signing of a partnership agreement between EAC and key development partners having programs on the lake.

The Second Development Strategy covered teg period between 2001 and 2005. Its main focus was the implementation of the treaty on the establishment of a Customs Union and a Common Market and widening and deepening the cooperation for the mutual benefit of partner states.

6.6.3. Priority programs in the second development strategy

Establishment of a Customs Union and a Common Market; continuation of regional programs reflected in the first development strategy; liberalisation of cross border trade and movement of persons; macro-economic stability to promote investment and create economic growth; enhancement of supply capacities in the main productive sectors; development of infrastructure and support services; development of human resources, science and technology; operationalisation of other organs of the Community, the Court and the Assembly; strengthening of the institutions of cooperation and political cooperation in enhancing peace and security in the region.

The EAC also intends to enhance cooperation with the private sector and civil society organisations and some organisations have already applied for observer status. Some of these organisations are: the East African Business Council (EABC); the East African Trade Union Council (EATUC); International Council for Social Welfare; East African Youth Council; East African Magistrates' and Judges' Associations. Other closely cooperating organisations are the East African Jua Kali/Nguvu Kazi Association; the East African Law Society and the Uongozi Institute.

The EAC intends to adopt strategies to negotiate as a block on international matters and to increase outreach programs to educate East Africans on the benefits of the integration.

6.7. The Current State of Regionalism in the East African Region

6.7.1. Trade flows in East Africa

Trade between the EAC members has grown over the past decade. Table 19 shows Kenya's trade with the East African Community between 2002 and 2006.

TABLE 19: KENYA'S TRADE WITH THE EAST AFRICAN COMMUNITY (KSH. MILLION)

Region	Total Exports					Total Imports				
	2002	**2003**	**2004**	**2005**	**2006**	**2002**	**2003**	**2004**	**2005**	**2006**
Tanzania	14181	14588	17921	19954	18288	803	1368	2009	3099	4514
Uganda	31280	30668	37059	42679	27812	664	1038	1009	1396	1002
Rwanda	4313	6012	6190	7282	4765	6	5	16	115	210
Burundi	1798	2752	2972	3714	2184	1	2	3	20	106
Total EAC	51572	54020	64142	73629	53050	1474	2413	3037	4630	5832
%of total exports/ imports	30.5	29.5	29.9	28.3	21.1	0.6	0.9	0.8	1.0	1.1

Source: Kenya National Bureau of Statistics

As Table 19 shows insignificant regional trade flows. The proportion of exports from Kenya to the EAC declined from 30.5 per cent in 2002 to 21.1 percent in 2006. The proportion of imports to Kenya from the EAC increased slightly from 0.6 percent in 2002 to 1.1 per cent in 2006. It can also be seen that the value of exports increased from 4.7 per cent in 2003 to 18.7 per cent in 2004. After that it increased by 14.8 percent in 2005 and thereafter, it declined by 27.9 percent in 2006.

Table 20 shows the direction of trade between Kenya and other EAC countries in terms of proportion of total trade.

TABLE 20: KENYA: SHARE OF TRADE FLOWS (PER CENT OF TOTAL) WITH THE EAC

Region	Total Exports					Total Imports				
	2002	**2003**	**2004**	**2005**	**2006**	**2002**	**2003**	**2004**	**2005**	**2006**
Tanzania	27.5	27.0	27.9	27.1	34.5	54.5	56.7	66.2	66.9	74.4
Uganda	60.6	56.8	57.8	58.0	52.4	45.0	43.0	33.2	30.2	16.5
Rwanda	8.4	11.1	9.7	9.9	9.0	0.4	0.2	0.5	2.5	3.5
Burundi	3.5	5.1	4.6	5.0	4.1	0.1	0.1	0.1	0.4	5.6
Total	100	100	100	100	100	100	100	100	100	100

As Table 20 shows, Kenya's trade in the EAC is dominated by Tanzania and Uganda. Exports and imports from these two countries comprised more than half of the trade between 2002 and 2006. Kenya's exports to Tanzania remained steady at 27 per cent but rose sharply to 35 per cent in 2006. Kenya growth of imports from Tanzania rose from a low of 54.5 per cent in 2002 to 74.4 per cent in 2006. On the other hand, exports to Uganda fell from 60.6 per cent in 2002 to 52.4 per cent in 2006. Imports from Uganda also fell during this period from a high of 45 per cent in 2002 to 16.5 per cent in 2006. Trade with Rwanda shows a steady rise between 2002 and 2006. Exports rose from 8.4 per cent to 11.1 per cent

between 2002 and 2003 but declined to 9.0 in 2006. Imports, on the other hand rose from 0.4 per cent in 2002 to 3.5 per cent in 2006. Trade with Burundi shows t he same pattern of growth as Rwanda.

Differences in the level of industrialisation among the countries are reflected in the trade pattern presented in Table 21.

TABLE 21: EAC COUNTRIES: REGIONAL TRADE BY COMMODITIES, 2002 (PER CENT OF TOTAL)

Kenya	**Exports To**				**Imports from**			
	Uganda	**Tanzania**	**Rwanda**	**Burundi**	**Uganda**	**Tanzania**	**Rwanda**	**Burundi**
Food products	33.6	56.0	9.9	0.4	14.2	85.8	0	0
Agricultural materials	76.8	17.8	4.9	0.5	36.6	63.1	0.2	0.1
Fuels	69.9	13.8	11.0	5.3	2.3	97.7	0	0
Manufacturing	69.1	26.3	3.8	0.8	6.8	93.2	0	0
Burundi	**Exports to**				**Imports from**			
	Uganda	**Tanzania**	**Rwanda**	**Kenya**	**Uganda**	**Tanzania**	**Rwanda**	**Kenya**
Food products	0	3.6	76.7	19.7	0.9	95.9	0.1	2.5
Agricultural materials	8.6	0	88.2	3.2	0	88.3	0.1	11.6
Fuels	0	0	0	0	0	19.2	0	80.8
Manufacturing	0	0	100	0	0	54.3	9.2	36.5
Rwanda	**Exports to**				**Imports from**			
	Uganda	**Tanzania**	**Burundi**	**Kenya**	**Uganda**	**Tanzania**	**Burundi**	**Kenya**
Food products	0	1.3	0.1	98.6	15.1	33.1	4.1	47.7
Agricultural materials	18.4	7.1	0	74.4	8.6	17.4	0	74.0
Fuels	0	0	0	0	0.4	3.6	0	96.0
Manufacturing	94.3	0	4.2	2.7	36.2	10.4	0	53.4
Uganda	**Exports to**				**Imports from**			
	Rwanda	**Tanzania**	**Burundi**	**Kenya**	**Rwanda**	**Tanzania**	**Burundi**	**Kenya**
Food products	7.7	2.6	10.3	79.4	12.1	12.1	16.6	59.2
Agricultural materials	6.7	3.8	0	89.5	0.4	5.9	0	93.7
Fuels	2.9	11.9	0	85.2	0.02	0.02	0	99.9
Manufacturing	63.8	14.8	12.1	9.4	1.6	3.2	0	95.2
Tanzania	**Exports to**				**Imports from**			
	Rwanda	**Uganda**	**Burundi**	**Kenya**	**Rwanda**	**Uganda**	**Burundi**	**Kenya**
Food products	0	4.8	4.8	90.4	0	16.1	0	83.9
Agricultural materials	6.2	8.2	24.0	61.6	0.2	17.0	0	82.8
Fuels	0	69.6	5.7	24.7	0	0	0	100
Manufacturing	6.2	19.3	28.8	45.7	0	0.8	0	99.2

From Table 21, it can be seen that differences in the level of industrialisation among the countries reflect the pattern of trade. Kenya exports lots of manufactured goods to the five countries. Rwanda and Burundi's trade in 2002 was not very significant. Table 3 also shows that interregional trade is quite important and especially manufactures. Table 3 indicates that within the EAC region Kenya exported 69.1 percent of its manufactures to Uganda while it imported 93.2 per cent of total manufactures from

Tanzania. Uganda and Tanzania imported 95.2 per cent and 99.2 per cent respectively of their manufactures from Kenya.

Fuels also play an important role in interregional trade as Table 3 shows. For example, for Tanzania 100 per cent of its fuel imports are from Kenya.

This shows that expansion of interregional trade has provided a market for manufacturing and fuel sectors in the EAC member states particularly Kenya.

However, the European Union remains the main trading partner of the EAC countries. The European Union remains the largest market for EAC's exports, absorbing 40 per cent. EAC imports are quite diversified: around a quarter come from the European Union, and about 20 per cent from Asia and the Middle East respectively.

Outside the region, EAC's main exports are agricultural commodities, and its main imports are manufactures. Table 22 shows that food and agricultural commodities dominated the composition of exports outside the region for Kenya, Uganda and Tanzania in 2001.

TABLE 22: NON-REGIONAL TRADE BY COMMODITIES IN 2001 (PER CENT OF TOTAL)

Commodity	**EAC**[2]		**Kenya**		**Tanzania**		**Uganda**	
	Import	**Export**	**Import**	**Export**	**Import**	**Export**	**Import**	**Export**
Food products	11.7	54.9	11.6	49.5	13.6	59.5	6.3	75.5
Agricultural materials	2.8	14.1	3.1	13.9	2.2	13.9	2.7	15.4
Textile fibres	2.3	2.9	2.4	0.7	2.1	8.1	2.4	5.1
Ore, Minerals and metals	1.3	2.8	1.6	1.7	0.8	6.6	1.0	1.7
Energy	2.5	8.4	1.7	12.0	4.4	1.5	2.2	1.9
Manufactures	79.4	16.9	79.6	22.2	76.9	10.4	85.4	4.9

Table 22 shows that Kenya's share of exports of food products and agricultural products is lowest at 63.4 per cent, Tanzania's at 73.4 per cent while Uganda's share stands at 90.9 per cent. Kenya has the largest share of manufacturing exports at 22.2 per cent; Tanzania at 10.4 per cent and Uganda's at 4.9 per cent. Imports into the EAC countries from outside the region are dominated by manufactures which account for 99.4 per cent while food products are second at 11.7 per cent. The trading patterns of the EAC members indicate that trade linkages are relatively weak as Table 4 shows. Therefore, one cannot really characterise the economies as either complementary or competitive. Khandwelwal (2004) developed estimates of bilateral product complementary indices[3] in COMESA and SADC. The results indicate that within COMESA, product complementarities between Kenya's exports and the imports of the other member countries average 38.6. For all other countries, except Egypt, average product complementarity for exports is far lower. Another EAC member, Uganda, had an average of 19.8. The results reinforce the observation that the economies of the EAC are neither complementary nor competitive.

[2] Excluding Rwanda and Burundi

[3] The index is a measure of similarities between the export basket of one country and the import basket of another country. The value of the complementarity index can range from 0, which represents no complementarity between the exports and imports of two countries, to 1000, which implies a perfect match. The higher the index between two countries, the greater the product complementarity.

6.7.2. Trade regimes

Domestic trade liberalisation, regional integration, and tariff preferences have contributed to the increase in regional trade. In 2001, the EAC countries embarked on similar programs of trade policy reform including tariff and non-tariff barriers to trade. As a result, the three EAC countries' trade regimes have somewhat converged. The reduction and simplification of tariff rates, the abolition of quantitative restrictions, and the elimination of export subsidies have been common features in the three countries' reform programs since the mid 1980s.

However, the trade regimes of the EAC member countries are characterised by a cascading tariff structure. In such a tariff regime, the lowest rates are imposed on raw materials and capital goods, moderate rates on intermediate goods, and the highest rates on consumer goods. These structures reflect the historical pattern of tariffs in many countries, with high rates being placed on consumer goods partly to restrain demand and collect revenue but also to protect producers of final consumer goods from foreign competition or stimulate domestic production of consumer goods.

Table 23 shows the evolution of the tariff regimes in Kenya, Uganda and Tanzania between 1997 and 2002 in per cent.

TABLE 23: EVOLUTION OF EAC TARIFF REGIMES 1997-2002

Country	Tariff Rates	1997	1999	2001	2002
Tanzania	Tariff bands	7	5	4	5
	Maximum rate	50	25	25	25
	Simple average tariff	23.5	16.4	12.8	12.1
	Weighted average tariff	18.4	20.9	10.9	11.1
Uganda	Tariff bands	5	3	3	3
	Maximum rate	30	15	15	15
	Simple average tariff	13.2	9.2	9.1	6.1
	Weighted average tariff	10.7	NA	7.4	7.7
Kenya	Tariff bands	5	5	5	5
	Maximum rate	40	35	35	35
	Simple average tariff	20.8	15.2	16.6	16.2
	Weighted average tariff	16.1	11.1	13.6	10.9

Source: World Trade Organisation and the United Nations Conference on Trade and Development

As Table 23 shows, all the three countries have progressively liberalised their tariff rates since the mid 1990s. Uganda and Tanzania have liberalised their tariff schedules significantly as can be seen by the reduction of the maximum rate, the number of tariff bands, and the tariff levels as measured by the simple average tariff and the weighted average tariff. The most significant changes were in Uganda, and to some extent Tanzania. Uganda has narrowed the differences between the maximum rate on consumer

goods and the lower rates on low materials and capital goods. Although Kenya's maximum rate and the number of bands have remained unchanged over the same period, it's simple average tariff and the weighted average tariff have fallen as a result of changes in tariff categorisation; products have been moved from higher to lower tariff bands. Hence Kenya's simple average tariff has marginally declined as a consequence of modifications in tariff classifications.

Table 24 shows the tariff rates on a Most Favoured Nation (MFN) basis to imports from countries with which the EAC member states do not have preferential trade agreements.

TABLE 24: AD VALOREM MFN TARIFF RATES (IN PER CENT), 2001-02

Country	Tariff Band				
	1	2	3	4	5
Kenya	0	5	10	25	35
Tanzania	0	10	15	25	NA
Uganda	0	7	15	NA	NA

Within the EAC, Tanzania and Uganda grant Kenya an 80 per cent tariff reduction and Kenya grants a 90 per cent tariff reduction on imports from Uganda and Tanzania. The regionally applied tariff rates are thus significantly lower than the MFN rates. Kenya is a member of COMESA free trade zone and grants duty free access to the eleven members of the free trade area. Preferences for the nine members of the preferential trade area vary. Uganda grants an 80 percent tariff preference to COMESA members whereas Tanzania grants SADC members preferential market access.

While progress in trade liberalisation and regional integration has been made, several constraints for global and regional trade persist. In all three countries, non-tariff barriers such as discriminatory surcharges, standards and import procedures hinder trade. As regional integration becomes deeper, harmonisation in standards, procedures, import procedures and so on can confer significant benefits to the member states.

In the context of the EAC customs union negotiations, the three countries are addressing the problem of discriminatory surcharges such as suspended duties or discriminatory excise taxes. These are applied to the CIF value of imports plus the tariff. Suspended duties are temporary or transitory and can be levied and removed case by case. Excises are anchored item by item in the tax and are therefore much more permanent. Tanzania and Uganda make extensive use of such surcharges as a means of protection. Tanzania applies suspended duties on 122 items mostly Kenyan imports. It also applies excises but in a non-discriminatory manner. Uganda does not apply suspended duties but it imposes excise on 454 goods. Most of these excises are only applied on imports implying that they are discriminatory. Non-discriminatory excises are levied on mineral water, alcoholic beverages, tobacco products and sacks and bags in Uganda. Most of the Ugandan excises are at 10 per cent, not withstanding a specific tariff equivalent of 57 per cent ad valorem on petroleum products. Kenya also apples excises but in a non-discriminatory manners and imposes suspended duties only for petroleum products.

6.7.3. The East African Common External Tariff (CET)

The East African Treaty provided for the establishment of a customs union (CU) by January 2005. A Customs Union may be defined as a merger of two or more customs territories into a single customs

territory, in which customs duties and other measures that restrict trade are eliminated for substantially all trade between the merged territories. The territories, in turn apply the same duties and measures in their trade with third parties.

The formation of the CU requires members to dismantle all barriers to trade (tariff and non tariff) between each other. They are also expected to implement a harmonised customs administration, including commodity classification, customs valuation system, customs procedures, documentation, and Rules of Origin. They also have to agree on the modality of sharing the tariff revenue and the common external tariff for the customs union.

The three countries agreed on a set of rules of origin in late 2002 that are based on the ones developed by COMESA, with a few product specific modifications based on SADC rules of origin. The EAC countries also agreed on a harmonised nomenclature at the 8 digit level as well as documentation of procedures. They also adopted the WTO rules and regulations on customs valuation.

The CET has three tariff bands comprising 0 per cent for meritorious goods, raw materials and capital goods; 10 per cent for intermediate goods and 25 per cent for consumer goods.

The treaty establishing the EAC recognises asymmetry as a core principal underpinning the formation of the EAC customs union. Its inclusion in the treaty is justified on the basis of the understanding that the three member states are at different levels of economic development and that the existing imbalances, which could be worsened by the customs union, need to be addressed.

Under the EAC common external tariff, Tanzania is supposed to eliminate tariffs on all imports except for an agreed list of commodities – 906 tariff lines for Tanzania and 426 for Uganda, for which the tariff will be reduced gradually to zero within a period of up to five years. In Uganda, the items on that list will initially attract a 10 per cent tariff that over five years will be reduced uniformly. Tanzania has a more complicated arrangement for tariff reduction with e ach product group having a different schedule for reducing tariffs. However, no tariff will initially be higher than 25 per cent and the reduction to zero will be within five years. In short, the EAC common external tariff will be implemented in two phases. First, all three countries will adopt the three band structure, but Tanzania and Uganda will maintain internal tariffs on select Kenyan imports. Second, after five years all internal tariffs will be removed and all Kenyan imports will enter Tanzania and Uganda free of tariffs.

A major issue in the negotiations on the CET was reaching agreement on the classification of about 20 per cent of the tariff lines defined as sensitive items. The EAC members wanted to protect the following products form import competition:

- Subsidized exports, mainly agricultural products from industrialised countries; and
- Second hand items.

According to the World Bank (2003), the sensitive items included cigarettes, dry cells, fabrics, garments, matches, milk, cement, packing materials of plastic, palm oil, sugar, tyres, used clothes, vehicles (reconditioned cars), vehicle chassis, rice, wheat and wheat flour. These items are equivalent to 361 tariff lines and are estimated at about 20 per cent of total imports. The EAC member states reached an agreement on the classification of sensitive products and the applicable rates of duty with the exception of jute bags, rice and wheat. They also agreed that sensitive products could not be protected by the

maximum rate and therefore required special policy measures. They agreed that the sensitive products would attract rates of more than 25 percent and in some instances, a mixture of specific duty and ad valorem rates.

The CET will have different effects on the trade regimes in the member countries. The introduction of the three band tariff structure will increase tariffs in Uganda (3066 tariff lines) and to a lesser extent Tanzania (1224 tariff lines) and (1144 tariff lines) in Kenya. In contrast the CET is likely to lower significantly more tariffs in Kenya (3216) than in Tanzania (2.364) or even Uganda (1,353). In addition, the World Bank (2003) estimates that with the full implementation of the CET the simple average tariff in the three countries will be 10.9 per cent which represents a significant decline for Kenya from a simple average tariff of 16.6 per cent and a smaller decline for Tanzania from a simple average tariff of 14.3 per cent. However, Uganda's simple average tariff will increase by about 20 per cent.

Tanzania and Uganda apply excise duties and other discriminatory charges to protect products from Kenyan imports. This means that while tariffs are currently lower in Tanzania and Uganda, the nominal rates of protection may not vary considerably among EAC members. However, with the implementation of the CET, all discriminatory excise duties (except those applied to mineral water, tobacco, beer and other alcoholic beverages) together with suspended duties will be eliminated. From the analysis above, it is seen that the CET will reduce Kenya's external tariffs and therefore lower the price of imports.

6.8. Common Market for Eastern And Southern Africa (COMESA)

The Common Market for Eastern and Southern Africa (COMESA) evolved out of the former Preferential Trade Area (PTA) which had existed since the early days of 1981. The establishment of COMESA followed a treaty signed in 1993 and was ratified in 1994. COMESA was established as an organisation of free independent sovereign states which have agreed to cooperate in developing their natural and human resource for the good of all their people. The COMESA has a strategy of economic prosperity through regional integration. Its main focus is the formation of a large economic and trading unit that is capable of overcoming some of the barriers that are faced by individual states.

6.8.1. History of COMESA

At the first and second conferences of independent African States, held in Accra, Ghana, in April 1958 and in Addis Ababa, Ethiopia in June 1960, respectively, economic problems to be faced by independent Africa were discussed. There was a consensus that the smallness and fragmentation of post-colonial African national markets would constitute a major obstacle to the diversification of economic activity, away from a concentration on production of a narrow range of primary exports, to the creation of modern and internationally competitive enterprises, which would satisfy domestic needs and meet export requirements. It was, therefore, agreed that African countries which had gained political independence, should promote economic co-operation among themselves.

Two options were advocated for the implementation of the integration strategy in Africa:

- The Pan-African, all-embracing regional approach, which envisaged the immediate creation of a regional continental economic arrangement; and

- The geographically narrower approach that would have its roots at the sub-regional levels and build on sub-regional co-operation arrangements to achieve geographically wider forms of co-operation arrangements.

The majority of the countries favoured the narrower sub-regional approach. Based on this, the United Nations Economic Commission for Africa (ECA) proposed the division of the continent into four sub-regions: Eastern and Southern, Central, West and North Africa. The Commission's proposals were adopted by the Organisation of African Union (OAU) Conference of Heads of State and Government. All independent African Sates were enjoined to take, during the 1980's, all necessary steps to strengthen existing sub-regional economic co-operative groupings and, as necessary, establish new ones so as to cover the whole continent subregion by subregion and promote co-ordination and harmonization among the groupings for the gradual establishment of an African Economic Community by the end of the century.

The origins of the COMESA can be traced as far back as the mid-sixties. Before the Lagos Plan of Action and the Final Act of Lagos were adopted, the countries of Eastern and Southern Africa had already initiated the process towards creating an Eastern and Southern African co-operation arrangement.

In October 1965, the ECA convened a ministerial meeting of the then politically independent states of eastern and southern Africa to consider proposals for the establishment of a mechanism for the promotion of subregional economic integration. The meeting, which was held in Lusaka, Zambia, recommended the creation of an Economic Community of Eastern and Southern African states. To achieve this objective, the meeting also recommended that an Interim Council of Ministers, assisted by an Interim Economic Committee of officials, should be set up to negotiate the treaty and initiate programmes on economic co-operation, pending the completion of negotiations on the treaty.

At the first meeting of the interim Ministerial Council held in Addis Ababa, in May 1966, the Terms of Association to govern the interim arrangements before the signing of the formal Treaty were adopted and signed by Burundi, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Somalia, Tanzania, and Zambia. In November 1967, a meeting of the Interim Economic Committee of officials recommended an interim programme of action for implementation which would be integrated into the Treaty when approved. Parallel with these developments, two other organizations were established, the Pan-African Freedom Movement in East, Central and Southern Africa (PAFMECSA), and the conference of East and Central African states. Although these were mainly political in their orientation, their membership extended beyond the subregion and they included in their activities programmes on economic co-operation.

In the 1970's, the need for a subregional economic arrangements became more urgent as a result of three major developments. First, the collapse of the federations in Eastern and Central Africa reduced political cooperation amongst States of the region and this needed to be addressed. Second, the destabilization of the economies of the southern African States by apartheid South Africa made it necessary to create, as a matter of urgency, a subregional organization which would be an economic counterweight to South Africa. Third, despite the failure of earlier efforts to establish a sub-regional economic cooperation arrangement, the countries of Eastern and Southern Africa recognised that there was no alternative to reducing their traditional economic dependence on the industrialized countries of the north and that this could only be done through the adoption of self-sustaining development measures in all sectors.

In March 1978 the First Extra-ordinary meeting of Ministers of Trade, Finance and Planning met in Lusaka. The meeting recommended the creation of a sub-regional economic community, beginning with a

subregional trade area which would be gradually upgraded over a ten-year period to a common market until the community had been established. To this end, the meeting adopted the Lusaka Declaration of Intent and Commitment to the Establishment of a Preferential Trade Area for Eastern and Southern Africa and created an Intergovernmental Negotiating Team on the Treaty for the establishment of the PTA. The meeting also agreed on an indicative time-table for the work of the Intergovernmental Negotiating Team.

After the preparatory work had been completed a meeting of Heads of State and Government was convened in Lusaka on 21st December 1981 at which the Treaty establishing the PTA was signed. The Treaty came into force on 30th September 1982 after it had been ratified by more than seven signatory states as provided for in Article 50 of the Treaty.

The PTA Treaty envisaged its transformation into a Common Market and, as such, the Treaty establishing COMESA was signed on 5th November 1993 in Kampala, Uganda and was ratified a year later in Lilongwe, Malawi on 8th December 1994.

The process of economic integration in Eastern and Southern Africa has, therefore, not been episodic, but rather systematic, following a logical progression on a step by step basis. Firstly, a Preferential Trade Area was established and operated for over a decade, which was then transformed into a common market. The third phase will involve the eventual establishment of an Economic Community.

However, due to COMESA's economic history and background its main focus is on the formation of a large economic and trading unit that is capable of overcoming some of the barriers that are faced by individual states.

COMESA's current strategy can thus be summed up in the phrase 'economic prosperity through regional integration' http://www.comesa.int. With its 19 member states, a population of over 389 million and annual import bill of around US$32 billion and with an export bill of US$82 billion, COMESA forms a major market place for both internal and external trading. Its area in the African Continent covers a geographical area of 12 Million (sq km). Its achievements to date have been significant.

6.8.2. COMESA's priorities and objectives

The priorities and objectives of COMESA are defined in the Treaty and its protocols. They were designed to as to facilitate the removal of the structural and institutional weaknesses in the member states and the promotion of peace, security and stability so as to enable the member states attain sustained development individually and collectively as a regional bloc. The objectives are as follows:

- To achieve trade promotion, which includes:
  - Trade liberalisation and Customs co-operation, including the introduction of a unified computerised Customs network across the region;
  - Improving the administration of transport and communications to ease the movement of goods services and people between the countries;
  - Creating an enabling environment and legal framework which will encourage the growth of the private sector, the establishment of a secure investment environment, and the adoption of common sets of standards; and

- The harmonisation of macro-economic and monetary policies throughout the region.

- To attain sustainable growth and development of the member states by promoting a more balanced and harmonious development of its production and marketing structures;
- To promote joint development in all fields of economic activity and the joint adoption of macroeconomic policies and programs;
- To raise the standard of living of its people;
- To foster closer relations among its member states;
- To cooperate in the creation of an enabling environment for foreign, cross border and domestic investment, including the joint promotion of research and adaptation of science and technology for development;
- To cooperate in the promotion of peace, security and stability among the member states in order to enhance economic development in the region;
- To cooperate in strengthening the relations between the Common Market and the rest of the world and the adoption of positions in international fora; and
- To contribute towards the establishment, progress and the realisation of the objectives of the African Economic Community.

The COMESA agenda is to deepen and broaden the integration process among member States through the adoption of more comprehensive trade liberation measures such as the complete elimination of tariff and non-tariff barriers to trade and elimination of customs duties; through the free movement of capital, labour, goods and the right of establishment; by promoting standardised technical specifications, standardisation and quality control; through the elimination of controls on the movement of goods and individuals; by standardising taxation rates (including value added tax and excise duties), and conditions regarding industrial co-operation, particularly on company laws, intellectual property rights and investment laws; through the promotion of the adoption of a single currency and the establishment of a Monetary Union; and through the adoption of a Common External Tariff (CET).

By agreeing to the above, member States have agreed on the need to create and maintain:

- a full free trade area guaranteeing the free movement of goods and services produced within COMESA and the removal of all tariffs and non-tariff barriers;
- a customs union under which goods and services imported from non-COMESA countries will attract an agreed single tariff all COMESA States;
- free movement of capital and investment supported by the adoption of common investment practices so as to create a more favourable investment climate for the entire COMESA region:
- a gradual establishment of a payments union based on the COMESA Clearing House and the eventual establishment of a common monetary union with a common currency;
- the adoption of a common visa arrangement, including the right of establishment leading eventually to free movement of bona fide persons.

6.8.3. Principles of COMESA

The Treaty establishing COMESA binds together free independent sovereign States which have agreed to cooperate in exploiting their natural and human re- sources for the common good of all their peoples. In attaining that goal, COMESA recognises that peace, security and stability are basic factors in providing investment, development, trade and regional economic integration. Experience has shown that civil strife,

political instabilities and cross-border disputes in the region have seriously affected the ability of the countries to develop their individual economies as well as their capacity to participate and take full advantage of the regional integration arrangement under COMESA. It has now been fully accepted that without peace, security and stability there cannot be a satisfactory level of investment even by local entrepreneurs.

Therefore, in pursuit of the aims and objectives stated in Article 3 of the COMESA Treaty, and in conformity with the Treaty for the Establishment of the African Economic Community signed at Abuja, Nigeria on 3rd June 1991, the member States of COMESA have agreed to adhere to the following principles:

- equality and inter-independence of the member States;
- solidarity and collective self-reliance among the member States;
- inter-State co-operation, harmonisation of policies and integration of programmes among the member States;
- non-aggression between the member States;
- recognition, promotion and protection of human and people's rights in accordance with the provisions of the African Charter on Human and People's Rights;
- accountability, economic justice and popular participation in development;
- the recognition and observance of the rule of law;
- the promotion and sustenance of a democratic system of governance in each member State;
- the maintenance of regional peace and stability through the promotion and strengthening of good neighbourliness; and
- the peaceful settlement of disputes among the member states, the active co-operation between neighbouring countries and the promotion of a peaceful environment as a pre-requisite for their economic development.

COMESA is an all-embracing development organisation involving co-operation in all economic and social Sectors. However, due to resources constraints, the implementation of activities and programs will be prioritised to areas where the greatest impacts can be made. To that end, the first COMESA Authority of Heads of State and Government, at its meeting held in Lilongwe, Malawi from 8th to 9th December 1994, adopted the following five priorities to be the basis of COMESA's focus for the next five to ten years:

- significant and sustained increases in productivity in industry, manufacturing, processing and agro-industries to provide competitive goods as the basis for cross-border trade and to create more wealth, more jobs and more incomes for the people of the region;
- increase agricultural production, with special emphasis on the joint development of lake and river basins so as to reduce dependence on rain-fed agriculture and new programmes on food security at the provincial or district levels, national and regional levels;
- development of transport and communications infrastructures and services with special emphasis on linking the rural areas with the rest of the economy in each country as well as linking the member States;
- new programs for trade promotion, trade expansion and trade facilitation especially geared to the private sector, so as to enable the business community to take maximum advantage of the Common Market, and

- development of comprehensive, reliable and up to date information data bases covering all sectors of the economy including industry, energy, environment, agriculture, transport, communications, investment and finance, trade, health and human resources to form the basis for sound investment decisions and macroeconomic policy formulation and programming.

6.8.4. COMESA Institutions

Several institutions have been created to promote sub-regional co-operation and development. These include:

The COMESA Court of Justice

This is the judicial organ of COMESA, having jurisdiction to adjudicate upon all matters which may be referred to it pursuant to the COMESA Treaty. Specifically, it ensures the proper interpretation and application of the provisions of the Treaty; and it adjudicates any disputes that may arise among the member states regarding the interpretation and application of the provisions of the Treaty. The decisions of the court are binding and final. Decisions of the court on the interpretation of the provisions of the COMESA Treaty have precedence over decisions of national courts.

6.8.4.1. CLEARING HOUSE

The Clearing House was brought into existence when the countries of the region had strict exchange control regimes in place and foreign exchange was scarce. The clearing system allows businesses to invoice their exports in national currencies or in UAPTA. The COMESA central banks, in turn, offset these transactions on a daily basis through the Clearing House but only settle net debtor balances in hard currencies every two months.

The advantage derived from the Clearing House consists of the alleviation of the problem of inadequate foreign exchange through the use of national currencies in the region's transactions, thus giving them partial convertibility; confirmation of letters of credit is not necessary because they are only opened after the importer's monetary authority approves the transaction and takes on an obligation to settle its net balances at the end of the two month period; and prompt payment is made to the exporter as each transaction is backed by the central banks.

All the parties to this arrangement benefit in that net debtor countries gain credit in foreign exchange for their outstanding net debit balances, whereas net creditor countries increase their export potential.

With the adoption of economic reform and structural adjustment programs in most COMESA countries, leading to the direct availability of foreign exchange to firms and importers, the value of the services the Clearing House has been offering since 1984 have diminished and the Clearing House needs to redefine its role and the services it offers.

Some of the roles it could offer to enhance integration and, through integration, economic growth would include:

- improving the efficiency of clearing operations so that they are able to complement the services offered by commercial banks;

- providing traders within the region with some form of political insurance on intra-regional trade; and
- the facilitation of monetary and fiscal policy harmonisation within the region.

6.8.4.2. THE PTA TRADE AND DEVELOPMENT BANK

The Eastern and Southern African Trade and Development Bank (PTA Bank) was established on 6 November 1985 following the provisions of the Treaty of 1981 establishing the Preferential Trade Area (PTA), which has since been transformed into the Common Market for Eastern and Southern African States (COMESA), as a financial arm of the integration arrangement.

ZEP-RE

ZEP-RE (PTA Reinsurance Company) is a regional organisation charged with the task of promoting trade, development and integration within the COMESA region through trade of insurance and reinsurance business.

ZEP-RE was created by an Agreement of Heads of State and Government of the COMESA region on 21st November 1990 in Mbabane, Swaziland. The Company established office in Nairobi, Kenya in September 1992 and commenced writing business on 1st January 1993. The Company is headquartered in Nairobi, Kenya and operates a regional office in Khartoum, Sudan.

6.8.4.3. LEATHER AND LEATHER PRODUCTS INSTITUTE

The COMESA/Leather and Leather Products Institute (LLPI) headquartered in Addis Ababa, Ethiopia, was established by the signing of the Charter by COMESA Member States in Mbabane, Swaziland on 23rd November 1990 in order to promote productivity, competitiveness, trade and regional integration in the leather sub-sector through the provision of the following key services:

- Human resources development;
- Investment and trade promotion;
- Research and development;
- Consultancy and extension and
- Information collection and dissemination.

6.8.4.4. NON-COMESA INSTITUTIONS

Regional Integration Facilitation Forum (RIFF) is a voluntary and non-binding arrangement under which participating countries implement measures aimed at facilitating the flow of investment into their economies and across the region, and further improving their trade regimes. These measures are intended to contribute to the repositioning and restructuring of their economies as well as enhancing their integration regionally and globally. The RIFF is not a COMESA program.

The Inter-Regional Coordination Committee (IRCC) is a joint effort of the regional integration organizations (RIO) and was formed in January 2003 for the programming, implementation, monitoring, review and evaluation of the regional strategy and its programs and projects amongst the RIOs. It is based at the COMESA secretariat.

6.8.5. COMESA's achievements

COMESA, as well as its predecessor the PTA, has achieved a lot in the area of trade, customs, transport, development finance and technical co-operation.

Intra-COMESA trade, valued at about US$4.2 billion, is growing at the rate of 20per cent per annum. Trade with third countries is growing at about 7 per cent per annum.

Transport transit facilitation measures have resulted in a reduction of costs by 25 per cent.

Inter-state movement of persons, goods and means of transport facilitated.

COMESA has established several important institutions including the PTA Trade and Development Bank, the COMESA Clearing House, the COMESA Re-insurance Company and the COMESA Leather and Leather Products Institute.

The Re-Insurance Company (ZEP-RE) has, since its establishment in 1992, been able to carve out a reasonable share of the regional insurance business and is now transacting business in some nineteen countries.

The PTA Bank has, over the years, been very active in promoting investments and providing trade financing facilities.

COMESA also recognizes the need to promote investment in the region and addresses this issue through facilitation of bilateral agreements; promoting export drives by individual member States, and identifying specific projects which have the potential to act as growth poles between two or more member States.

In the sector of telecommunications, special emphasis has been placed on network development to enable direct telecommunication links through more reliable infrastructure in order to avoid third country transit systems, which prove to be very costly.

6.8.6. Benefits of COMESA

Benefit from financial assistance extended by the African Development Bank and other international funding institutions in the area of promoting exports to African countries.

The Agreement provides for the establishment of an advanced shared information system within member countries.

More gains can be accrued from the Agreement in the area of industrial and agricultural cooperation as well as transport and communication.

Benefit from exchanged exemptions, given the accession to the COMESA free trade area of 11 member countries where imports of products originating in other member countries are allowed duty-free.

Populations in the COMESA member countries are estimated at 380 millions which would normally account for a wide and competitive market for their products.

Regional trade agreements can play an important role in addressing the hindrances to trade. They can help address concerns over policy credibility by locking in domestically implemented trade liberalisation and functioning as an agency of restraint.

Regional cooperation such as COMESA can be effective in addressing weaknesses in infrastructure and harmonisation of standards and customs procedures.

A strong COMESA can also strengthen the Members bargaining power in the multilateral negotiations.

A strong COMESA can also be a means for deeper integration where deep integration includes integration of national regulatory systems and policies, competition policies and investment rules. Deep integration is viewed as having the potential to create an open and credibility policy environment to encourage foreign direct investment (FDI) and export oriented growth. However, according to Chauvin and Gaulier (2002), important structural changes may be necessary in order to expand trade potential in the region.

6.8.7. Challenges of COMESA

Most of the countries that are members of COMESA are also members of EAC and other regional trading blocks such as SADC. Conflicting objectives among rival arrangements may contribute to a lack of progress in many areas (Iqbal and Khan, 1997).

Product complementarities between countries are an important indicator of potential for expansion of intraregional trade.

Table 25 shows Kenya's trade in the COMESA region in Kenya Shillings from 2002 to 2006. The Table shows Kenya's exports to the COMESA region reached a peak in 2005 and fell slightly in 2006. It is also important to note that the proportion of Kenya's exports to the COMESA region is over 30 per cent of its total export s in the world market. However, the proportion of its imports from the COMESA region forms only a small proportion (less than 3 per cent) of its total imports from the world market.

TABLE 25: KENYA'S TRADE WITH THE COMESA (KSH. MILLION)

Region	Total Exports					Total Imports				
	2002	2003	2004	2005	2006*	2002	2003	2004	2005	2006
Angola	65	259	119	124	311	24	1	-	10	89
Burundi	1798	2752	2972	3714	2184	1	2	3	20	339
Comoros	272	307	365	514	384	-	-	-	-	-
Congo, D. R	4951	5367	7832	10171	7627	431	57	414	906	923
Djibouti	471	378	524	676	851	-	-	1	113	713
Egypt	6752	5453	6918	8848	9871	2865	4855	6426	6268	8212
Eritrea	431	411	205	1034	574	-	3	1	908	31
Ethiopia	1981	1625	2218	2530	3671	11	16	102	64	119
Madagascar	656	474	281	414	522	15	-	1	8	61
Malawi	758	759	1133	1437	1808	925	1122	647	443	256
Mauritius	163	744	608	511	491	439	489	1249	970	414
Namibia	2	22	20	9	11	91	76	23	16	22
Rwanda	4313	6012	6190	7282	4765	6	5	16	115	210
Seychelles	245	199	242	281	282	8	-	3	-	321
Sudan	2818	4379	5574	6797	10100	254	566	234	217	86
Swaziland	3	72	3	9	8	2030	1749	3340	2869	3842
Uganda	31280	30668	37059	42679	27812	664	1038	1009	1396	1002
Zambia	1696	1646	2352	2726	2043	345	390	645	809	1431
Zimbabwe	443	242	178	268	120	1511	1493	478	324	205
Total COMESA	59098	61769	74794	90026	75436	9620	11863	14593	15455	17565
% of total exports/imports	34.9	33.7	34.8	34.6	30.1	3.7	4.2	4	3.5	2.9

* Provisional

Source: Kenya National Bureau of Statistics

The bilateral product complementarity index between two countries j and k (C_{jk}) is defined as:

$$(C_{jk}) = 100 - \sum_i (|M_{ik} - X_{ij}| \div 2) \qquad (1)$$

Where X_{ij} represents share of good i in the total exports of country j and M_{ik} represents the share of good I in the total of country k (Tsikata, 1999). The index is a measure of similarities between the export basket of one country and the import basket of another country. The value of the complementary index can range from zero, which represents no complementarity between exports and imports of two countries, to one hundred, which represents a perfect match. The higher the index between two countries, the greater the product complementarity (Khandelwal, 2004).

Khandelwal (2004) calculated the bilateral product complementarity indices for COMESA member countries using the UN-COMTRADE data at the two digit classification level. The author's results indicate that within COMESA, product complementarities between exports of Egypt and imports of other member countries average to 43.0 while those for Kenya's exports to the region average 38.6. For all other countries, the average product complementarity for exports is far lower. This implies that while there is scope for Egypt and Kenya to export to the region, there is no much scope for other countries to do the same since there are few complementarities for their exports. Kenya and Egypt do not also import many of the products exported by other countries in the region. This asymmetric complementarity implies that the more developed economies of Egypt and Kenya are in a much better position to market their exports in

COMESA but the less developed countries are unable to find significant markets in COMESA. This can lead to polarisation as investment may be attracted towards the larger and more industrially diversified economies in the region. Yeats (1998) also found that African countries tend to have exports concentrated in a few commodities, reducing their possibilities of intra-regional trade.

Within COMESA, intra-regional trade expanded at an average annual rate of 18.8 per cent since the creation of the Free Trade Area in 2000. Growth in intra-regional trade slowed in the mid and late 1990s but recovered after the creation of the FTA. However, although intra-regional and total trade have been growing at a healthy pace in recent years, opportunities for trade from greater integration in the COMESA region might be somewhat limited since the product complementarities and levels of intra-regional trade are low and there is risk of polarisation.

Iqbal and Khan (1997), Oyejide, Elbadawi and Yeo (1997) note that African trade is hindered by a number of factors including distorted trade regimes, high transaction costs due to inadequate transport, information and communications infrastructure, lack of political commitment and frequent policy reversals, difficulties in implementing harmonisation provisions, multiple and conflicting objectives of overlapping regional arrangements, and limited administrative resources.

COMESA has a great deal to do in order for member states to take advantage of possible benefits from regional integration. It is important that COMESA becomes an effective vehicle for non-discriminatory tariff liberalisation as well as addressing weaknesses in infrastructure, harmonisation of standards and customs procedures. It should function as an agent of restraint and provide policy credibility through locking in trade openness.

6.9. Impact of EAC and COMESA Trade Agreements on Kenyan Trade

We first look at the impact of EAC on Kenyan trade and thereafter we shall look at the impact of COMESA.

6.9.1. Impact of EAC on Kenyan trade

McIntyre (2005) found that the EAC customs union will have positive trade benefits for Kenya because the adoption of the EAC common external tariff will lead to increased flows of cheaper extra regional imports that are likely to lower consumer prices with positive welfare effects. This would happen if the removal of internal tariffs is accompanied by a lowering of Most Favoured Nation (MFN) tariffs with the adoption of the EAC common external tariff. However, a World Bank (2000) study concluded that regional integration arrangements between developing countries that provide preferential access to member states but keep external trade policy with respect to the rest of the world unchanged are likely to lower welfare for the bloc as a whole. High external tariffs encourage trade diversion and provide strong incentives for inefficient firms to expand. That is, high external tariff barriers negate the benefits from increased competition. Therefore, to ensure that a RTA does not encourage inefficiency, facilitate trade diversion, and ultimately reduce economic welfare, it is essential to lower MFN tariffs as barriers to intra-RTA trade are eliminated, that is open regionalism.

However, despite the potential benefits from liberalisation of the trade regime, there are costs that would have to be addressed. Trade creation means that import competing sectors would face increased

competition and would need to make adjustments to improve efficiency and overall competitiveness. Consequently, there may be transitional output and employment losses associated with the EAC customs union. Policies would need to be put in place to minimize the dislocation caused by the lowering of tariffs. For import competing sectors to respond to increased competition from cheaper imports, it is important that Kenya, over the medium term, sustain the implementation of a comprehensive package of macroeconomic and structural reforms to improve efficiency and international competitiveness. This would include strong governance policies to improve transparency and accountability and eliminate corruption; strengthening the efficiency of the financial system; labour market reforms to increase labour market flexibility; an accelerated program of parastatal reform and privatisation to increase efficiency and private sector involvement in the economy and prudent fiscal policies to ensure that adequate resources are devoted to infrastructural development and improving the levels of education and health.

McIntyre (2005) using simulations of import flows and the tariff schedules for Kenya also found that the customs union may result in Kenya experiencing revenue losses of $US113.3 million. This is in contrast to the World Bank (2003) study that estimated the revenue losses from the three band structure (0, 10, 25) approximately $US150 million for Kenya. The World Bank study had estimated the revenue effects by calculating a baseline using data on import flows, tariff schedules, excises and VAT rates. Thus, empirical evidence suggests that there will be short run revenue losses from the full implementation of the EAC customs union and policy makers have to design policy responses to recoup revenue losses. World Bank (2003) estimated that in Kenya, customs exemptions amount to 22 per cent of potential customs revenue, so to compensate for revenue losses policy makers could streamline exemptions, widening the tax base and increasing revenues.

Castro et al (2004) used data collected by the governments of Kenya (Kenya Revenue Authority); Customs and Excise), Tanzania (Tanzania Revenue Authority, Excise and customs Department) and Uganda (Uganda Revenue Authority, Customs Department0 on trade flows, MFN tariff rates, preferential tariff rates, customs revenue, suspended duties, and excises at the 8-digit HS level. They also got from the Kenya Revenue Authority (KRA) the negotiated CET and a list of “sensitive” and other products for which the three countries had so far not decided tariff classification. They used IMF data on Kenyan imports on which Tanzania and Uganda would levy temporary tariffs which are to be phased out according to an agreed schedule.

Table 26 shows their baseline 2002 import flows into the EAC member states from within and outside the region, in values and shares calculated on the basis of the data received from the authorities in the three EAC countries.

TABLE 26: EAC REGIONAL AND TOTAL IMPORTS BASELINE

In % unless otherwise indicated	**Kenya**	**Tanzania**	**Uganda**	**EAC**
Total Imports ($US million)	3,449.7	1,512.3	917.9	5,880.0
Imports from third countries	99.6	95.1	74.8	94.6
Imports from EAC	0.4	4.9	25.2	5.4
Imports from Kenya	-	4.6	24.6	-
Imports from Tanzania	0.19	-	0.6	-
Imports from Uganda	0.22	0.3	-	-

- not applicable

Source: World Bank calculations based on 2002 data.

After doing some simulations, Castro et al (2004) found that as a result of reducing the remaining regional barriers to trade, imports from other EAC members would moderately increase in all three EAC member states compared to the 2002 baseline. Table 9 shows the results of these simulations.

TABLE 27: IMPORT CHANGES WITH TOP RATE AT 25 PER CENT AND TEMPORARY TARIFFS ON IMPORTS FROM KENYA

Changes in %	Kenya	Tanzania	Uganda	EAC
Total Imports	11.16	13.94	-0.91	9.99
Imports from third countries	11.20	14.57	-1.27	10.53
Imports from EAC	2.18	1.66	0.15	0.59
Imports from Kenya	-	1.52	0.08	-
Imports from Tanzania	3.90	-	2.78	-
Imports from Uganda	0.68	3.87	-	-

- not applicable
Source: World Bank Staff Simulations based on 2002 data

From Table 27 it can be seen that an increase in imports from Kenya is kept in check by the temporary tariffs on selected imports imposed by Tanzania and Uganda. Imports from Tanzania and Uganda increase a bit more, but since they start from a low base, the value of the increase is almost insignificant.

Implementation of the CET will significantly increase third country imports into Kenya and Tanzania and reduce them for Uganda. For Kenya and Tanzania, the tariff reduction following the CET implementation will result in significant increases of imports from outside the EAC region. For Kenya the increase is 11.2 per cent, and for Tanzania 14.6 per cent. However, in Uganda, where the protection rises with implementation of the CET, imports from outside the EAC decline by 1.3 per cent.

The increase of third country imports implies cheaper imports fro Kenyan and Tanzanian consumers and producers. For Kenya and Tanzania, the CET schedule is more liberal than the current trade policy regime. Thus, the Customs Union implementation will make third country imports cheaper, and demand for such imports will surge. For imported consumption goods, consumer surplus will increase as a result of the price decline. For producers using imported inputs, production costs will decline, and producer surplus will increase. Producers of goods that compete with imports will see their profit margin shrink because of the decline in the domestic price. In the aggregate, these effects should lead to a welfare increase for the Kenyan and Tanzanian economies.

Conversely, in Uganda, the customs union implementation will increase prices for imported goods. This is because the CET in Uganda is higher than the current tariff schedule, and the customs union implementation thus leads to more expensive imports, which will cause demand to contract. Consumer surplus for consumers of imported goods will decline, as will producer surplus for producers using imported inputs. Producers of import-competing goods will see their producer surplus increase. In the aggregate, the decline in third country imports signifies a welfare loss.

Elimination of temporary tariff will increase regional imports but further reduce third country imports into Uganda. Table 10 shows import changes with respect to the base line that would occur if the EAC was to immediately implement the second phase of the customs union where all transitional tariffs against imports from Kenya are eliminated.

TABLE 28: IMPORT CHANGES WITH TOP RATE AT 25 PER CENT AND NO TEMPORARY TARIFFS ON IMPORTS FROM KENYA

Changes in %	Kenya	Tanzania	Uganda	EAC
Total Imports	11.16	13.94	-0.91	9.99
Imports from third countries	11.20	14.50	-3.26	10.26
Imports from EAC	2.18	3.12	6.05	5.20
Imports from Kenya	-	3.07	06.14	-
Imports from Tanzania	3.90	-	2.78	-
Imports from Uganda	0.68	3.87	-	-

- not applicable

Source: World Bank Staff Simulations based on 2002 data

The change in total imports will be the same as in the first phase since in a small customs union, import prices will be determined by the world market and the MFN common external tariff schedule, which is the same in the first and second customs union phase. Comparing Tables 9 and 10, we see that elimination of Ugandan and Tanzanian tariffs on Kenyan imports would result in higher increases of imports from Kenya. For Tanzania, the increase would be twice as large at 3.07 per cent. For Uganda, imports from Kenya increase by 6 per cent. Since total import changes are the same in the first and second phase, the higher increase of regional imports means a lower increase in third country imports. The difference is minimal for Tanzania where third country imports will still increase by about 15 per cent. For Uganda, however, the decline in third country imports is much larger if temporary tariffs on Kenyan imports are not in place. The reason for this difference is that imports from Kenya are a much larger fraction of total imports for Uganda than for Tanzania.

6.9.2. Trade creation and trade diversion

The welfare implication of an increase in regional trade following a customs union formation is ambiguous. By dismantling regional trade barriers, formation of a customs union is expected to increase trade between the member countries. If trade expands following international comparative advantage, then there would be trade creation. If trade is created, a more competitive producer from within the customs union would replace a less competitive domestic one, which would increase efficiency of resource allocation and thus reduces consumer prices and increases welfare. However, the formation of a customs union can also reduce the efficiency of resource allocation when trade creation between customs union members expands because of the preferential market access given to customs union members as compared to the rest of the world. This is what is referred to as trade diversion because imports are shifted from the most efficient source to a more expensive one within the customs union. Trade diversion is not driven by competitive advance and therefore leads to a distortion in resource allocation, little or not change in consumer prices, a decline in tariff revenue and a decline in over all welfare.

Castro *et al* (2004) included the supply functions to the original partial equilibrium model and changed the assumption that the most favoured nation common external tariff determines all import prices. This assumption imposed on the model that regional preferences will cause trade diversion. Table 29 shows what fraction of regional imports is in goods where the EAC countries import from a mix of third countries and regional sources.

TABLE 29: TRADE CREATION OR TRADE DIVERSION

Fraction of regional imports where there are also third country imports in the same tariff line (in % of total)				
		Kenya	**Tanzania**	**Uganda**
From	To			
Kenya		-	98.98	98.53
Tanzania		100	-	93.98
Uganda		100	99.98	-

From Table 29, it can be seen that in all countries, regional imports are dominated by imports from third countries. Nearly 100 per cent of regional trade flows are in goods where importing countries source predominately from third countries, and only a small fraction where EAC partners are sole suppliers of import products. It is therefore likely that all increases in regional trade are driven by substation of regional for third country imports that is trade diversion.

Schiff and Winters (2003) compiled studies on the trade and welfare effects of customs unions across the world and concluded that the elimination of regional trade integration and tariff between small developing countries is likely to generate mostly trade diversion and little trade creation. However, in many cases the formation of regional trade blocs between developing countries has been accompanied by significant tariff liberalisation, and reduction in most favoured nation tariff rates had resulted in trade creation and thus positive welfare effects for the customs union member states. In the Castro et al (2004) simulations, they found that the dismantling of regional trade barriers leads to significant trade diversion for Uganda. Therefore, the EAC customs union would lead to less skewed welfare effects if the common external tariff was lower, at least as lows as the current Uganda tariff schedule with rates of 0 per cent, 7 per cent and 15 per cent.

6.9.3. Revenue loss/gain

From the Castro et al (2004) simulations of the changes in import flows that are likely to follow the customs union implementation, they concluded that for Kenya and Tanzania, the EAC customs union is likely to be welfare enhancing because of cheaper imports for consumers and producers. Uganda is likely to be worse off. Another welfare effect of the customs union is the revenue implications of changes in trade policy.

Imports from third countries will significantly increase for Tanzania and Kenya, which will have a positive welfare effect through an increase of consumer surplus and producer surplus for producers using imported input. Producers of import competing goods will see their profit margin shrink under the competition of imports. The overall effect will be increased welfare for the whole economy, although there will be winners and losers. Cheaper imports especially of goods consumed by the poor, and inputs for subsistence farmers will help poverty alleviation. Structural adjustment for sectors that will become less competitive needs to be well understood in advance so that the government can develop a strategy to avoid displaced producers or workers falling into poverty. The situation is different for Uganda where for total imports decline compared with pre-customs union situation. This implies a negative economy-wide welfare effect, distributed as follows: (a) Consumers surplus and surplus for producers using imported inputs will decline whereas producers of import competing goods will benefit from the higher protection; (b) the gain for these producers reflects an inefficient resource allocation. In addition, Uganda will suffer welfare losses through foregone revenue because of trade diversion. This revenue will be transferred to Kenya and to

lesser extent Tanzania exporters, who will see producer surplus increase as they become more competitive in the Ugandan market because of duty free market access.

6.9.4. Impact of COMESA on Kenyan trade

Musila (2004) used the gravity model to examine the impact of the Common Market for Eastern and Southern Africa on the flow of Kenya's exports. The empirical results suggested that COMESA has the effect of trade creation. No evidence for trade diversion was found. Accordingly, COMESA has helped to improve Kenya's export performance and, in turn, assisted in the effort to achieve the Millennium Development Goals. The results also show that nominal GDP of importing countries, distance, adjacency, and common official language had a statistically significant impact on the flow of Kenya's exports.

6.10. Expected Impact of the Economic Partnership Agreements (EPAs)

6.10.1. Definition of EPAs

Free Trade Agreements (FTAs) between developing countries and developed countries have increased in recent years. This represents a shift from the non-reciprocal trade preferences that were traditionally offered to developing countries. Trade preferences for developing countries authorized under the enabling clause of the General Agreement on Tariffs and Trade (GATT) were based pm recognition of the relatively disadvantaged position of developing countries within the international trading systems. It was expected that preferential access to the markets of developed countries without the requirement for reciprocity would allow developing countries to expand and diversify exports thereby promoting economic growth.

The increase in north-south free trade agreements derives from the increasing pressure for trade liberalization in the global economy. The Doha Round of multilateral trade negotiations stalled mainly due to the failure of the United States of America and the European Union to agree to the demands of developing countries for further liberalization of agricultural trade. Consequently, bilateral free trade agreements are increasingly being used to pursue trade liberalization outside of the multilateral framework. The European Union (EU) has entered into bilateral free trade agreements with South Africa, Mexico and the Mediterranean countries and has been negotiating Economic Partnership Agreements with its former colonies in Africa such as Kenya, the Caribbean and the Pacific.

Free trade areas allow developed countries to gain enhanced access to the markets of developing countries. In addition, FTAs provide opportunities for developed countries to use their superior bargaining power to get some developing countries to enter into agreements on issues such as investment and labor standards that developing countries have consistently resisted during multilateral trade negotiations. For the developing country partner the net economic effect of a FTA with a developed country may not necessarily be positive. The potential economic benefits of the FTA depend on the ability of the developing country to take advantage of any increased market access offered by the FTA. On the other hand, the economic costs of a FTA to the developing country is contingent on the concessions it makes with respect to access to its markets for goods and services as well as on the terms of agreements on trade related issues such as intellectual property, investment and government procurement. Given the relatively weak bargaining position of developing countries compared to the developed countries, it is possible for the

economic costs of the FTA to outweigh the economic benefits that accrue to the developing country from improved market access.

6.10.2. Features of EPA

The EPA is expected to take the form of an FTA. It is expected that the EU will provide market access similar to that under the "Everything But Arms" (EBA) initiative. The provision of such a market access under EPAs will not be an improvement for LDC members of the negotiating group and by itself, will provide them with few incentives to participate. The rules of origin under EBA are more restrictive than those under the Cotonou Agreement. Therefore, LDCs are likely to seek an improvement through simpler and less restrictive rules of origin and full cumulation across all ACP countries, the EU, and other EBA countries.

6.10.3. History of EU- EPAS

On 23 November 2007 in Uganda the European Union and East African Community initialled an interim EPA agreement. This agreement will apply to the EU and to Kenya, Uganda, Tanzania, Rwanda and Burundi. Negotiators agreed that the first phase of negotiations for an EPA had been successfully completed and that they would continue negotiations towards a full EPA in 2008 and a rendezvous clause is included in the agreement to this effect.

The EU is an important trade partner in respect to imports and exports for countries in the African region. For example, the proportion of Kenya exports to the EU as a per cent its total export amounts to 30.1 per cent while the proportion of its imports from the EU amounts to about 23.6 per cent.

Historically, a group of 77 African-Caribbean-Pacific countries which includes all

member countries of COMESA except Egypt had been recipients of unilateral preferences into the EU market under the Lome Conventions. These preferences had provided them with important market access for agricultural and other exports. However, these unilateral preferences are incompatible with (World Trade Organisation (WTO) rules since the Enabling Clause in the GATT does not allow unilateral preferences that discriminate between groups of developing countries, except in favour of LDCs. Since preferences that had been granted to ACP countries were neither available to all developing countries, nor were they restricted to just LDCs, the Cotonou Agreement, concluded in 2000 required all ACP countries to negotiate WTO-compatible EPAs with the EU to replace unilateral preferential arrangements by end of 2007. The EPAs will involve reciprocal market access into the ACP countries for the EU with a possible transition period of 10 to 12 years for the phasing out of trade barriers between the parties in accordance with GATT Article XXIV.

According to the EU, the EPAs have a development and growth focus. They assist ACP countries in enlarging their markets by improving the predictability and transparency of the regulatory framework for trade and creating conditions for increased investment. In this context, the EU has placed strong emphasis on South-South integration through reinforcing existing regional integration initiatives, harmonisation of rules and creation of customs unions. Negotiations were conducted with regional economic groupings instead of individual countries.

6.10.4. Effects of EPAs on the Kenyan economy

One way of looking at the impact of EPAS on the Kenyan economy is to analyse the trade liberalisation impact on poverty reduction. The effect of trade liberalisation on poverty reduction depends on:

- How much poor people produce exported goods and consume imports;
- The degree of labour mobility;
- The state of domestic industries; and
- The state of income distribution.

Depending on these factors, trade liberalisation can create winners and losers, aggravating or reducing gender, income or regional disparities. A successful or pro-poor trade liberalisation strategy is one that ensures that the winners' gains outweigh the losers' losses. That is, the winners can compensate the losers.

The experience of the East Asian tigers demonstrates that successful trade policies must be aligned with rather than pursued in isolation from development strategies. For instance, trade liberalisation might be accompanied by complementary measures such as infrastructure development, skills formation, asset redistribution, interventions in basic services such as health and the extension of credit facilities.

According to an ActionAid International (www.actionaid.org), there is little evidence that trade liberalisation under EPAs would be aligned with Africa's or even Kenya's development needs. On the contrary, it would follow the indiscriminate approach employed during structural adjustment programs (SAPs), i.e. opening markets without considering the development needs of individual countries.

According to an ActionAid International (www.actionaid.org) report, the EPAs between the EU and the ACP countries constitute a major threat to poverty reduction and development. The EPAs will:

- Construct new rules and unfair trade rules by creating free trade areas between the EU and regional groupings of ACP;
- Reduce the policy space that ACP countries need to develop their economies and eradicate poverty;
- Lead to significant losses in ACP fiscal revenues;
- Lead to de-industrialisation in ACP countries;
- Undermine African regional integration; and
- Grant European corporations greater rights over African economies.

The report challenges the EU's argument that free trade EPAs are the only way to meet WTO requirements and to integrate African countries into the global economy. According to ActionAid, developing countries have a right to special and differential treatment under WTO rules and any new trade agreement between the EU and ACP countries must preserve this right.

In their research on Kenya, ActionAid refutes the EU's argument that EPAs will aid poverty reduction and promote sustainable development. ActionAid contends that reciprocal trade liberalisation under EPAs will lead to a decline in manufacturing and agro-industrial. Agro-processing industries such as Kenyan sugar industries are particularly vulnerable. This is because they will be forced to compete with established European corporations. Lost revenues from indiscriminate and premature trade liberalisation will create a strain on government finances and public services. EPA investment agreements will restrict the ability of the

Kenyan government to pursue nationally prioritised economic and social objectives. Hence, eliminating tariffs will create significant revenue losses to Kenya leading to either severe cutbacks in public services or increased taxes on poor people.

The EU is using the EPA negotiations to push through agreements on investment, government procurement and competition policy that the developing countries rejected in 2003. These agreements will reduce the policy space available to the Kenya government and to African governments in general.

EPAs threaten regional integration, a central plank of African development strategy since political independence. This strategy has sought to eradicate the economic problems created by the colonial fragmentation of Africa into many nation states with little economic coherence. The EPAs configuration process has created new regional groupings that are inconsistent with and undermine existing African economic and political blocs. Reducing regional integration to trade liberalisation undermines the broader socio-economic and political objectives of existing bodies.

ACP concerns have been marginalised while the EU had employed divide and rule tactics in the EPA negotiations. According to ActionAid, the EU ignored ACP concerns during the first phase of the negotiations and continues to meddle in internal ACP negotiation processes under the guise of capacity building.

ActionAid suggests that there are alternatives to EPAs such as extending the EBA scheme to all ACP countries or revising WTO rules to allow for truly pro-poor and pro-development EPAs.

ActionAid calls on British and European governments to change the European Union's EPA negotiating mandate and withdraw demands for reciprocal trade liberalisation and agreements on the Singapore Issues. Both EU and ACP countries must push for the reform of WTO rules to allow for pro-poor and pro-development trade agreements between developing and developed countries and that the EU must begin an immediate examination of all possible alternatives to EPAs.

The growing influence of developing countries such as China, India and Brazil has made it more difficult for the EU and the US to dictate terms to the rest of the world. As a result, both superpowers have increasingly focused on bilateral and regional trade negotiations in order to secure new markets for their goods and services and obtain concessions from poor countries such as Kenya that would be difficult to achieve a the WTO.

EPAs are premised on the assumption that indiscriminate trade liberalisation and market deregulation are best for achieving development. This model of development was forced upon many developing countries in the 1980s and 1990s through policy conditions imposed by World Bank and the IMF with disastrous consequences. Under this model, the number of people living below the poverty line continued to rise rather than decline. For example, in Africa, the number increased from 217 million in 1987 to 291 million (46 per cent of the total population) in 2000 (World Bank, 2001). In Kenya, its beverage, textile, sugar, cement, tobacco, leather and glass sectors have been struggling to survive competition from imports since a major trade liberalisation program was initiated in 1993. Between 1993 and 1997, growth in industrial output fell by 2.6 per cent while growth in industrial employment fell by 2.2 per cent.

The impact of trade liberalisation under EPAs would be deeper than that experienced under structural adjustment programs because SAPs involved tariff reduction, not elimination.

UNECA (2004) concludes that trade liberalisation alone will not boost growth and poverty reduction in Africa. Instead, UNECA argues that successful integration of Africa into the world economy will require better educated and healthier work forces, improved economic and political governance, better quality infrastructure, and dynamic trade policies including gradual and targeted trade liberalisation. UNCTAD (2004) also draws the same conclusion. UNCTAD warns that if past trends continue, the poorest countries in the world will continue to lag behind the rest in 2015, the year by which the international community hopes to halve the proportion of the global population living in extreme poverty.

Evidence from successful developed countries shows that protecting infant industries was an important part of their early trade and industrial policy. Careful use of protection together with other policies to encourage backward and forward linkages, learning and adoption of technology will be needed by African countries Kenya included to overcome the many market failures that exist in their economies. ActionAid argues that successful development needs dynamic, long term policy approach, which Africa will lose if it locks itself into free trade with Europe. ActionAid calls for the demands for full reciprocal trade liberalisation and negotiations on investment, competition policy and public procurement to be dropped from the EPA negotiations and that an alternative to EPA must be sought.

So far, Kenya's trade with the EU has been based on preferential market access. This means that most of her exports that are predominantly primary agricultural products have attracted no tariffs. On the other hand, EU exports to ACP countries have attracted tariffs based on the applicable tariffs notified to the WTO. The new trade arrangement under EPAs will liberalise tariffs which means that African countries will need to eventually remove tariffs to EU imported goods creating fully reciprocal trade agreement. Kenya is expected to agree on a common tariff structure that could lower tariffs on at least 80 per cent of imports.

In addition, EPAs could create new binding rules targeting liberalisation in key areas such as investment, competition, government procurement, intellectual property and services. These measures are expected to have varying impacts on ACP economies. The current paralysis at the WTO as a result of the collapse of trade talks in July 2006 has increased the urgency for the EU to conclude the negotiations and put ACP countries under tremendous pressure to beat the year-end deadline to conclude the talks.

Kenya largely exports primary agricultural products to the EU while importing mainly value-added goods such as machinery, electronic equipment, chemicals and vehicles. A new trade regime with the EU is expected to impact on areas identified as key to Kenya's trade strategy such as value-addition where EU imports will compete with local goods in key markets like COMESA.

The Kenya Institute of Public Policy Research and Analysis (KIPPRA) estimated a 15 per cent loss in Kenya's regional trade under an EPA and concluded that the EU stands to gain significantly in terms of expanded trade into EAC/COMESA. It warns that with manufacturing forming a large part of Kenya's exports to the region, this will undermine the country's trade in value-added goods and increase dependence on primary exports, narrow the range of products that Kenya currently trades in as well as the diversity of its trading partners. Yet, the government's Economic Recovery Strategy for Wealth and Employment creation (ERSWEC) has identified priority areas for trade expansion as value-added production, boosting the competitiveness of domestic producers and diversification of export products and destinations.

In the past Kenya has liberalised trade mainly under the Bretton Woods structural adjustment programmes and in compliance with WTO rules which involved a dismantling of quantitative import restrictions and

reduction of tariffs from an average 30 percent to less than 18 percent for most products. Under EPAs, Kenya will be expected to lower tariffs further on at least 60 per cent of its imports from the EU. This could have negative consequences for Kenya in terms of lowering the level of government revenue collected from EU import duties by as much as 8-12 percent - higher than the government's annual expenditure on health. Direct competition from EU products could threaten manufacturing firms involved in food processing, textiles, paper and printing which collectively employ over 100,000 people.

Since EPAs will not affect the continued use of subsidies which enable EU agricultural products to sell cheaply at below their true market value, Kenya's agricultural sector could face unfair competition from subsidised EU products. Products that could be potentially affected include wheat, rice, sugar, dairy, maize, meat and meat products. An FTA with the EU thus presents the potential to adversely affect key sectors which emphasises the need to negotiate for compensation and adequate protection measures to mitigate these potential impacts.

However, whilst some sectors of the economy could stand to gain from signing an EPA, others will definitely lose out. For 40 per cent of Kenya's exports to the EU such as raw tea and coffee are zero rated under the Most Favoured Nation principle and will be unaffected whether or not an EPA is firmed up with the EU.

But for 60 percent of exports into the EU such as flowers, vegetables, fruit and fish a new trade regime, such as that which might be offered by an EPA, is necessary to secure the zero rated duty that these products have enjoyed under the Cotonou treaty preferential trade arrangement. If a regime is not found that retains the zero duty into the EU then these products could face tariff hikes of between 2 to 24 percent if automatically shifted onto the global Generalised System of Preferences (GSP) scheme at the end of 2007.

Countries entitled to preferential trade schemes like the EBA initiative such as Tanzania and Ethiopia or the GSP Plus (GSP+) scheme such as Colombia, Ecuador and Guatemala would become more competitive and could take a share of Kenya's exports granted their zero duty access into the EU.

Kenya is facing tremendous pressure to sign an EPA both externally from the European Commission and internally from sectors which stand to lose out on zero-duty access and in the absence of a trade deal that secures such access into the EU. Yet Kenya could be entitled to join a preferential scheme such as GSP+ which would largely retain the existing preferential treatment for most of her exports to the EU market without threatening manufacturing growth in the future.

Still, the potential benefit to Kenya of signing an EPA is primarily dependent on the deal addressing supply side constraints which are a major obstacle in increasing export volumes. Equally important is the extent to which the EU would be prepared to favourably liberalise areas of particular interest to Kenya's value-added exports. A change in existing tariff peaks could therefore provide incentives for Kenyan producers to diversify into value-addition of primary agricultural exports such as roasted and decaffeinated coffee which still attract a 7.5 and 9 percent tariff into the EU respectively.

It is also hoped that an EPA would simplify complex rules of origin and multiple non-tariff barriers to trade such as arbitrary health standards. The latter has significantly impacted on Kenya's fish, flower and horticultural exports. Between 1998 and 2001, for instance, a ban imposed on Kenyan fresh water fish exports to the EU necessitated a costly restructuring of the fish industry to comply with EU food and health standards resulting in the closure of more than half of the 14 fresh water factories on the coast of Lake

Victoria. However, it is unlikely that health standards could be changed for the EPA region alone, but rather that funding is made available to enhance internal capacity to meet EU standards.

Trade liberalisation under EPAs has potential advantages and downsides though it is the EU with more competitive industries that is, in the end, likely to benefit most from a reciprocal trade arrangement. An impact assessment carried out by the IMF estimated that Kenya could lose 65 percent of industry and a further 8 percent of government revenue under the proposed EPAs. On its part, the European Commission's own Sustainability Impact Assessment has projected greater loss to Kenya. The assessment projected Kenya could lose 82 percent of total customs revenue under a reciprocal EPA with the EU that would translate into a 12 percent loss of government revenue.

A potentially sensitive area in the ongoing negotiations is tariff binding which is expected to cap further increases in tariffs above the agreed bound levels. Kenya and other ACP countries could effectively lose their future flexibility to use tariff policy as a means of encouraging investment, production and protection of industries from EU competitors in order to enable industries mature and grow into value-added production. This flexibility was used by the Kenya government in the early 1990's to protect and revive the dairy industry from EU imports of powdered milk through a raise in tariffs from 35 to 60 percent. This sector now employs around 625,000 people directly and indirectly supports 3 million people. In practice governments can still protect local industries using other policy interventions, but the flexibility to raise tariffs can be an important tool in stimulating industrial development.

Since it is anticipated that ACP countries will be able to exclude about 20 percent of their trade with the EU from tariff liberalisation under the EPA, it is possible to protect the most sensitive or strategic sectors. However, Kenyan negotiators are unhappy with this and favour a more ambitious 40-60 per cent threshold – given the country's desire to protect both agriculture and manufacturing. However, this is likely to be opposed by the EU. Regardless of the final protection threshold offered within the EPA, future policy intervention outside protected sectors will be severely constraining and Kenya and ACP countries must consider other options to the thorny problem of retaining export preferences with the EU.

6.11. Kenya's Policy on Regional Integration

In the current industrialisation strategy aimed at turning Kenya into a newly industrialising country by the year 2030, pursuance of regional trade arrangements is a key element of trade policy alongside export subsidisation and promotion and further trade liberalisation. Regional integration is also seen as a vehicle for achieving poverty alleviation and employment creation. Regional integration is expected to facilitate exploitation of economies of scale, attract local and foreign investment, and improve resource allocation and technology transfer. Within the broad regional strategy, the Government of Kenya (GOK) has the objective of:

- Pushing for the rationalisation of the regional arrangements or groupings;
- Supporting trade relations with other trading blocs such as South East Asia;
- Encouraging the domestic manufacturing sector to exploit regional industrial support services; and
- Improving the negotiation skills and capability of Kenyans to maximise the benefits the country received from multilateral negotiations.

As a reflection of Kenya's commitment to these policies, the country is not only a member of the World Trade Organisation (WTO), but is also a member of numerous regional groupings as indicated earlier. The

country is committed to the principle of free trade through multilateral negotiations under the WTO framework.

Kenya remains committed to tariff elimination and a common external tariff both for EAC and COMESA. We are not yet sure of EPAs.

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Chapter 7: Tourism Industry in Africa

Dr. Samuel M. Nyandemo

7. Introduction

The commission on trade of goods, services and commodities at its second session (17-21 November 1997) decided to convene an expert meeting on strengthening the capacity for expanding the tourism sector in developing countries with particular focus on tour operators, travel agencies and other suppliers. Indeed tourism is an important component of trade in services in many African countries and accordingly many countries will wish to pay adequate attention in formulating their negotiating strategies and more importantly in drawing up commitments as well as initial offers.

The world tourism industry has grown at double the pace of gross domestic product (GDP) over the last 30 years. International trade in services creates additional employment, generates added value and tax revenue, and attracts investment and foreign currency, since the sector boasts strong multiplier and spillover effects. Tourism is therefore the key source of wealth creation, helps the majority of nations to overcome poverty and generate employment opportunities. Above all, it creates various business opportunities for micro-, small and medium enterprises.

The dynamism of tourism is expected to continue outpacing economic growth in the future, driven by globalization and economic expansion in developing countries. Traditionally, trade in tourism services has been concentrated in the developed countries, but with time the situation is changing in favour of developing countries, which need to be helped to benefit from the tourism sector by adopting appropriate policies to direct tourists to them.

Tourism services are supplied by hotels, tour operators, travel agents and transport companies. In their business relations with tour operators, many suppliers in tourist services in developing countries (hotels, tourist guides, and transport providers) are hampered by their weak bargaining positions and their lack of negotiating skills, which often result in unfavourable contractual conditions. Moreover, when these supplier firms are small and medium-size enterprises (SMEs) they face fierce competition from larger companies, including those with foreign capital participation.

African countries use the multilateral trade framework and free trade agreements to dismantle barriers and support the implementation of a new generation of trade policy devices and mechanisms to help them face up to a more competitive trade environment and globalized markets. There is need to take advantage of GATS which might enhance the contribution of trade in services for development. They can also seek commitments with respect to training of personnel and access to the distribution channels which are essential to tourism exports, as provided for in Articles IV and XIX of the Agreement.

7.1. Tourism and Development in Africa

Tourism is the temporary, short-term movement of persons to destinations outside the place where they normally live and work and the various activities they engage in during their stay at these destinations for not more than one consecutive year for leisure, business and other purposes. By definition, there are three forms of tourism:

- Domestic tourism: involving residents of a given country travelling within that country;
- Inbound tourism: involving the non-residents received by a destination country from the point of view of that destination; and
- Incoming tourism: involving foreigners coming and spending their holidays in other countries i.e. outgoing tourism.

There are three sub-sectors in the tourism industry: hotels and restaurants, travel agencies and infrastructure-dependent services. Immigration regulations have a direct influence on the supply of international tourists' services.

Africa's contribution to total world tourism is small but growing. It provided 4.4 per cent of the world's international arrivals and 3 percent of world's receipts. In 2004 Africa grew both in terms of arrivals (+8.5%) and receipts (+6.6%) as expressed in local currencies constant prices. Africa's good results can be attributed to a number of factors. In 2004 the continent enjoyed the best economic growth rate in 8 years; progress was made towards the peaceful resolution of conflicts in several areas; although many still continued, the strong Euro encouraged European visitors to Africa; destinations developed new products such as business tourism, cultural tourism, eco-tourism and sports tourism, and above all opened up new markets. By the end of 2004 a total of ten African countries negotiated approved destination status (ADSL agreements with China and expectations are high for this market (WTO, 2005).

For the last 25 years, tourism trends in Africa have generally been positive. Between 1980 and 1990 the number of international arrivals more than doubled from 7.3 million in 1980 to 15.2 million in 1990. The figures nearly doubled again over the following years by 2%. From 1990 to 2004, Africa's share of the world total tourism trade increased by almost one percentage point from 3.5 percent to 4.4 per cent (WTO, 2005). Africa is the only region to have escaped the impact of the global recession, recording a 4% increase in arrivals through the first eight months of 2009 (UNWTO, 2010).

The tourism industry in Africa reached 27.6 million arrivals and receipts of U.S$ 10.7 billion in 2000, yet the potential of the continent is much higher. Tourism has tended to develop unevenly in Africa. This indeed is the case with countries such as Egypt, Kenya, Mauritius, Morocco, Tunisia and South Africa. For example the North-Africa region has benefited more from tourism than any other sub-region. Furthermore those African countries which have had better economic performance have had good performance in tourism as is evidenced by the cases of Morocco, Mauritius, South Africa and Botswana (EAC, 2000).

A sub-regions analysis of tourism in Africa clearly reveals the structure of the industry in sub-regional as well as the main origin of tourists arriving in African countries. For example North Africa is still the sub-region which attracts most tourists from Europe, although it has lost more than 20% of its share to South Africa. On the other hand, 71.2% of South Africa's tourism is interregional. The other sub-regions of Africa have the largest percentage of inter-African tourist arrivals (WTO, 2005).

In 2004, with international tourist arrivals estimated at over 3 million, Africa reported an 8.5 per cent increase over 2003. This positive result compares with 10 percent growth worldwide for the same year. Visits to destinations in North Africa increased by 15 percent growth contributing decisively to Africa's overall growth rate. International tourist arrivals have been concentrated in a region composed of more than 50 countries and territories. Only six countries received over one million tourists each, with South Africa receiving 6.9 million.

TABLE 30: INTERNATIONAL TOURIST ARRIVALS BY REGIONS (MILLIONS)

	1990	1995	2000	2002	2003	2004
North Africa	8.4	7.3	10.2	10.6	11.1	12.8
West Africa	1.4	1.9	2.4	2.7	2.9	3.1
Central Africa	0.4	0.4	0.7	0.6	0.7	0..7
East Africa	2.8	4.9	6.6	6.9	7.2	7.6
Southern Africa	2.2	5.9	8.2	8.8	9.0	9.2
Africa	15.2	20.3	28.2	29.6	30.8	33.4

Source: World Tourism Organization 2005

The African continent earned nearly US$ 19 billion in 2004. In absolute terms, this figure represents an increase of US$ 3 billion over 2003. As in the case of arrivals, the continents' leading sub-regions in terms of 2004 receipts were North-Africa and Southern Africa, accounted for more than two thirds of the regions total receipts with US$ 7.4 billion and US$ 3.7 billion.

East Africa is the continent's third largest tourism receiving sub region, having seen significant growth in tourist arrivals in recent years from less than 3 million in 1990 to more than 7.5 million in 2004. The region has panoply of destinations that are representative of the continent's rich heritage, national parks and internationally renowned beaches that provide a diverse range of tourist attractions. Kenya entered the 'million plus club' in 2004.

East Africa recorded reasonable growth in arrivals and very strong growth in receipts mainly because of the spectacular results of well-established tourism destinations. The traditional priorities of tourism development have been to contribute to Gross National Product (GNP), foreign exchange earnings and employment. However, concerns have been raised about potentially negative social, cultural and environmental effects of tourism. A sustained flow of tourists will contribute to industrial development through generation of foreign exchange, creation of income earning opportunities, expansion of markets, induced investments in supporting physical infrastructure and related services, and development of local entrepreneurship. By the end of 1999, Kenya occupied the fifth position as the most preferred tourist destination in Africa behind South Africa, Morocco, Tunisia and Mauritius. Due to its strong linkage with the major sectors of the economy, the tourism sector has the potential of leading African economies from absolute poverty to prosperity.

Tourism earnings have tended to increase at higher rates than earning from other export commodities in a number of African economies. The earnings are in turn used to offset shortfalls on the visible trading account and hence are of critical importance. Tourism equally contributes to government revenue through license fees, customs and excise duty, VAT on tourism services, landing fees as well as taxes levied on employees in the tourism industry.

The tourism sector has significant influence on the local communities. Tourism is a labour intensive industry, which generates employment opportunities at semi-skilled, technical and managerial levels. It consists of predominantly small scale businesses despite the fact there is increasing investment and involvement in the sector by multinationals and local companies. It is a decentralized industry capable of diversifying regional economies and is relatively non-pollutant, which, if properly managed, can contribute to conservation and promotion of natural and cultural heritage. It is also an important vehicle for promoting

cultural exchanges that enhance understanding and goodwill among peoples of the world. It equally acts as a catalyst for the development of other sectors.

Tourism can help to unlock opportunities for the poor. Although poor countries only command a minority share of international tourism market, in 11 of the 12 poorest countries, tourism is a significant part of GDP (DFID, 1999). The pro-poor nature of the economic growth of tourism is due to a number of factors, namely:

- The customer comes to the product and creates opportunities for additional sales.
- Tourism inherently is more labour intensive and employs a higher proportion of women.
- A tourism product based on culture, natural assets and local communities is precisely one based on the generally excluded economic groups.
- Tourism has a greater positive impact in under-developed areas than other industries due to its rapid development pattern and greater involvement of the informal sector.

7.2. Tourism Trends in Kenya from Main Tourist Destinations

The arrivals of tourists in Kenya over the past 5 years have been from the UK, USA, Germany, Italy and France. From table 32, the UK has been the key source of inbound tourists to Kenya, followed by USA, then Germany, Italy and France in that order.

TABLE 31: INBOUND TOURISTS TO KENYA

YEAR/ COUNTRY	2005	2006	2007	2008	*2009*	*2010*
UK	153,228	171,409	204,644	123,322	164,169	174,051
USA	73,576	86,528	101,095	75,536	102,225	107,842
GERMANY	75,780	83,394	83,413	44,138	65,101	63,011
ITALY	67,656	81,904	84,260	39,503	66,889	87,694
FRANCE	41,466	50,281	52,566	20,799	41,062	50,039

Source: Ministry of Tourism

Figure 6 illustrates more vividly the trends of inbound tourists to Kenya. Of these, the UK alone contributes approximately 40 percent of inbound tourists, with USA and Germany contributing 20 percent each. The remaining 20 percent is shared between Italy and France.

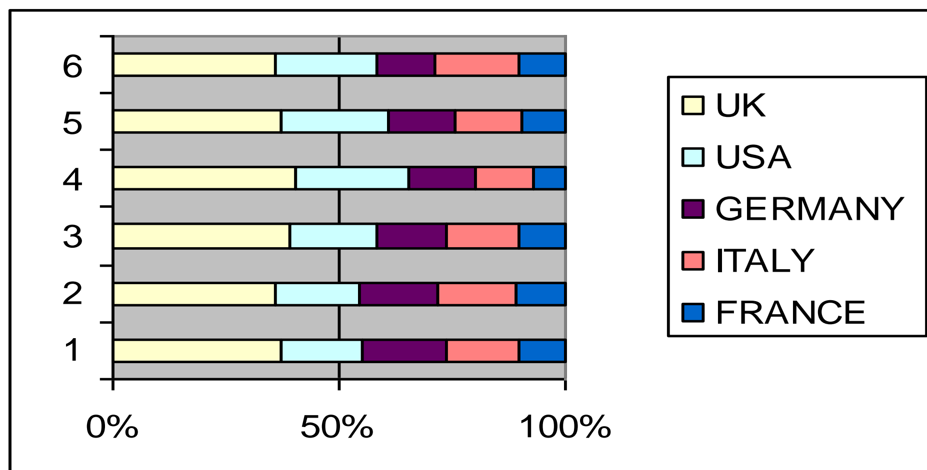

FIGURE 6: INBOUND TOURISTS TO KENYA
Source: Author's own Calculations

7.3. Tourism in Eastern and Southern Africa

East Africa is comprised of five countries: Kenya, Uganda, Tanzania, Rwanda and Burundi. However, the new Republic of South Sudan is also aiming to be included as a member of the EAC. Each of these countries has unique features that make them potential tourist destinations. For example, Uganda has at one time received the top tourist destination award in the world by Top Planet. Rwanda has equally been feted as the top tourist destination in East Africa through its single visa point.

TABLE 32: TOURISM IN EASTERN AND SOUTHERN AFRICA:

Country	International tourist arrivals (1000's)						Market share in the region			% change	
	1990	1995	2000	2003	2004	2005*	1990	2000	2005*	03/04	04/05
Kenya	814	896	899	927	1199	-	5.3	3.2	-	29.3	-
Rwanda	-	-	104	-	-	-	-	0.4	-	-	-
Tanzania	-	285	459	552	566	-	-	1.6	-	2.5	-
Uganda	69	160	193	305	512	468	0.5	0.7	1.3	68.2	-8.7
Botswana	543	521	1104	1406	1523	-	3.6	3.9	-	8.3	-
Lesotho	242	209	302	329	304	304	1.6	1.1	0.8	-7.8	0.2
Namibia	-	272	656	695	-	-		2.3			
South Africa	1029	4684	6001	6640	6815	7518	6.8	21.2	20.1	2.6	10.3
Swaziland	263	300	281	461	459	839	1.7	1.0	2.2	-0.4	82.8

Source: UN World Tourism Organisation (2006)

Table 33 shows the trends in Eastern and Southern Africa for the period 1990 to 2005 in five year intervals. Kenya is a key tourist destination in the EAC, recording more than one million tourists in 2004, more than the numbers received by Tanzania and Uganda combined. Statistics for Rwanda are not readily available for the period under review. However, over the 2003/2004 period, Uganda recorded a marked improvement in tourist arrivals of 68.2 percent.

With the move towards the EAC common market, it is hoped that the region as a whole would be better placed to marshal enough synergy that would better equip the region as a major potential for tourism in terms of free movement of goods and people (including domestic tourism), improved macroeconomic and political stability, and better mechanisms for improved security.

For the Southern African region, South Africa alone leads the region with 21.2 percent of all tourists within this region. Botswana then closely follows South Africa, with Lesotho not performing well in the overall tourist arrivals. However, Swaziland seems to have developed great potential for tourist arrivals with an impressive record growth of 82.8 percent over the period 2004/05.

7.4. Challenges and The Way Forward for Tourism Development in Africa

While tourism development in Africa seems to have performed relatively well, there are constraints that have stalled even better performance. Political instability, insecurity and corruption are among the key issues that will need to be addressed. In particular:-

High proportion of economic leakages of foreign currency

According to the World Tourism Report (2000); a generally high percentage of the foreign exchange income generated by international tourist arrivals leaks out of the economy. This leakage can be in the form of repatriation of benefits of foreign tourism companies, fees to hotel management companies, remuneration of foreign staff and, last but not least, imports of goods and services to respond to the tourists' needs i.e., external service providers. Governments need concerted efforts at reducing the leakages and increase the linkages between the tourism industry and other local economic activities. UNWTO is currently engaged in action research projects in this respect, working with hotel trade associations and governments of a few developing countries with a view to find the most suitable operational mechanisms to better integrate tourism with the rest of the local economy.

Insufficient awareness among national and international financial authorities about the real potential of tourism

In order to yield good fruits, there is need for careful planning and support development of tourism. The World Tourism Report rightly observes that above the natural and cultural attractions that are abundant in most countries, at least the following conditions are prerequisites for the sustainable development of the tourism sector:

- the involvement of the local people in all aspects and stages of tourism development, management, operations and monitoring;
- the definition of a clear long term strategy and carefully designed master plans to respect the environmental, social and cultural constraints in each country and destination; and the implementation and respect of such plans by all concerned, including private investors and operators;
- intensive capacity-building and training of both national public officials at central and local levels, and training and empowerment of local communities to empower them to become active stakeholders and beneficiaries in the tourism development process;

- Infrastructure support, at least in terms of transport, basic utilities and telecommunications, without which tourism development is impossible. The responsibility for the provision of such infrastructure is usually outside the realm of tourism authorities.

Lack of coordination among the many actors that intervene, directly or indirectly, in the tourism development process

This lack of coordination is observed at the national level, firstly among different government departments that make decisions on tourism related issues and among public and private institutions concerned with tourism. This lack of cooperation is also manifest between these two stakeholders and the community-based organizations or single micro entrepreneurs that have created a tourism offer, but that remains outside the mainstream marketing and promotional channels. The lack of coordination is also common among the UN and bilateral agencies, as well as international financial institutions and NGOs that provide assistance to LDCs, either in tourism or in sectors that affect tourism. UNWTO and WTO have made efforts in recent years to attempt a higher degree of coordination with the aim of increasing the effectiveness of the technical and financial assistance granted to these countries in connection with tourism.

Lack of commitment of the private sector

The private sector, despite being a player in the tourism industry via investment in tourism infrastructure or as an air carrier or yet as operator of tourism circuits, has not always exercised full social responsibility vis-à-vis the local population and the local economic interests. Accusations regarding bad employment and pay practices, or unfair trading terms, or the inadequate use of natural or local cultural heritage assets, or the sudden suspension of air travel connections, among others, are common. Similarly, little efforts have been made by foreign tourism operators to intensify the use of local resources; in order to avoid the huge economic leakages that are typical of this industry in most LDCs.

Governments as well as other stakeholders should encourage the private corporations, and establish if necessary the appropriate mechanisms for the private corporate tourism sector to fully comply with its social responsibility vis-à-vis the least developed countries. For this purpose, the UNWTO Global Code of Ethics for Tourism, and the UN Global Compact initiatives can be considered (World Tourism Report, 2000).

Increasing threats to security

While Kenya as a whole has enjoyed sound peace and a relatively stable political environment, recent developments have put the country on a bad ranking as a risky environment for tourism. There has been the post election violence after the 2008 general elections that affected tourist arrivals to the country. This problem has thankfully been well subdued with the efforts of the government and the international community intervening early enough to restore Kenya's pride as "a land of peace". Most recently however, the abductions of tourists in Lamu and parts of the North Eastern region of the country by Al-Shabaab Militia of Somalia have led to the government entering Somalia to repulse the militia group from the border. While this is a bold move, it is justified not only to protect the integrity of the country, but indeed to assure tourists of their security in the country as well.

7.5. Conclusion

The African continent is blessed with a great diversity of natural resources and landscapes and can boast unique tourism assets. With its extraordinary wildlife, remarkable and varied topography and distinctive cultures, Africa can offer a wide range of tourism attractions to suit all tastes. Madagascar, Mali, Mauritius, Kenya, Tanzania and Zambia reported that cultural tourism attracted a growing number of tourists in 2004. Policies need to focus on the type of tourism to be encouraged, particularly where capacity is high.

7.6. References

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Editors:

Tabitha Kiriti Nganga

Tabitha Kiriti Nganga is a Senior Lecturer in the School of Economics. She has over 28 years of teaching experience in the University. She has been teaching International Economics for more than 12 years to both under and postgraduate students. She attained her PhD from the University of Queensland in Australia. She has attended international trade courses offered by the World Bank Institute such as WITS, Analytical and Policy Issues in Macroeconomic Management and many others. She also got a diploma in International Economic Policy and law From the University of Barcelona. She has published articles in international journals such as the International Journal of_Agricultural Resources, Governance and Ecology, the African Journal of Economic Policy, Indian Journal of Economic Policy, Indian Development Review, Food Agriculture and Environment, International Journal of Social Economics, Quarterly Journal of International Agriculture, Asian-African Journal of Economics and Econometrics, Regional Development Studies, International Journal of Afro Asian Studies International Journal of Women, Social Justice and Human Rights, Indian Journal of Social and Economic Policy International Journal of Human Development and Information System Indian Journal of Human Rights Asian-African Journal of Economics and Econometrics and_International Journal f Business Policy and Economic. She has also written books, contributed and published book chapters and edited books. She has visited and undertaken joint research at Cornell University. She has acted as a consultant for the United Nations Department of Economic and Social Affairs (UNDESA), Institute of Economic Affairs (IEA) and the World Bank, and a consultant for the Government on Kenya on Sector Performance Standards and Performance Contracts.

Jasper A. Okelo

Jasper is the current chair holder of the WCP at the School of Economics, University of Nairobi, Kenya. Jasper has taught at the University of Nairobi for slightly over 40 years. He participated in the organisation, coordination and delivery of the WTO Regional Trade Policy Courses that were started at the University of Nairobi from 2002 to 2004. To-date he is still lecturing at the same in the countries where the courses have been launched. He was instrumental in designing and implementing the teaching of Multilateral Trading Systems at the Master's in the School of Economics, University of Nairobi. Jasper also coordinated the training in Economic Management Policy Course for the English speaking countries, funded by Commonwealth Secretariat from 1994-1997, at the University of Nairobi's School of Economics. He has been the chair of the National Committee on WTO in Kenya in 1999 and several times when called upon to do so. He has continued to be a member of the Kenya National Committee on WTO, and a member of various sub committees of the same. He has participating in the preparation of the Kenya National positions negotiated at WTO in Geneva and at all the Ministerial Conferences of WTO since 1999. He represents of the University of Nairobi in the delegations of the Kenya Government at the WTO ministerial conferences. Jasper has also been in the Panel of Experts reviewing of the Performance Contracting in the Public Sector for the Government of Kenya. Jasper co-authored a book titled Privatization in Kenya, published by Basic Books (K) Ltd, Nairobi, 1998. He co-edited Proceedings of a Workshop organized by the Kenyan Economic Association in 1988, titled, Recurrent Costs of Public Investment and Budget Rationalization in Kenya. Jasper wrote consultancy paper for UNCTAD on **Trade Issues, Market Access and Supply Capacity constraints of African LDCs –** in preparation for the third UN Conference on the LDCs in Brussels, 13-20 May 2001; Consultancy work commissioned by UNECA/OAU/UNDP from 4/5/1992 to 16/6/1992 on "African Economic Community-Trade and Customs Protocols" based on the then PTA Region. He did a paper for AU in 2002, entitled AGOA and its impact in Africa.